University of Richmond
Robins School of Business

§1. Introduction to Corporate Finance

Fin 360: Principles of Financial Management

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WHAT IS CORPORATE FINANCE?

Corporate finance is the study of ways to address three basic questions:

❶ What long-term investments should the firm take on?

Lines of business? Property needed? Machinery? Factory?

❷ How will the firm obtain long-term financing to pay for these investments?

Borrow? Give up ownership interest and shares for cash?

❸ How will the firm manage everyday financial activities?

Collect from customers and pay suppliers?

Question ❶ is addressed by **capital budgeting**: the process of managing long-term investments. The value of the cash flow generated by an investment should exceed its cost. Investments depend on the nature of the business.

EXAMPLES: Capital budgeting decisions include:

- Disney purchasing Lucasfilm, expanding theme parks, or developing streaming platforms
- Lego building a manufacturing facility in the United States near Richmond[1]

Capital Structure addresses question ❷. It is the mix of borrowing (debt) and ownership interest (equity) offered to raise long-term financing to pay for the firm's assets.

EXAMPLES: Capital structure decisions include:

- Harley Davidson raises $500 million by selling bonds to investors, promising to pay back that money with interest to investors
- Rivian Automotive raises $13.7 billion by selling ownership interest in its company, and the new owners of the firm as *shareholders* enjoy the benefits of fractional ownership in the firm (i.e., dividends, voting, **residual claim**).[2]

The optimal mix of debt and equity is based on the cost associated with each, such as interest payments or expectations of dividends and market returns.

Question ❸ has to do with the firm's **working capital**, or its current assets and current liabilities.

- How much cash should the firm hold?
- How many days' worth of inventory should be on hand?
- Should the firm purchase on credit from suppliers or pay cash?
- How quickly can the firm collect its accounts receivable?

EXAMPLES: Working capital decisions include:

- Conagra Brands, owners of Duncan Hines and Healthy Choice, evaluating methods to collect payments more quickly from customers.
- ServiceNow Inc., a software company that develops platforms to help businesses track their efficiency, delicately allowing customers flexibility to make payments.[3]

Too much cash or inventory on hand may be costly (low returns, storage costs). Too little can leave the firm in a vulnerable position.[4]

Are the following capital budgeting, capital structure, or working capital decisions? (a) An automobile manufacturer issues bonds to raise money for general corporate purposes, (b) a supplier of cardboard and paper goods agrees to extend a pizzeria's deadline to pay for boxes from 30 days to 45 days, (c) Salesforce acquires communication platform Slack Technologies for $29 billion.

