# Test Bank for Corporate Finance-Core Principles and Applications 2026 Release 1st Edition by Ross, Westerfield, Jaffe, Jordan, Shue

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Answers are located at the end of each chapter.

**MULTIPLE CHOICE - Choose the one alternative that best completes the statement or answers the question.**

1) Generally, among those who report directly to the __________ are the treasurer and the controller of a corporation.
   - A) board of directors
   - B) chairperson of the board
   - C) chief executive officer
   - D) president
   - E) chief financial officer

2) A typical chain of command in a corporation is described by which one of the following statements?
   - A) The information systems manager reports to the treasurer.
   - B) The credit manager reports to the treasurer.
   - C) The controller reports to the chief executive officer.
   - D) The tax manager reports to the treasurer.
   - E) The capital expenditures manager reports to the controller.

3) Answering which one of the following questions involves making a capital budgeting decision?
   - A) How much debt should the firm borrow from a particular lender?
   - B) Should the firm build a new production facility?
   - C) Should the firm issue new equity to pay for its growth goals?
   - D) How much inventory should the firm keep on hand?
   - E) How much credit should the firm extend to a particular customer?

4) Which one of the following statements is accurate?
   - A) Net working capital equals current assets plus current liabilities.
   - B) Current liabilities are debts that must be repaid in 18 months or less.
   - C) Current assets are assets with short lives, such as accounts receivable.
   - D) Long-term debt is defined as a residual claim on a firm’s assets.
   - E) Tangible assets are fixed assets such as patents.

5) Among the typical responsibilities of the corporate controller is:

A) capital expenditures management.
B) cash management.
C) tax reporting.
D) financial planning.
E) credit management.

6) __________ is typically the responsibility of the corporate treasurer.

A) Financial planning
B) Cost accounting
C) Tax reporting
D) Information systems
E) Financial accounting

7) A firm’s __________ define(s) its capital structure.

A) mixture of various types of production equipment
B) investment selections for its excess cash reserves
C) combination of cash and cash equivalents
D) combination of accounts appearing on the left side of its balance sheet
E) proportions of financing from debt and equity

8) The focus of short-term finance is on:

A) the timing of cash flows.
B) acquiring and selling fixed assets.
C) financing long-term projects.
D) capital budgeting.
E) issuing additional shares of common stock.

9) Net working capital includes:

A) copyrights.
B) manufacturing equipment.
C) common stock.
D) long-term debt.
E) inventory.

10) __________ is defined as planning and managing a firm’s long-term assets.

A) Working capital management
B) Cash management
C) Cost accounting management
D) Capital budgeting
E) Capital structure management

11) An amount the firms owes, which it must repay within twelve months, is called a(n):

A) current liability.
B) long-term debt.
C) intangible asset.
D) accounts receivable.
E) current asset.

12) The business entity that is typically the *least* expensive to form is the:

A) limited liability company.
B) joint stock company.
C) general partnership.
D) limited partnership.
E) sole proprietorship.

13) A __________ is a business owned by a single individual.

A) corporation
B) sole proprietorship
C) general partnership
D) limited partnership
E) limited liability company

14) Regarding a sole proprietorship, which one of the following statements is accurate?

A) It is more difficult to form than other forms of business.
B) Its business profits are taxed twice at the federal level.
C) Its business profits are taxed separately from the personal income of the owner.
D) The owner may be forced to sell his or her personal assets to pay the company's debts.
E) It has an unlimited life span.

15) Regarding a sole proprietorship, which one of the following statements is accurate?

A) The ability to raise capital is limited by the owner's personal wealth.
B) It pays taxes at the corporate tax rate.
C) Ownership of the firm is easy to transfer to another individual.
D) It must pay income taxes separately from the taxes paid by the owner.
E) The legal costs to form it are usually substantial.

16) The primary advantage of being a limited partner rather than a general partner is:

A) being entitled to a larger portion of the partnership's income.
B) having responsibility for day-to-day management of the business.
C) earning profits that are free from income taxation.
D) the ability to have overall control of the partnership.
E) one's personal financial liability is limited to the amount of capital invested.

