Fundamentals of Corporate Finance (Canadian) 8th edition BREALEY Solutions Manual

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Brealey, *Fundamentals of Corporate Finance*, 8ce
Solutions for Chapter 1

1. real

   plant and machinery

   brand names

   financial

   stocks

   investment

   capital budgeting

   financing

2. A firm might cut its labour force dramatically which could reduce immediate expenses and increase profits in the short term. Over the long term, however, the firm might not be able to serve its customers properly or it might alienate its remaining workers; if so, future profits will decrease, and the stock price will decrease in anticipation of these problems.

   The moral of this examples is that because stock prices reflect present *and future* profitability, the firm should not necessarily sacrifice future prospects for short-term gains.

3. The key advantage of separating ownership and management in a large corporation is that it gives the corporation permanence. The corporation continues to exist if managers are replaced or if stockholders sell their ownership interests to other investors. The corporation's permanence is an essential characteristic in allowing corporations to obtain the large amounts of financing required by many business entities.

   Both public and private corporations are distinct legal entities, separate from its owners (i.e.., its shareholders). The key difference between public and private corporations is the rules governing the sale of their common shares. The common shares of a public corporation are listed for trading on a stock exchange and investors can freely buy and sell the corporation's shares at the current stock price. The common shares of a private corporation are not listed for trading on a stock exchange. Shareholders of private corporations must negotiate directly with potential buyers and are subject to resale restrictions.

   You can learn to identify the risks associated with investing in private companies by going to Ontario Securities Commission's website at: http://www.osc.gov.on.ca/en/Investors_cbyi_index.htm

4. A sole proprietorship is easy to set up with a minimum of legal work. The business itself is not taxed. For tax purposes, the income of the proprietorship is treated as the income of the proprietor. The main disadvantages of a proprietorship are the proprietor's unlimited liability for the debts of the firm, and difficulty in raising large amounts of financing as the business grows.

   A partnership has the same tax advantage as the proprietorship. The partnership per se does not pay taxes. The partnership files a tax return, but all the partnership income is allocated to the partners and treated as personal income. Also, it is easy to set up a partnership. Because there can be many partners, a partnership can raise capital more easily than a proprietorship. However, like sole proprietors, general partners have unlimited liability for the debts of the firm. In fact, each partner has unlimited liability for all the business' debts, not just his or her share.

   Corporate organization has the advantage of limited liability. Its owners, the shareholders, are not personally responsible for the debts of the corporation. It also allows for separation of ownership and management, since shares in the firm can be traded without changing management. A public corporation has the added advantage of easier access to equity financing because its shares are traded in public stock markets. The major disadvantage of corporate organization is the double taxation of income. Corporations pay taxes on their income, and that income is taxed again when it is passed through to shareholders in the form of dividends. Another disadvantage of corporate organization is the extra time and cost required in order to manage a corporation's legal affairs. These costs arise because the corporation must be chartered and is considered a distinct legal entity. Such administrative costs are significant only for small corporations, however. Furthermore, public corporations must provide investors with detailed financial information in their annual reports and inform investors about significant events. Disclosure takes time and resources and may also be costly in the sense that competitor firms become aware of inside information that the corporation may not necessarily want competitors to be aware of.
   LLP's may be hybrid organizations to the extent that while individual partners have unlimited liability, they are not liable for the actions of their partners.

5. *Double taxation* means that a corporation's income is taxed first at the hands of the corporation at the corporate tax rate, and then, when the income is distributed to shareholders as dividends, the income is taxed again at the hands of shareholders at the shareholder's personal tax rate.

6. a, c, d.

7. The responsibilities of the treasurer include the following: supervising cash management, raising capital, and banking relationships. The controller's responsibilities include supervision of accounting, preparation of financial statements, and tax matters. The CFO of a large corporation supervises both the treasurer and the controller. The CFO is responsible for large-scale corporate planning and financial policy.

8. a. Investment decision

   b. Financial asset

   c. Public corporation

   d. Corporation

   e. Treasurer

   f. The cost resulting from conflicts of interest between managers and shareholders

9. Financing decisions involve sources of capital used in the running of a firm. Investment decisions, typically called capital budgeting, involve the uses of capital raised in the financing process.

   a. Investment decision

   b. Financing decision

   c. Investment decision

   d. Investment decision

   e. Investment decision

   f. Financing decision: On the surface, this may appear similar to a dividend decision, but in reality retiring debt is a change in capital structure and more closely aligned with a financing decision.

10. a. Private corporation

   b. Partnership

   c. Public corporation

   d. Public corporation

11. C. Ownership can be transferred without affecting operations and D. Managers can be fired with no effect on ownership.

12. The individual stockholders of a corporation (i.e., the owners) are legally distinct from the corporation itself, which is a separate legal entity. Consequently, the stockholders are not personally liable for the debts of the corporation; the stockholders' liability for the debts of the corporation is limited to the investment each stockholder has made in the shares of the corporation.

13. As discussed in Question 2 which is similar,, a corporation might cut its labor force dramatically, which could reduce immediate expenses and increase profits in the short term. Over the long term, however, the firm might not be able to serve its customers properly, or it might alienate its remaining workers; if so, future profits will decrease, and the stock price, and the market value of the firm, will decrease in anticipation of these problems. Similarly, as another example, a corporation can boost profits over the short term by using less costly materials even if this reduces the quality of the product. Once customers catch on, sales will decrease and profits will fall in the future. The stock price will fall. The moral of these examples is that because stock prices reflect present and future profitability, the corporation should not necessarily sacrifice future prospects for short-term gains.