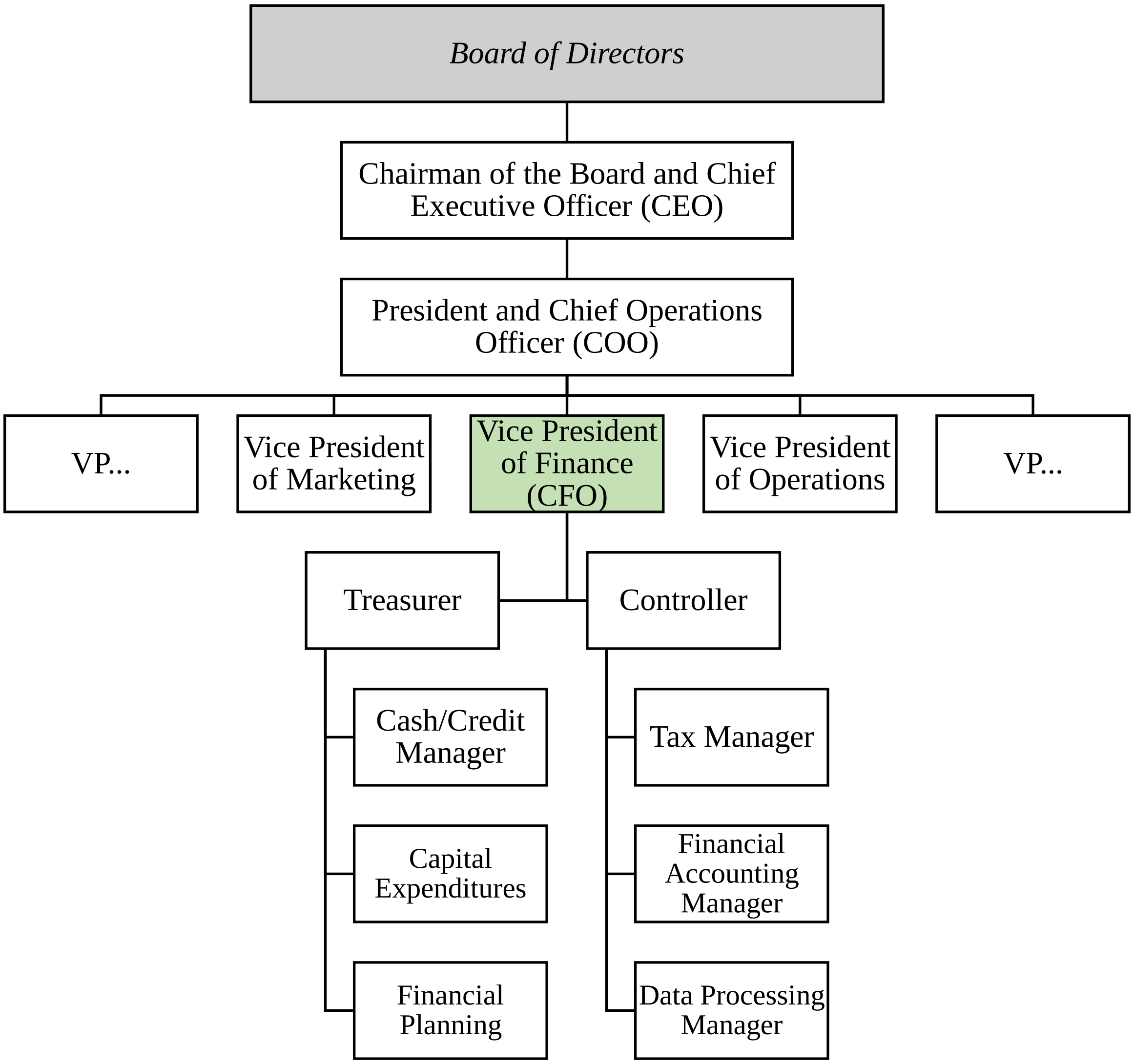
FINANCIAL MANAGERS AND FINANCIAL MANAGEMENT DECISIONS

The firm's top *financial manager*, such as the **Vice President of Finance** or **Chief Financial Officer (CFO)**, attempts to address these corporate finance questions. The company's treasurer and controller are also important roles in the firm, often reporting directly to the CFO.

- **Treasurer**: oversees cash and credit management, capital expenditures, and financial planning.

- **Controller**: oversees taxes, cost accounting, financial accounting, and data processing.

Figure 1: Sample Firm Organizational Structure



Forms of Business Organization

Now that we've discussed organization within businesses, we can think about how businesses themselves choose to organize. The main types of business organization include:[5]

1. **Sole Proprietorship**
2. **Partnership**
3. **Corporation (C corps**, **S corps**, **B corps**, **nonprofits**, and **cooperatives)**
4. **Limited Liability Corporation (LLC)**

Sole Proprietorship

A **Sole Proprietorship** is a business owned by a single individual. The simplest form of organization, the business has no existence apart from its owner.

- Taxed once as income to the individual (no separate corporate tax rate)
- Simple structure: all profits to the single owner
- Limited to the life of the owner, ceasing to exist upon owner's death
- Difficult to raise external money (generally, only through borrowing)
- *Unlimited liability*: business lenders and individuals can go after your personal wealth if your business cannot pay back debts

Partnership

A **Partnership** is a business organized much like a sole proprietorship but owned by *two or more* individuals. A **partnership agreement** is important to spell out the rights and duties of each partner.

- **General Partners** are similar to the proprietors of a sole proprietorship and are subject to unlimited liability.
- **Limited Partners** may hire general partners to run the business while they themselves have *limited liability*, where the maximum loss is their investment in the firm.

Corporation

A **Corporation** is a business created as a *distinct legal entity* composed of one or more individuals or entities. These corporations may have many thousands or millions of owners.

C Corps

C Corps (most **publicly traded companies** in the United States) must file their **corporate charter** or **articles of incorporation** and **bylaws** that define its purpose, rules, and how directors are elected.