17) A general partner:

A) has less legal liability than a limited partner.
B) can end the partnership by withdrawing.
C) faces double taxation of profits whereas a limited partner does not.
D) cannot lose more than the amount of his or her equity investment.
E) is the term applied only to corporations that invest in partnerships.

18) A partnership:

A) is taxed in the same fashion that a corporation is taxed.
B) terminates upon the death of any limited partner.
C) creates for all general partners an unlimited liability for the partnership's debts.
D) has the same ability as a corporation to raise capital.
E) allows for easy transfer of ownership from one general partner to another.

19) One advantage of a partnership is the:

A) personal liability for all of the firm's debts.
B) limited life of the entity.
C) limited liability protection for all of the partners.
D) relatively low cost of formation.
E) ease of transferring full ownership to others.

20) One disadvantage of the corporate form of business ownership is the:

A) limited liability protection provided for all owners.
B) firm's ability to raise cash.
C) unlimited life of the firm.
D) difficulties encountered when changing ownership.
E) double taxation of business profits.

21) Which one of the following statements is correct?

A) Both partnerships and corporations are subject to double taxation.
B) Sole proprietorships and partnerships are taxed in a similar fashion.
C) Partnerships are the most complicated type of business to form.
D) Both partnerships and corporations have limited liability for all owners.
E) All types of business formations have limited lives.

22) The articles of incorporation:

A) can be used to remove the firm's management.
B) are amended annually by the firm's stockholders.
C) set forth the rights granted to shareholders.
D) set forth the rules by which the corporation regulates its existence.
E) can set forth the conditions under which the firm can avoid double taxation.

23) Corporate bylaws:

A) establish the name of the corporation.
B) establish the rights granted to its shareholders.
C) set forth the purpose of the firm.
D) establish the rules by which the corporation regulates its existence.
E) set forth the number of members of the initial board of directors.

24) Regarding corporations, which one of the following statements is accurate?

A) After a predetermined number of years, ownership can no longer be transferred.
B) The ability to raise capital is limited by the personal wealth of the owners.
C) Primary shareholders have unlimited liability for corporate debts.
D) The entity can outlive all of its initial owners.
E) When the last original owner dies or withdraws, the entity is terminated.

25) If a business is formed as a corporation, ownership of the business:

A) must be granted with equal rights assigned to each and every shareholder.
B) can be transferred an unlimited number of times.
C) can only be transferred with the approval of the board of directors.
D) is controlled by the corporate officers.
E) must be held by non-management owners.

26) The owners of a limited liability company typically would prefer to:

A) be taxed like a corporation.
B) have liability exposure similar to that of a sole proprietor.
C) be taxed personally on all business income.
D) have liability exposure similar to that of a general partner.
E) be taxed like a corporation, and have liability like a partnership.

27) In a general partnership, the general partners have __________ liability for the firm's debts and have __________ control over day-to-day operations.

A) limited; no
B) unlimited; total
C) limited; total
D) unlimited; no
E) unlimited; limited

28) Which one of the following business types is best for raising large amounts of capital?

A) Sole proprietorship
B) Limited liability company
C) Corporation
D) General partnership
E) Limited partnership

29) Which type of business organization has the same rights and privileges as those accorded to a legal person?

A) Sole proprietorship
B) General partnership
C) Limited partnership
D) Corporation
E) Limited liability company

30) A ___________ is a business formed by two or more individuals who each have unlimited personal liability for all of the firm's debts.

A) corporation
B) sole proprietorship
C) general partnership
D) limited partnership
E) limited liability company

31) The ___________ describes the fraction of the work and cash to be contributed to a partnership by each member of that partnership.

A) indemnity clause
B) indenture contract
C) statement of purpose
D) partnership agreement
E) group charter

32) A(n) ___________ is a business created as a distinct legal entity, separate from its owners.