14. Financial managers refer to the opportunity cost of capital because corporations increase value for their shareholders only by accepting all investment projects that earn more than this rate. If the company earns below this rate, the market value of the company's stock falls and stockholders look for other places to invest. To find the opportunity cost of capital for a safe investment, managers and investors look at current interest rates on safe debt securities, such as Canadian Treasury debt.

15. There are not necessarily right or wrong answers to these issues. It is important, however, to keep in mind that short selling, acquisitions, and tax avoidance are all the by-product of an attempt to maximize shareholder value. In the absence of laws banning companies from producing wealth for their owners, someone will use these techniques to create value for owners.

16. a. A fixed salary means that compensation is (at least in the short run) independent of the firm's success.
b. A salary linked to profits ties the employee's compensation to this measure of the success of the firm. However, profits are not a wholly reliable way to measure the success of the firm. The text points out that profits are subject to differing accounting rules and reflect only the current year's situation rather than the long-run prospects of the firm.
c. A salary that is paid partly in the form of the company's shares means that the manager earns the most when the shareholders' wealth is maximized. This is, therefore, most likely to align the interests of managers and shareholders.

17.

a.	A share of stock	financial
b.	A personal IOU	financial
c.	A trademark	real
d.	A truck	real
e.	Undeveloped land	real
f.	The balance in the firm's chequing account	financial
g.	An experienced and hardworking sales force	real
h.	A bank loan agreement	financial

18. a. Real assets are items that are used to produce goods and services. Real assets include both tangible and intangible items. Tangible (physical) real assets include such items as machinery, building, and inventories. Intangible real assets include items such as research ideas, brand names and skilled work force. In contrast, financial assets are items that have value only because of their claim to cash flows generated by real assets. Many different types of financial assets exist, including bank loans, bonds, stocks, and options.

    b. Investment or capital budgeting decisions involve deciding which real assets to acquire. Financing decisions involve arranging the money needed to pay for investments in the real assets. So, when making investment decisions you decide what to spend money on and when making financing decisions, you decide how to get the money to spend.

    c. Both capital budgeting and capital structure are long-term decisions. Capital budgeting decision is the process of deciding the real asset investment plans. Capital structure decision is the process of deciding the mix of the long-term financing to use to fund the firm's assets. Essentially, capital structure decision involves selecting between equity financing and long-term debt financing.

19. Capital budgeting decisions

    Should a new computer be purchased?
    Should the firm develop a new drug?
    Should the firm shut down an unprofitable factory?

    Financing decisions

    Should the firm borrow money from a bank or sell bonds?
    Should the firm issue preferred stock or common stock?
    Should the firm buy or lease a new machine that it is committed to acquiring?

20. The stock price reflects the value of both current and future dividends the shareholders will receive. In contrast, profits reflect performance in the current year only. Profit maximizers may try to improve this year's profits at the expense of future profits. But stock price maximizers will take account of the entire stream of cash flows that the firm can generate. They are more apt to be forward looking.

21. a. This action might appear, superficially, to be a grant to former employees and thus not consistent with value maximization. However, such 'benevolent' actions might enhance the firm's reputation as a good place to work, might result in greater loyalty on the part of current employees, and might contribute to the firm's recruiting efforts. Therefore, from a broader perspective, the action may be value maximizing.

b. The reduction in dividends to allow increased reinvestment can be consistent with maximization of current market value. If the firm has attractive investment opportunities, and wants to save the expenses associated with issuing new shares to the public, then it could make sense to reduce the dividend in order to free up capital for the additional investments.

c. The corporate jet would have to generate benefits in excess of its costs in order to be considered stock-price enhancing. Such benefits might include time savings for executives, and greater convenience and flexibility in travel.

22. a. Increased market share can be an inappropriate goal if it requires reducing prices to such an extent that the firm is harmed financially. Increasing market share *can* be part of a well-reasoned strategy, but one should always remember that market share is not a goal in itself. The owners of the firm want managers to maximize the value of their investment in the firm.

b. Minimizing costs can also conflict with the goal of value maximization. For example, suppose a firm receives a large order for a product. The firm should be willing to pay overtime wages and to incur other costs in order to fulfill the order, as long as it can sell the additional product at a price greater than those costs. Even though costs per unit of output increase, the firm still comes out ahead if it agrees to fill the order.

c. A policy of underpricing any competitor can lead the firm to sell goods at a price lower than the price that would maximize market value. Again, in some situations, this strategy might make sense, but it should not be the ultimate goal of the firm. It should be evaluated with respect to its effect on firm value.

d. Expanding profits is a poorly defined goal of the firm. The text gives three reasons:

(i) There may be a trade-off between accounting profits in one year versus accounting profits in another year. For example, writing off a bad investment may reduce this year's profits but increase profits in future years. Which year's profits should be maximized?

(ii) Investing more in the firm can increase profits, even if the increase in profits is insufficient to justify the additional investment. In this case the increased investment increases profits, but can reduce shareholder wealth.

(iii) Profits can be affected by accounting rules, so a decision that increases profits using one set of rules may reduce profits using another.