- Most (over half) incorporate in Delaware given its unique legal system, lax corporate laws, and its specialized corporate law court system[6]

- All owners have *limited liability* where only their investment in the firm, not personal wealth, may be lost in bankruptcy
- Transferring ownership is easier than in sole proprietorships or partnerships (i.e., exchanging ownership shares in markets)
- Raising money is possible through both debt (borrowing) and/or equity (giving up ownership for capital)
- Unlimited life
- Double taxation: the firm, as a separate legal entity pays taxes while owners are taxed on the distributions (i.e., dividends) the firm pays out

S Corps

S Corps are limited to 100 individual US citizen or resident owners. S Corps operate as corporations, but without double taxation. Profits pass directly to owners and are taxed at the individual level.

B Corps, nonprofits, and co-ops

Benefit corporations (**B corps**) are for-profit but are driven by both profit and mission. Shareholders may require the B corp to submit reports to demonstrate the benefit they provide. **Nonprofits**, however, are created for charitable or educational purposes, are not required to pay taxes, and cannot distribute profits (i.e., dividends) to members. **Cooperatives (co-ops)** are owned and operated by its members who use the company's services, and these members may have voting power in decisions and may receive distributions of profits.

LIMITED LIABILITY CORPORATIONS

Limited Liability Corporations (**LLC**) are a "hybrid" form of corporation that operate as a sole proprietorship or partnership but retain limited liability and generally avoid double taxation. This form is often recommended for anyone starting a small business.[7] **Limited Liability Partnerships** (**LLP**) are similar, but are usually reserved for professional services (accounting, law) where partners take a managing role.

Start your own business! Visit your state's Secretary of State or Department of State website for necessary forms and to look up a business listing.

The Goal of Financial Management

What is the goal of a corporation?

- Maximize sales? *But we can incur costs to the point where there are no profits?*
- Maximize profits? Minimize costs? *When? In the short term? Is this at the expense of the future?*
- Survive? *Could this lead to less risk-taking and lower profits?*

> ★ The goal of financial management is to maximize the current value per share of existing shares of ownership (stock) or to *maximize the value of the firm*.

By maximizing value to existing shareholders, there's little ambiguity about timing, surviving, or costs. But should maximizing value be done at any cost? What about ethics? What about the firm's **stakeholders**, or the customers, suppliers, employees, and the society that the firm impacts?

The Agency Problem

Now we know *who* the financial manager is, *the questions* they attempt to answer, and their *ultimate goal*. But given ownership of the firm can be spread over a large number of shareholders, a hired manager may have different interests than that of the owners.

Agency Problem: the possibility of conflict between the owners of a firm (**principals**) and the management of a firm (**agents**).

> **Example:** A financial manager does not pursue a risky investment opportunity that may pay off for shareholders but cost them their job if it fails. Or perhaps the manager engages in **empire-building** by increasing their power in the firm but at the expense of shareholder value. Is the manager's use of the corporate jet necessary?

Addressing the Agency Problem: Incentive Based Compensation

Firms can align incentives between managers and owners through compensation. The firm can issue **restricted stock units (RSUs)** to a manager that only have value if the manager meets certain performance goals. **Executive or employee stock options** (**ESOs**) allow the manager to pay a low price for shares in the company that they may sell at a much higher price to others in the future.

EXAMPLES: RSU – the manager will receive 100 shares of the company in 1 year if the stock performance is above a certain threshold *and* they still work for the firm.

ESO – the manager will be allowed to buy 100 shares of the company for $20 each, even though the shares are worth $70 each.

Thus, if the company's value increases, the manager's compensation also increases. Cash salary is often only a small part of an executive's compensation. A former Boeing CEO earned a cash salary of $1.4 million and RSU and ESO awards worth $16 million.[8]

ADDRESSING THE AGENCY PROBLEM: MONITORING

Shareholders vote for directors who hire, fire, and monitor managers. However, voting rights are often concentrated among the founders, managers, and CEOs of the firm, implying that small individual investors (or **retail investors)** have little voting power. SEC-mandated disclosures and the threat of corporate takeover also help to mitigate the agency problem.

FINANCIAL MARKETS AND THE CORPORATION

A notable benefit of the corporate form of government is that the firm can raise a large amount of money from a large number of owners. **Financial markets** allow for this (1) raising of capital and for the (2) exchange of ownership.