A) corporation
B) sole proprietorship
C) general partnership
D) limited partnership
E) unlimited liability company

33) In a limited partnership, each limited partner's liability for the partnership's debts is:

A) limited to his or her personal net worth.
B) limited to the amount he or she invested into the partnership.
C) limited to his or her total earnings received from the partnership.
D) unlimited.
E) limited to the total amount invested by all partners.

34) A ___________ provides each owner with limited liability, and is operated and taxed like a partnership.

A) limited liability company
B) general partnership
C) limited proprietorship
D) limited partnership
E) corporation

35) The profits earned by a partnership are:

A) fully distributed as taxable income to the partners.
B) distributed to general partners after interest is paid to limited partners.
C) distributed to the partners after the partnership pays its income taxes.
D) generally reinvested in the firm to fund future growth, rather than being distributed to owners.
E) generally held by the partnership for several years before being distributed as dividend payments.

36) Financial managers primarily create firm value by:

A) maximizing current dividends.
B) investing in assets that generate cash in excess of their cost.
C) lowering the earnings per share.
D) increasing the firm's market share.
E) maximizing current sales.

37) Accounting profits and cash flows are generally:

A) equal because they reflect current laws and accounting standards.
B) equal because accounting profits reflect the timing of cash flows.
C) unequal because of how income is recognized according to GAAP.
D) unequal because cash inflows must occur before revenue recognition.
E) equal because of the requirements of GAAP.

38) Which one of the following transactions will result in a cash outflow from the corporation?

A) Selling an asset
B) Paying income taxes
C) Issuing common stock
D) Borrowing from a lender
E) Retaining profit earned by the firm

39) A firm creates value by:

A) having a greater cash inflow from its stockholders than its outflow to them.
B) paying more cash to its creditors and stockholders than the amount it received from them.
C) borrowing long-term debt.
D) generating sales whether or not payment is received for all of those sales.
E) purchasing assets that create cash inflows equal to the cost of those assets.

40) If a firm is profitable, it follows that:

A) its cash inflows exceed its cash outflows.
B) its sales exceed its costs.
C) its cash flows are known with certainty.
D) it has sufficient cash to pay its bills in a timely manner.
E) the timing of its cash flows is irrelevant.

41) Which one of the following statements is accurate?

A) Individuals generally prefer later cash flows rather than current cash flows.

B) The value of an investment depends on the size, timing, and risk of the investment's cash flows.

C) When selecting one of two projects, managers should select the project with the higher total expected cash flow.

D) Most investors prefer greater risk rather than less risk.

E) Accountants record sales and expenses after the related cash flows occur.

42) A firm is considering a new project. Analysts at the firm would be justified in having the greatest level of certainty in the:

A) amount of the project's cash inflow in Year 3.

B) timing of the last cash inflow from the project.

C) project's initial cost.

D) risk of a pessimistic scenario occurring.

E) amount of the cash inflow from the project in Year 1.

43) Financial managers should primarily strive to:

A) minimize costs while increasing current dividends.

B) maximize the current profits of the firm.

C) maximize the current value per share of existing stock.

D) maximize current dividends even if doing so adds financial distress costs to the firm.

E) maximize current market share in every market in which the firm participates.

44) Financial managers should make decisions in such a way as to increase the:

A) size of the firm.

B) growth rate of the firm.

C) marketability of the managers.

D) market value of the existing owners' equity.

E) firm's current sales.

45) Which one of the following actions by a financial manager creates an agency problem?

A) Borrowing money, when doing so creates value for the firm
B) Lowering selling prices, which will result in increased firm value
C) Agreeing to expand the company at the expense of stockholders' value
D) Agreeing to pay management bonuses based on the market value of the firm's stock
E) Refusing to spend current cash on an unprofitable project

46) The primary goal of financial management is to:

A) maximize current dividends per share of the existing stock.
B) maximize the current value per share of the existing stock.
C) avoid financial distress.
D) minimize operational costs and maximize firm efficiency.
E) maintain steady growth in both sales and net earnings.