23. The contingency arrangement aligns the interests of the lawyer with those of the client. Neither makes any money unless the case is won. If a client is unsure about the skill or integrity of the lawyer, this arrangement can make sense. First, the lawyer has an incentive to work hard. Second, if the lawyer turns out to be incompetent and loses the

case, the client will not have to pay a bill. Third, the lawyer will not be tempted to accept a very weak case simply to generate bills. Fourth, there is no incentive for the lawyer to charge for hours not really worked. Once a client is more comfortable with the lawyer, and is less concerned with potential agency problems, a fee-for-service arrangement might make more sense.

24. The national chain has a great incentive to impose quality control on all of its outlets. If one store serves its customers poorly, that can result in lost future sales in all its locations. The reputation of each restaurant in the chain depends on the quality in all the other stores. In contrast, if Joe's serves mostly passing travelers who are unlikely to show up again, unsatisfied customers pose a far lower cost. They are unlikely to be seen again anyway, so reputation is not a valuable asset.

    The important distinction is *not* that Joe has one outlet while the national chain has many. Instead, it is the likelihood of repeat relations with customers and the value of reputation. If Joe's store was located in the center of town instead of on the highway, one would expect his clientele to be repeat customers from town. He would then have the same incentive to establish a good reputation as the chain.

25. While a compensation plan that depends solely on the firm's performance would serve to motivate managers to work hard, it would also burden them with considerable personal risk tied to the fortunes of the firm. This would be unattractive to managers and might cause them to value their compensation packages less highly; it might also elicit excessive caution when evaluating business opportunities.

26. Takeover defenses make it harder for underperforming managers to be removed by dissatisfied shareholders, or by firms that might attempt to acquire the firm. By protecting such managers, these provisions exacerbate agency problems as they are more likely to act in their own interest rather than the firm's.

27. Traders can earn huge bonuses when their trades are very profitable, but if the trades lose large sums, as in the case of Barings Bank, the trader's exposure is limited. This asymmetry can create an incentive to take big risks with the firm's (i.e., the shareholders') money. This is an agency problem.

28. a. A fixed salary means that compensation is (at least in the short run) independent of the firm's success.

    b. A salary linked to profits ties the employee's compensation to he success of the firm as measured by profits. However, profits are not a wholly reliable way to measure the success of the firm. The text points out that profits are subject to differing accounting rules, and reflect only the current year's situation rather than the long-run prospects of the firm.

    c. A salary that is paid partly in the form of the company's shares means that the manager earns the most when the shareholders' wealth is maximized. This is, therefore, most likely to align the interests of managers and shareholders.

d. Stock options create great incentives for managers to contribute to the firm's success. In some cases, however, stock options can lead to agency problems. For example, a manager with many options might be tempted to take on a very risky project, reasoning that if the project succeeds the payoff will be huge, while if it fails, the losses are limited to the lost value of the options. Shareholders, in contrast, bear the losses as well as the gains on the project, and might be less willing to assume the risk.

29. Even if a shareholder could monitor and improve managers' performance, and thereby increase the value of the firm, the payoff would be small, since the ownership share in a large corporation is very small. For example, if you own $10,000 of GM stock and can increase the value of the firm by 5 percent, a very ambitious goal, you benefit by only: (0.05 × $10,000) = $500.

    In contrast, a bank that has a multimillion-dollar loan outstanding to the firm has a large stake in making sure that the loan can be repaid. It is clearly worthwhile for the bank to spend considerable resources on monitoring the firm.

30. Long-term relationships can encourage ethical behavior. If you know that you will engage in business with another party on a repeated basis, you will be less likely to take advantage of your business partner if an opportunity to do so arises. When people say "what goes around comes around," they recognize that the way they deal with their associates will influence the way their associates treat them. When relationships are short-lived, however, the temptation to be unfair is greater since there is less reason to fear reprisal, and less opportunity for fair dealing to be reciprocated.

31. As the text notes, the first step in doing well is doing good by your customers. Businesses cannot prosper for long if they do not provide to their customers the products and services they desire. In addition, reputation effects often make it in the firm's own interest to act ethically toward its business partners and employees since the firm's ability to make deals and to hire skilled labour depends on its reputation for dealing fairly.

    In some circumstances, when firms have incentives to act in a manner inconsistent with the public interest, taxes or fees can align private and public interests. For example, taxes or fees charged on pollution make it more costly for firms to pollute, thereby affecting the firm's decisions regarding activities that cause pollution. Other "incentives" used by governments to align private interests with public interests include: legislation to provide for worker safety and product, or consumer, safety, building code requirements enforced by local governments, and pollution and gasoline mileage requirements imposed on automobile manufacturers.

32. Some customers might consider this practice unethical. They might view the firm as gouging its customers during heat waves. On the other hand, the firm might try to convince customers that this practice allows it to charge *lower* prices in cooler periods, and that over long periods of time, prices even out. Whether customers and firms have an "implicit contract" to charge and pay stable prices is something of a cultural issue.

33. This website provides information on the various types of business structures. However, to find out some details on rules and regulations ask your students to go to the Business Development Bank of Canada (https://www.bdc.ca). For province-specific rules regarding registration of sole proprietorships or partnerships you can go to https://www.canada.ca/en/services/business/start/register-with-gov/register-sole-prop-partner.html. Rules and regulations governing different forms of business share similarities and differences across provinces.