- **Primary Markets**: when the firm issues equity shares (or bonds and debt) for the first time. Money raised goes to the firm, such as through an **initial public offering** (**IPO**).

- **Secondary Markets**: when investors and owners of the firm trade shares (or bonds and debt) among themselves. The corporation receives no proceeds, but the value of the traded shares establishes the value of the firm.

Secondary markets include (i) **auction markets** (like the **New York Stock Exchange**) where buyers and sellers of securities match with one another after stating their terms and (ii) **dealer markets** (like NASDAQ) where dealers buy and sell shares for themselves "**over the counter**" with other dealers, intending to sell their securities to other investors at a profit later.

Why do managers care about their firm's stock price? The firm's profitability is not necessarily affected by its share price, but the value of the firm (number of shares outstanding × price per share, or its **market cap**) is affected by the share price.

- Compensation and evaluation
- Raising money in the future
- Takeover threat
- Lenders can use the stock price to evaluate the health of the firm

IN SUMMARY

Corporate finance examines the firm, including its structure, managers, decisions, and organization. Problems arise in the separation of owners and managers, but solutions like effective monitoring and compensation may mitigate these issues.

With this understanding, we will begin to evaluate firm quality and assess their decision making.

Critical Thinking & Conceptual Questions

1. What is corporate finance?
2. Provide an example of a capital budgeting, capital structure, and working capital decision. What differentiates these types of decisions from one another?
3. Which of the three types of financial decisions tends to be shorter-term? Why is short-term decision making important for a firm?
4. What is a residual claim?
5. What is the VP of Finance or the CFO of the firm ultimately responsible for?
6. What are the three main responsibilities of the controller?
7. What are the three main responsibilities of the treasurer?
8. Would the treasurer or controller be more likely to handle the preparation of the audited financial statements?
9. What is the role of the Board of Directors at the firm? Whose interests do they represent? How do they earn their spot on the Board?
10. Describe the differences between limited and unlimited liability.
11. Why is limited liability important? Why are limited liability structures "permitted" in the US? What benefit does it offer society?
12. List the features of the sole proprietorship. What features are attractive? What features may be problematic?
13. What type of partner in a partnership is allowed to participate in the day-to-day operation of the firm? What risks does this type of partner take on?
14. Describe the features of a corporation. Which features are attractive? Which features may be problematic?
15. Define "double taxation" as it pertains to types of business organization.
16. What's the difference between C Corps and S Corps?
17. Explain how transferring ownership is generally easier for owners of a C Corp than for owners of a partnership, sole proprietorship, LLC, or S Corp.
18. Two things finance the purchase of assets: debt and equity. What do debtholders expect to receive for financing a firm's assets? What do equity holders expect to receive for financing a firm's assets?
19. What is the only source of equity that a sole proprietor can "raise" if they want to finance an asset purchase without borrowing?
20. Corporations can borrow through a bank or by issuing what financial instrument to investors?
21. If you wanted to start a small business, what form of business organization would most likely be the best one to choose? Why? How would you go about creating this business? What organization(s) are responsible for granting and approving your business structure?
22. Maximizing sales, maximizing profits, and surviving might often be mistaken as the ultimate goal of financial management at a corporation. Why are each of these goals insufficient? What *is* the ultimate goal of financial management at a corporation?
23. Who are stakeholders, and how might they each be negatively affected by the ultimate goal of financial management? Are stakeholders always negatively affected by firms pursuing that goal?

24. What causes agency problems? Name and describe two ways in which firms might overcome or mitigate the agency problem.
25. Which of the main types of business organization are most likely to experience agency problems? Why?
26. Describe the difference between primary markets and secondary markets. Why are each important? In which of these markets does the firm experience a cash flow?
27. What is the major difference between the NYSE and NASDAQ?
28. List and define four reasons why managers care about their stock price.
29. Describe how a declining market cap can increase the firm's chance of being taken over.

Analytical Questions

Patagonia and REI are both outdoor brands. Visit the following websites and discuss whether they are B corps, co-ops, or nonprofits. What are their goals and missions? In what ways do they qualify as a B corp, co-op, or nonprofit? What "benefit" do they offer? How are members rewarded?

- https://www.patagonia.com/ownership/
- https://www.rei.com/membership#perks

NOTES & REFERENCES

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