47) Of the following choices, __________ is the best way to increase current shareholder value.

A) maximizing the firm's amount of available cash
B) increasing the current value of the overall firm
C) postponing all new projects
D) minimizing the overall size of the firm
E) decreasing the number of employees

48) A financial manager should make decisions based on:

A) the effects those decisions will have on current profits.
B) the best interests of the manager and his or her peers.
C) the welfare of the current shareholders.
D) minimizing the firm's tax liability.
E) their personal goals and ambitions.

49) A(n) __________ is defined as a conflict of interest between the stockholders and managers of a firm.

A) stockholders' liability
B) corporate breakdown
C) agency problem
D) corporate activist
E) legal liability

50) Of the following choices, __________ is most likely to create an agency problem.

A) increasing the dividend payments to shareholders
B) paying off debt in a timely manner
C) increasing the sales of a profitable division
D) abandoning a profitable project because it involves some risk
E) selling an unprofitable division of the firm

51) Of the following choices, __________ is *least* likely to convince managers to work in the best interest of the stockholders.

A) being threatened with a takeover of the firm by unsatisfied stockholders
B) implementing a stock option plan
C) raising managers' salaries based on their length of service
D) tying management compensation to the market value of the firm's stock
E) receiving a threat of a proxy fight

52) Which form of business structure typically has the greatest potential for agency problems?

A) Sole proprietorship
B) General partnership
C) Limited partnership
D) Corporation
E) Limited liability company

53) A proxy fight occurs when:

A) the board of directors disagree on the members of the management team.
B) a group solicits voting rights to replace the board of directors.
C) a competitor offers to sell its ownership interest in the firm.
D) the firm files for bankruptcy.
E) the firm is declared insolvent.

54) Ultimately, the __________ control(s) the corporation.

A) board of directors
B) stockholders
C) president
D) chief executive officer
E) chairperson of the board

55) Members of the board of directors are selected by:

A) shareholder voting.
B) company management.
C) the firm’s chief executive officer.
D) the largest five shareholders.
E) the firm’s managers and employees.

56) What is the main reason that corporations grant stock options to managers? To:

A) reduce agency costs.
B) increase current profits.
C) replace salary increases.
D) reward long-term employment.
E) replace promotions.

57) Of the following choices, which one best fits the description of an agency cost?

A) The costs of increasing the dividend payment per share
B) The benefits received from reducing production costs per unit
C) The payment of corporate income taxes
D) The payment required for an outside audit of the firm
E) The payment of interest on a firm’s debts

58) What is the general term used to describe someone who potentially has a claim on the cash flows of the firm?

A) Stakeholder
B) Borrower
C) Agent
D) Broker
E) Candidate

59) A stakeholder is any person or entity:

A) owning shares of stock of a corporation.
B) owning bonds or other long-term debt issued by a corporation.
C) that initially started a firm and currently has management control over that firm.
D) to whom the firm currently owes money.
E) other than a stockholder or creditor who potentially has a financial interest in a firm.

60) One intent of the Sarbanes-Oxley Act of 2002 is to:

A) prevent minority investors from making demands on corporations.
B) protect corporate directors from frivolous lawsuits.
C) guarantee the repayment of all future personal loans to corporate officers and directors.
D) protect investors from corporate abuses.
E) require all public corporations to “go dark” within the next twenty years.

61) The Sarbanes-Oxley Act requires public corporations to:

A) assess the company’s internal control structure at least quarterly.
B) distribute at least 90 percent of their profits as dividends on an annual basis.
C) list any deficiencies in internal controls.
D) file annual audit reports if the firm has “gone dark.”
E) disclose all personal loans to corporate officers or directors made after 2002.

62) Insider trading is:

A) prohibited by the Securities Act of 1933.
B) prohibited by the Securities Exchange Act of 1934.
C) impossible in today's efficient markets.
D) highly discouraged, but still legal.
E) prohibited by the Sarbanes-Oxley Act of 2002.