    In general, while provinces enjoy the authority to regulate businesses within their jurisdictions and may have differing statutes on occasion, closer examination indicates that the rules and regulation are quite similar.

    Turning to the question of how not-for-profit organizations differ from the for-profit structures, the same basic information on not-for-profit organizations is provided on each province's website, under the heading "Not-for-Profit Organization vs. Other Business Structures". The most basic information is found at https://ised-isde.canada.ca/site/corporations-canada/en/not-profit-corporations. The key point: a not-for-profit organization cannot be organized for commercial purposes and members, the not-for-profit equivalent of shareholders, must not benefit personally as investors. Unlike shareholders who are entitled to receive dividends from the profits generated in the pursuit of business, the members of a not-for-profit cannot receive any financial gain from the organization.

    Not-for-profits can be set up as not-for-profit corporations, providing separation between management and members and limited liability for its members. These benefits are like those for shareholder of for-profit corporations.

34. *Careers in Finance*. Here are examples of two areas of employment in finance:

    Corporate Finance- A career in corporate finance means you would work for a company to help it find money to run the business, grow the business, make acquisitions, plan for its financial future and manage any cash on hand. You might work for a large multinational company or a smaller player with high growth prospects. Responsibility can come fast and your problem-solving skills will get put to work quickly in corporate finance jobs.

    The job of the financial officer is to create value for a company. For example, the finance group at American Electric Power of Columbus, Ohio has four main areas of concentration: liquidity, flexibility, compliance with laws and regulatory support. AEP's Finance Department carries out four main activities to meet its objectives: 1) designing, implementing and monitoring financial policies, 2) planning and executing the financing program, 3) managing cash resources, and 4) interfacing with the financial community and investors.

Jobs in corporate finance are also relatively stable. Performance in these jobs counts, but your job is not going to depend on whether you're selling enough this week or getting good deals finished this quarter. Rather the key to performing well in corporate finance is to work with a long view of what is going to make your company successful.

Many would argue that corporate finance jobs are the most desirable in the entire field of finance.

Some of the benefits of working in corporate finance are:

1. You generally work in teams which help you work with people
2. It's a lot of fun to tackle business problems that really matter
3. You'll have many opportunities to travel and meet people and
4. The pay in corporate finance is generally quite good.

Commercial Banking- Commercial banks are in the business of providing banking services to individuals, small businesses and large organizations. While the banking sector has been consolidating, it is worth noting that far more people have jobs in the commercial banking sector than any other part of the financial services industry. Jobs in banking can be exciting and offer excellent opportunities to learn about business, interact with people and build up a clientele.

Today's commercial banks are more diverse than ever. You'll find a tremendous range of opportunities in commercial banking, starting at the branch level where you might start out as a teller to a wide variety of other services such as leasing, credit card banking, international finance and trade credit.

If you are well-prepared and enthusiastic about entering the field, you are likely to find a wide variety of commercial banking jobs open to you.

35. This question provides students with a website for exploring career information provided by the Government of Canada. The answer to the first part of the question is whatever the students learn about their interests and careers that are associated with these interests.
    From the homepage of jobbank.gc.ca, for instance type "Financial Managers" and click on the Financial Managers search result. You will find the description of the occupation with its NOC code and also some relevant job titles. From here, you can click on "Choose this occupation" and then choose your province or territory to get the detailed information about your selected occupation, such as job postings, average wage, outlook and prospects, licence and certification, main duties, job and skill requirements, and education and training.

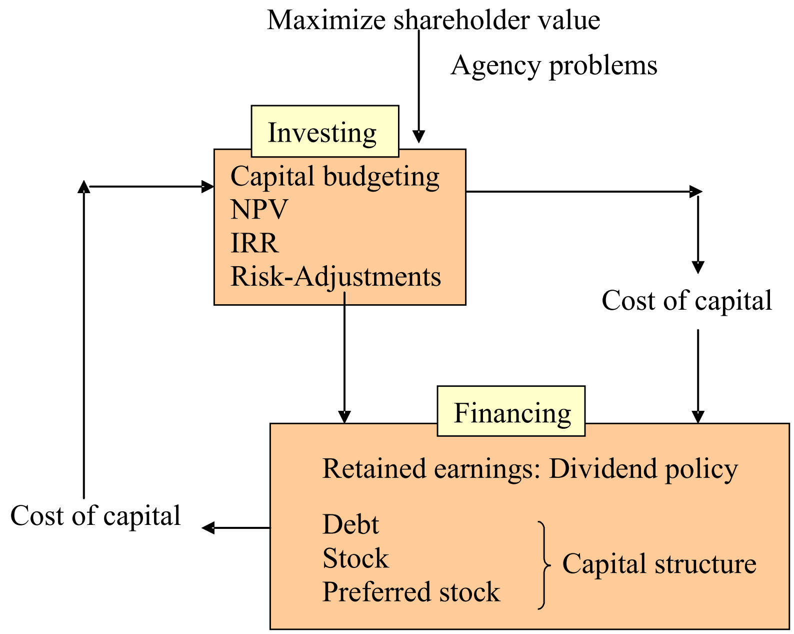
CHAPTER 1

GOALS AND GOVERNANCE OF THE FIRM

CHAPTER IN PERSPECTIVE

Part One, *Introduction,* of this new edition has one more chapter, which is a re-write of Chapter 17 from the previous edition, *Financial Statement Analysis.* This change puts back-to-back two chapters, Chapters 3 and 4, which are closely related to accounting. For professors who wish to cover accounting measures in the course, accounting measures naturally follows after Chapter 3, *Accounting and Finance.*

In this new edition Chapter 1 tells the story of Ron Joyce's collaboration with Tim Horton, a national Hockey League All-Star defenseman to start the Time Hortons restaurants, at the beginning of Section 1.1, *Investment and Financing Decisions,* to illustrate the investment and financing decision as the chief task of the financial managers. The story tells us about how financial management played a pivotal role in the birth and growth of RIM which just over a decade ago had global dominance of the cellular phone market. RIM later changed its name to Blackberry and no longer is in the cell phone business. Then the chapter provides the student with a look at the scope of finance and financial management. The scope of the managerial finance cycle, which includes raising funds in financial markets from investors, investing funds, managing the returning cash flow and the dividend/reinvestment decision, is effectively presented in the following chart. This is the chapter and time to provide a "big picture" look at the scope, concerns, and issues of corporate finance. It is important for students to have this overview, and to be reminded of it as future chapters present small, detailed parts of the "big picture." Students tend to focus on the details and see neither how it all fits together nor the overall scope of finance. Presenting this "big picture" is an important role of the professor, and this first chapter provides several themes that will be reemphasized throughout the text:



1. The goal of corporation is value maximization. It is concerned with cash flows and the timing and variability of the cash flows, is the preferred decision criterion and is consistent with the financial market processes that determine value for securities.

2. The major decisions that a financial manager is required to make: investment and financing decisions.

3. The investment decision is also called the capital budgeting decision. If a project's value is greater than its required investment, then the project is attractive financially. The capital budgeting decision criteria, such as Net Present Value (NPV) and Internal Rate of Return (IRR), help financial manager to identify attractive capital investment projects.

4. The major capital components are debt (bond) and equity (stock). The choice between debt and equity financing is the capital structure decision.

5. Identify the range of agency problems that exist related to financial management, from global firms to the hardware up the street.

One of the most important decisions that a new business must make is the choice of business organization. This book focuses on corporations, one of the three primary forms, sole proprietorship, partnership, and corporation. Instead of skipping the discussion, consider this choice as an important financial decision that must be made before others. Each form has a risk/return trade-off that affects the ability to raise capital, so it does not take the students long to realize that the corporation is the likely choice once beyond a certain level of operations. This risk/return discussion is a good one to have early, before the topic is formally introduced.

CHAPTER OUTLINE

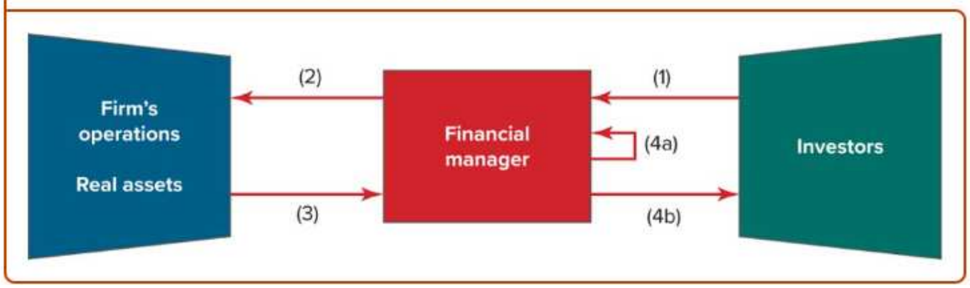
TOPIC OUTLINE, KEY LECTURE CONCEPTS, AND TERMS

1.1 INVESTMENT AND FINANCING DECISIONS

A. The primary functions of the financial manager or financial decision maker are to raise funds in financial markets (the financing decision), to invest such funds (capital budgeting decision), to generate cash from efficient operations, and to allocate cash flows generated for reinvestment, or to pay cash dividends. See Figure 1.1.

FIGURE 1.1

Flow of cash between investors and the firm's operations. *Key:* (1) cash raised by selling financial assets to investors; (2) cash invested in the firm's operations; (3) cash generated by the firm's operations; (4a) cash reinvested; (4b) cash returned to investors.



B. Funds are raised in financial markets by selling financial assets or securities to investors (stocks and bonds) and investing cash, in the case of manufacturing firms, in real assets, or physical assets used to produce goods and services.

The Investment (Capital Budgeting) Decision

A. The decision as to the amount and which **tangible** and/or **intangible** assets to acquire is an **investment (capital budgeting) decision**.

B. Where cash is invested affects the amount of future cash flows generated, the timing of those cash flows, and the variability or riskiness of those future cash flows and thus, the value or worth of the capital budgeting decisions.

The Financing Decision

A. Determining the maturity and type of funds raised in financial markets is part of the financing decision.

B. The selection and mix of long-term debt and equity securities sold in capital markets determines the **capital structure** of the firm.

1.2 WHAT IS A CORPORATION

A. A **corporation** is a legal entity separate from its owners, namely the shareholders. Shareholder owners have **limited liability**; their personal assets are free from the obligations of the corporations. If the corporation cannot pay its bills, its shareholders have no requirement to provide any money, beyond their initial investment in the shares. With limited liability to protect the shareholders, sometimes corporations are more inclined to invest in riskier asset ventures to create value than other types of business organizations.