63) The __________ established the basic regulatory framework for the public trading of securities in the United States.

A) New York Stock Exchange, when it was founded,
B) Securities Exchange Act of 1934
C) Federal Reserve Bank, when it was first authorized by Congress,
D) Securities Act of 1933 and the Securities Exchange Act of 1934
E) Sarbanes-Oxley Act of 2002

64) The Securities Act of 1933 focuses on:

A) all stock transactions.
B) the sales of existing securities.
C) the issuance of new securities.
D) insider trading.
E) Federal Deposit Insurance Corporation (FDIC) insurance.

65) The intent of the registration statement required for all new securities by the Securities Act of 1933 is to:

A) provide a governmental evaluation of the risks associated with those new securities.
B) set the price at which the securities will be offered.
C) guarantee the profitability of the new securities.
D) prevent any insider trading.
E) provide all necessary information to allow a potential investor to make an informed decision.

66) Which one of the following results have been reported as a consequence of a corporation "going dark?"

A) Increased market liquidity and lower costs
B) Lower audit costs and lower interest rates on bank loans
C) Increased access to capital and lower costs associated with that capital
D) Increased audit costs and stock price increases
E) Limited access to capital markets and stock price declines

67) A ___________ corporation is a new type of company that is for profit, but it has three additional legal attributes: accountability, transparency, and purpose.

A) solo
B) benefit
C) flagship
D) blocked
E) transferrable

**ESSAY. Write your answer in the space provided or on a separate sheet of paper.**

68) List and briefly describe the three basic areas addressed by a financial manager.

69) What advantages and disadvantages does the corporate form of organization have compared to sole proprietorships and general partnerships?

70) Why might a professional group select the LLC form of business over a general partnership or a corporate structure?

71) Why might a highly successful sole proprietor change the structure of his or her firm to the corporate form of ownership if that change results in the sharing of profits with other investors?

72) What should be the primary goal of the financial manager of a corporation? Explain why this is appropriate.

# Answer Key

Test name: Chapter 01

1) E
2) B
3) B
4) C
5) C
6) A
7) E
8) A
9) E
10) D
11) A
12) E
13) B
14) D
15) A
16) E
17) B
18) C
19) D
20) E
21) B
22) C
23) D
24) D
25) B
26) C
27) B
28) C
29) D
30) C
31) D
32) A
33) B
34) A
35) A
36) B
37) C

38) B
39) B
40) B
41) B
42) C
43) C
44) D
45) C
46) B
47) B
48) C
49) C
50) D
51) C
52) D
53) B
54) B
55) A
56) A
57) D
58) A
59) E
60) D
61) C
62) B
63) D
64) C
65) E
66) E
67) B
68) Essay
69) Essay
70) Essay
71) Essay
72) Essay

# Chapter 1

# INTRODUCTION TO CORPORATE FINANCE

## SLIDES

1.1 Introduction to Corporate Finance

1.2 Key Concepts and Skills

1.3 Chapter Outline

1.4 1.1 What Is Corporate Finance?