B. A corporation may *incorporate* federally, under the *Canadian Business Corporation Act* or provincially, under relevant provincial laws. A provincially incorporated firm may conduct its business in that province but may need additional permissions to do business elsewhere.

C. The incorporation documents are called *articles of incorporation* in most provinces.[1] When approved by the relevant government agency, these documents provide the charter to the firm to conduct its business as a corporation.

D. Shareholders vote for the board of directors, who, in turn, appoint senior management, creating a legal separation of ownership and management of the business. This legal separation of ownership and management gives corporations permanence. If management is changed or if the shareholders change, the corporation carries on.

E. Corporations are able to combine the capital of many shareholders and thereby garner substantial resources. Corporations whose shares are listed for trading on a stock exchange are **public corporations**. Shareholders of public corporations are able to freely trade their shares. Also, the corporation can easily raise additional equity financing by selling more shares. Being a public company increases the company's financial flexibility. However, the company must pay for a stock listing, provide financial information on a regular basis and disclose material changes. Public companies must also comply with the rules for operating the firm in the interest of its shareholders, known as *corporate governance* rules.

F. Corporations whose shares are not listed on a stock exchange are called **private corporations.** Private corporations face more restrictions on the sale of new securities but do not need to make public information disclosures and are not subject to the governance requirements of a public company.

G. Whether it is a public or private corporation, each corporation is a taxable entity. It pays taxes on its earnings before distributing dividends to its shareholders, who then pay tax on their dividend income.

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[1]These are also called *letters patent* or *memorandum of association* in some provinces.

H. To summarize, a corporation has the advantages of providing limited liability to its shareholders and the perpetual life provided by the separation of ownership from management. This makes it possible to become a public corporation, with shares trading on stock exchange and the convenience of issuing more shares to raise new capital. Private corporations can also sell more shares to raise financing, but cannot just sell them to anyone.

1.3 OTHER FORMS OF BUSINESS ORGANIZATION

Sole Proprietorships

A. The sole proprietorship business blends the personal and business assets of the individual in a business venture. On the other hand, it is cheap and easy to set up a sole proprietorship.

B. The sole proprietor incurs unlimited liability (exposure of personal assets to business obligations), limited life, business and personal income/assets are viewed by taxing authorities as one, and because of these risks, has considerable difficulty raising funds in financial markets.

Partnerships

A. A partnership is an agreement between individuals to pool their assets and talents in a business.

B. Like the sole proprietorship, partners are exposed to unlimited personal liability and limited life of the business. Also, business income is combined with personal income for tax purposes. Unlike a sole proprietorship, more than one person is involved, and thus, more capital may be raised in financial markets.

Hybrid Forms of Business Organization

A. A limited partnership has both limited (limited liability) partners and, at least, one general (unlimited liability) partner, who is the primary manager. Limited partners usually have a restricted role and cannot take part in the day-to-day management of the partnership but they have the right to share in partnership profits and to have their contributions returned if the business is dissolved.

B. A limited liability partnership (LLP) is a partnership that enables its partners to enjoy some of the limited liability features of corporations, but continue to be taxed as partners, thereby avoiding double taxation. As in an ordinary partnership, individual partners in an LLP continue to have unlimited liability for their own professional negligence or malpractice but are not liable for the negligence or malpractice of their other partners.

C. Similarly, the professional corporation (PC), used by doctors and other professionals, has limited liability for owners, except in the area of malpractice.

D. Income trusts are another hybrid business form. Trust is not taxed but passes its earnings to its unit holders (sort of similar to shares). Income trusts became very popular around 2004 when corporations used the structure to reduce taxes. However, the income trust boom came to sudden end on October 31, 2006, when the Federal Government announced plans to change the taxation of trust, removing the advantage of becoming an income trust.

E. The following chart summarizes the key aspects of the three main forms of business organizations:

	Sole Proprietorship	**Partnership**	**Corporation**
Who owns the Business?	The manager	Partners	Shareholders
Are managers and owner(s) separate?	No	No	Usually
What is the owner's liability?	Unlimited	Unlimited	Limited
Are the owner and business taxed separately?	No	No	Yes

F. The choice of business organization affects the risk and the potential return in the form of after-tax cash flow and thus, the value of the business.

G. Compare and contrast the following business organizational forms by:

1. The exposure or risks of personal assets from a business venture—limited or unlimited liability.
2. The ease and cost of organization and maintenance of the business organization.
3. The expected life of the business under each form of business organization.
4. The relative tax exposure of the earnings of the business.
5. The relative ease of raising capital in financial markets.

1.4 WHO IS THE FINANCIAL MANAGER?

The Financial Manager

A. The financial manager is anyone responsible for a significant corporate investment or financing decision. The term is more oriented to the decisions rather than a specific title or job position. This book studies a number of financial manager decision areas, several of which, have a significant impact on shareholder value.

B. Traditional financial manager titles include **treasurer** and **controller**. The treasurer's duties include financing, cash management, and financial market relationships, while the controller tends to be associated with more traditional accounting functions of financial statements, budgeting, and auditing. See Figure 1.2. The **chief financial officer**, in larger firms, oversees the treasurer and controller and is involved in formulating corporate strategy and financial policy.

1.5 GOALS OF THE CORPORATION

Shareholders Want Managers to Maximize Market Value

A. Shareholders want managers to make decisions based upon which alternative will maximize the *market value* of the shareholders' investment. Value maximization is preferred decision criterion for the financial manager.