1.5 Balance Sheet Model of the Firm

1.6 The Balance Sheet Reveals

1.7 The Capital Budgeting Decision

1.8 The Capital Structure Decision

1.9 Short-Term Asset Management

1.10 The Financial Manager

1.11 Hypothetical Organization Chart

1.12 1.2 The Corporate Firm

1.13 Forms of Business Organization

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1.15 A Global Phenomenon

1.16 1.3 The Importance of Cash Flows

1.17 The Conceptual Flow of Cash

1.18 Cash Flow ≠ Accounting Income

1.19 1.4 The Goal of Financial Management

1.20 1.5 The Agency Problem and Control of the Corporation

1.21 Agency Cost

1.22 Management Goals

1.23 Managing Managers

1.24 1.6 Regulation

1.25 Quick Quiz

1.26 End of Main Content

1.27 Accessibility Content: Text Alternatives for Images

1.28 Balance Sheet Model of the Firm—Text Alternative

1.29 The Capital Budgeting Decision—Text Alternative

1.30 The Capital Structure Decision—Text Alternative

1.31 Short-Term Asset Management—Text Alternative

1.32 Hypothetical Organization Chart—Text Alternative

1.33 The Conceptual Flow of Cash—Text Alternative

## CHAPTER WEBSITES

| *Section* | *Web Address* |
|---|---|
| 1.1 | For current issues facing CFOs, see www.cfo.com. |
| 1.2 | To find out more about LLCs, visit www.incorporate.com.<br>For more about benefit corporations, check out usca.bcorporation.net/benefit-corporation. |
| 1.4 | Business ethics are considered at sbeonline.org. |
| 1.5 | You can find the changing composition of boards for S&P 500 companies at www.spencerstuart.com. |
| 1.6 | For an annual survey of SOX costs, check out www.protiviti.com/us-en. |
| End-of-chapter material | Find the complete listing requirements for the NYSE at www.nyse.com and Nasdaq at www.nasdaq.com. |

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## CHAPTER ORGANIZATION

1.1 What Is Corporate Finance?

- The Balance Sheet Model of the Firm
- The Financial Manager

1.2 The Corporate Firm

- The Sole Proprietorship

The Partnership

The Corporation

A Corporation by Another Name…

1.3 The Importance of Cash Flows

Identification of Cash Flows

Timing of Cash Flows

Risk of Cash Flows

1.4 The Goal of Financial Management

Possible Goals

The Goal of Financial Management

A More General Goal

1.5 The Agency Problem and Control of the Corporation

Agency Relationships

Management Goals

Do Managers Act in the Stockholders' Interests?

Stakeholders

1.6 Regulation

The Securities Act of 1933 and the Securities Exchange Act of 1934

## ANNOTATED CHAPTER OUTLINE

***Slide 1.1 Chapter 1 Introduction to Corporate Finance***

***Slide 1.2 Key Concepts and Skills***

***Slide 1.3 Chapter Outline***

**PowerPoint Note**: If there is a slide that you do not wish to include in your presentation, choose to hide the slide under the "Slide Show" menu, instead of deleting it. If you decide that you would like to use that slide at a later date, you can just unhide it.

**PowerPoint Note**: Be *sure* to check out the notes that accompany some of the slides on the "Notes Pages" within PowerPoint.

***Slide 1.4*** **What Is Corporate Finance?**

Economic resources are required to establish and maintain a firm:

The Balance Sheet offers insight into the array of decisions, activities and objectives of the Financial Manager.

***Slide 1.5*** ***Balance Sheet Model of the Firm***

The Balance Sheet presents a picture of the firm at a point in time, and it provides a model which reveals the three basic questions that corporate finance managers must answer.

***Slide 1.6*** ***The Balance Sheet Reveals***

The top three concerns of corporate finance:

1. What long-term investments should the firm choose?
2. How should the firm raise funds for the selected investments?
3. How should current assets be managed and financed?

***Slide 1.7*** ***The Capital Budgeting Decision***

Long-term investment decisions determine the level of fixed assets.

***Slide 1.8*** ***The Capital Structure Decision***

Financing policy determines the liabilities and equity side of the balance sheet.

***Slide 1.9*** ***Short-Term Asset Management***

Short-term asset management choices (e.g., conservative versus aggressive) affect the level of net working capital.

***Slide 1.10*** ***The Financial Manager***

The firm's three main financial concerns are usually handled by a top officer and aides:

- V.P. or Chief Financial Officer—ordinarily acts as a financial strategist, coordinator, and authority dedicated to making decisions that increase the value of the firm
- Treasurer—concerned with cash flow, capital expenditures, and capital structure
- Controller—concerned with accounting, information systems, and taxes

***Slide 1.11*** ***Hypothetical Organization Chart***

The Vice President and Chief Financial Officer (CFO) coordinate the activities of the treasurer and the controller.

The controller handles cost and financial accounting, taxes, and information systems (i.e., data processing).

The treasurer handles cash and credit management, financial planning, and capital expenditures.