B. Making decisions that maximize shareholder value or wealth focuses the financial manager on expected cash flows from investments, the timing of the cash flows, and the variability or riskiness of those cash flows.

C. Other decision criteria, such as profit maximization or market share maximization, do not achieve value maximization. Making decisions based on profit maximization may focus on accounting income and not consider cash flow, is biased toward short-run returns perhaps ignoring the longer run implications of decisions, and ignores the relative riskiness of the decision alternatives.

Ethics and Management Objectives

A. Shareholders and the public are concerned that managers operate within the law and maintain the reputation and ethical good standing of the business. The corporations who do business unethically have to pay heavily eventually.

B. Fair and ethical relationships build and maintain long-run value. There is positive relation between maximizing value and doing business ethically.

Do Managers Really Maximize Firm Value?

A. The separation between ownership (principals) and management (agents) may create a potential conflict of interest between owners and managers. The study of this conflict and resolutions is called agency theory.

B. Shareholders are concerned that managers work for maximizing shareholders' wealth and not managers' wealth and lifestyle. **Agency problems** exist when managers, as agents of shareholders, have a conflict of interest with shareholders.

C. There are many diverse interests with a "stake" in the well-being of a business: managers, workers, suppliers, customers, government, shareholders, etc. These **stakeholders**' interest may conflict at times; managers must work to resolve these diverse interests.

D. *Compensation plans* should motivate managers to work for their own best personal interest and the best interest of the shareholders, thus resolving some agency problems.

E. The *board of directors*, elected by shareholders, oversees, and at times interferes, if managers do not act in the best interest of shareholders.

F. Managers whose company does not perform in the best interest of shareholders are candidates for a *takeover* by a new investor group.

G. Every public company and its managers are scrutinized and monitored by stock analysts. This *specialist monitoring* tends to focus managers on value creation.

H. Dishonest managers with stock option compensations may seek to hide the truth from investors. The scandals like WorldCom led the US Congress to pass the Sarbanes-Oxley Act, which aims to ensure that companies and their accountants provide directors, lenders, and shareholders with reliable financial information. Similar scandals, such as Nortel, occurred in Canada as well. Bill C-198, passed in Ontario, is known as "Canada's Sarbanes Oxley".

I. There are *legal and regulatory requirements* for CEOs and financial managers to act responsibly and in the interests of investors.

Stakeholder Capitalism:

While we assume that the goal of the firm should be to maximize shareholder value, it is increasingly argued that companies should have a wider responsibility to all their stakeholders. These include debtholders, customers and employees. This can result in having to make difficult choices between potentially conflict interests.

Ethical Disputes: Some instances are,

A. Short Selling: Investors who take a short position are betting that securities that they do not own will fall in price. Often they do this by borrowing the security and selling it in the hope that they will be able to buy it back cheaply.
B. Corporate Raiders: Buy companies whose assets can be profitably redeployed and sold.
C. Creative Accounting: Sometimes, when it appears that earnings may fall short of expectations, corporations turn to creative accounting.

1.6 CAREERS IN FINANCE

A. Careers in finance cover a wide range of activities but can be categorized into three areas: corporate finance, investments, and financial services.

B. Careers in corporate finance, starting as a financial analyst, include investment and financing analyses, cost analyses, and treasury management activities.

C. Careers in investments focus on researching investments, building portfolios, and managing portfolios for financial institutions (chartered banks, investment dealers, insurance companies, mutual funds, pension funds).

D. Careers in financial services are associated with providing customers, business and consumers, with financial services ranging from payment services, investments, credit services, insurance, trust, and financial advising. Services are provided by a wide range of financial institutions, including chartered banks, investment dealers, caisses populaires, credit unions, property/casualty and life insurance companies, credit card companies, and trust companies. Careers are also available for the regulatory agencies of the institutions listed.

1.7 PREVIEW OF COMING ATTRACTIONS

Following the definition of the financial manager, this book first studies investment decision making, and then financing decisions, then a variety of special issues.

Snippets of History

This book presents today’s financial practices and theories in a logical order, while financial practices and theories have a long, interesting history. A historical perspective underscores the fact that financial practices and theories are constantly evolving and new innovations are expected to emerge in the future. In this edition, this section has been updated with discussion of Brexit.

1.8 SUMMARY

PEDAGOGICAL IDEAS

General Teaching Note - Consider reviewing the table of contents of the text with the students at the end of your first chapter lecture. It will reinforce the "big picture" perspective, and give them a plan for your course. This chapter provides a "big picture" perspective that many students will soon forget as they get mired in the detailed chapters which follow. In future lectures always tie the day's chapter at hand back to the basic themes of the text, and perhaps your first chapter lecture. When the student has a sense of where and how a chapter fits into the whole, they can begin to tie chapters and concepts together, instead of staying mired in terms, computations, and specific topics.

REVIEW OF LEARNING OBJECTIVES (with teaching tips and notes)

The **first learning objective** is an understanding of the two major decisions made by financial managers. The primary functions of the financial manager or financial decision maker are to raise cash in financial markets (the financing decision) and to invest cash (capital budgeting decision).

The **second learning objective** is an understanding of the difference between real and financial assets. Financial managers raise funds in financial markets by selling financial assets, or securities, to investors as part of the financing decision, and invest this cash in real assets. The decision as to the amount and which tangible or intangible assets to acquire is an investment (capital budgeting) decision.

The **third learning objective** is an understanding of the corporate form of business organization. The choice of business organization affects the risk and the potential return in the form of after-tax cash flow and thus, the value of the business. Not all businesses are organized as corporations because of the time and cost of managing and maintaining a corporate entity, and to some extent, the double-taxation of corporate earnings in many countries.

The **fourth learning objective** is an understanding of the principal financial managers in the corporation. The classic financial manager titles are the treasurer and the controller, with the former being more associated with financing, cash management, and financial market relationships, and the latter being associated with more traditional accounting functions of financial statements, budgeting, and auditing. The chief financial officer, in larger firms, oversees the treasurer and controller and is involved in formulating corporate strategy and financial policy.

> **Teaching Note: Career Planning** – This first chapter is a good opportunity to get students thinking about careers in finance. The Finance in Practice (Working in Finance) section describing the work of four finance professionals can help students match their interests with a career in finance.

The **fifth learning objective** is an understanding of the goal of the firm. Shareholders want managers to make decisions based upon which alternative will maximize the market value of the shareholders' investment. Other decision criteria, such as profit maximization or market share maximization, do not achieve value maximization.

The **sixth learning objective** is an understanding of different mechanisms that can be used to align the interest of managers with those of shareholders. Agency problems exist when managers, as agents of shareholders, have a conflict of interest with shareholders. *Compensation plans* can motivate managers to work for the best interest of the shareholders, the *board of directors*, can monitor managers on behalf of shareholders, managers not performing in the best interest of shareholders are candidates for a *takeover*, and *legal and regulatory requirements* for financial managers require responsible actions in the interests of investors

The **seventh learning objective** is an understanding of why value maximization is ethical. Fair and ethical relationships build and maintain long-run value. There is positive relation between maximizing value and doing business ethically.

> **Teaching Note: Ethical Issues –** This first chapter provides a good opportunity to discuss ethical issues with the class that can be reinforced when covering material later in the course. The "Finance Through the Ages" section provides not only a good historical perspective on the financial practices and theories that are constantly evolving, but also a reminder that financial scandals arise regularly. The discussion on "Ethical Disputes" provides a good conversation starter for students to think about what constitutes good corporate behavior. A discussion of the ethical issues need not be a lecture in morality, but rather a discussion of conflicts which naturally exist within agency theory.

Student Career Planning - One of the greatest opportunities you can provide for your students is the chance to purchase Canadian newspapers and business publications such as The Globe and Mail, National Post, or Canadian Business or U.S. publications such as Wall Street Journal, Business Week, Fortune, etc., many of which are likely to be available at students' rates. The excitement and desire to keep up with current events in the field is an important part of the student becoming a professional.

Internet Exercises - The growing Internet has a vast number of finance-related sites. This section of the IM will analyze two Internet sites related to the chapter and suggest ways in which you can use the sites in your class. They can serve as "show and tell," if you have access to the Internet in your classroom or print out the home page of the site and distribute it in class. It has the purpose of providing a bibliography for continued study and reinforcement of chapter concepts or to boost student interest in the subject.

http://www.marketwatch.com

Marketwatch.com is a comprehensive "finance" site and is a good place for students to view the wide scope of finance. A simple investment game could be devised for the students to focus their attention on current events and the market valuation process. You could "give" them $100,000 and ask them to invest the funds in a stock portfolio for the term. They could then be asked to select from five to eight companies, allocate their funds (company stock price times number of shares), and follow the stocks for the semester. There are many stock portfolio games on the Internet, but this is simple. They are asked to link to http://www.fortune.com and select their companies from the many lists available. Most of the companies available on this link would be U.S. based but several large Canadian companies would be included also. The students could then be asked to research their companies at Smartmoney.com. This site has easy graphing capability, comparisons with industry/competitor performance, and even a portfolio manager. Using the valuation theme of the text as the major theme for the course, references to the stock market performance, and their stocks brings the text materials to real time! The many lists provided by Fortune also link to company home pages, where students can research careers available from the company.

http://www.fpadvisor.financialpost.com/

The Financial Post Advisor (formerly Financial Post Infomart) database is also an excellent source of researching Canadian companies. Universities often have access to the database through licensing arrangements. The database includes separate reference sources, namely, Financial Post Dividends, Mergers and Acquisitions, Profiler, Reports, and Analyzer. The Profiler and Dividends databases offer detailed financial information on a large number of publicly traded Canadian companies; the corporate Reports database provides access to historical, investor and industry reports of leading Canadian companies; while the Analyzer database allows the user to retrieve and analyze data.

http://www.canadiancareers.com

This site provides a collection of resources by occupation, occupational profiles, and Canadian career planning and occupational links. Information on Canadian labour market trends is also provided.

http://www.careers.org

The site provides exhaustive links to employment and University resources available in the U.S. and Canada. This site also gives a detailed list of financial services organizations in the US and Canada and offers links to financial company sites.

http://www.careers-in-business.com/

The Careers-in-Business site has in-depth analysis of several finance, accounting, and marketing careers; an excellent bibliography of "careers" books; and links to most of the major career sites on the Internet. For each career listed, the site provides an overview of the career, skills and talents required, job options, salaries, and links to related sites.

Overall, this site is an excellent place to start a review of careers in finance.