***Slide 1.12*** ***The Corporate Firm***

Although many forms of business organizations exist, the corporate form is the standard by which we address most large-scale problems, especially raising large quantities of funds. This approach, however, does not imply that the methods we develop are inappropriate for other business types.

***Slide 1.13*** ***Forms of Business Organization***

A. The Sole Proprietorship

A business owned by one person.

Advantages include ease of start-up, lower regulation, single owner keeps all the profits, and taxed once as personal income.

Disadvantages include limited life, limited equity capital, unlimited liability and low liquidity.

B. The Partnership

A business with multiple owners, but not incorporated.

General partnership—all partners share in gains or losses; all have unlimited liability for all partnership debts.

Limited partnership—one or more general partners run the business and have unlimited liability. A limited partner's liability is limited to his or her contribution to the partnership, and they cannot help in running the business.

Advantages include more equity capital than is available to a sole proprietorship, relatively easy to start (although written agreements are essential), and income taxed once at personal tax rate.

Disadvantages include unlimited liability for general partners, dissolution of partnership when one partner dies or wishes to sell, and low liquidity.

***Lecture Tip***: *Recent years have seen resurgence in the importance of private equity funds in the financing of firms. A discussion of this industry may increase student interest and facilitate a practical example of limited partnerships, which is the primary structure employed by these entities.*

C. The Corporation

A distinct legal entity composed of one or more owners

***Slide 1.14*** ***A Comparison***

Corporations account for the largest volume of business (in dollar terms) in the U.S. Advantages include limited liability, unlimited life, separation of ownership and management (ability to own shares in several companies without having to work for all of them), liquidity, and ease of raising capital.

Disadvantages include separation of ownership and management (agency costs) and double taxation. Recent tax laws reduce the level of double taxation, but it has not been eliminated.

***Lecture Tip:*** *Although the corporate form of organization has the advantage of limited liability, it has the disadvantage of double taxation. Today, all 50 states have enacted laws allowing for the creation of a limited liability company (LLC). The goal of this entity is to operate and be taxed like a partnership but retain limited liability for owners, so an LLC is essentially a hybrid of partnership and corporation. Although states have differing definitions for LLCs, the more important scorekeeper is the Internal Revenue Service (IRS). The IRS will consider an LLC a corporation, thereby subjecting it to double taxation, unless it meets certain specific criteria. In essence, an LLC cannot be too corporation-like, or it will be treated as one by the IRS. LLCs have become common.*

***Slide 1.15 A Global Phenomenon***

Corporations exist around the world under a variety of names. Table 1.2 lists several well-known companies, along with the type of company in the original language.

***Slide 1.16 The Importance of Cash Flows***

***Lecture Tip:*** *It is essential at this early stage to assure that students understand that finance examines both accounting income and cash flow. It is critically important for students to understand that a firm cannot sustain itself unless it produces a positive cash flow.*

If the firm is to prosper, it must purchase assets that produce more cash than they cost and finance itself using the least costly means of doing so. Successful firms produce more cash than they use.

***Slide 1.17 The Conceptual Flow of Cash***

The purpose of this slide is to provide a graphical representation of the interconnectedness of the three goals of financial management. It will be important for students to appreciate that it is the capital structure than enables capital spending. Capital spending in turn enables the production and sales that produce the cash flow necessary to make a return to investors, pay creditors, and add to the treasure of the business.

***Slide 1.18*** ***Cash Flow ≠ Accounting Income***

***Lecture Tip:*** *Now is the best time to assure students are comfortable with the distinction between accounting income and cash flow. It may be useful to refer to Example 1.1 in the text to drive the point home.*

***Slide 1.19*** ***The Goal of Financial Management***

A. What is the correct goal?

Profit Maximization—this is an imprecise goal. Do we want to maximize long-run or short-run profits? Do we want to maximize accounting profits or some measure of cash flow? Because of the different possible interpretations, this should not be the main goal of the firm.

Other possible goals that students might suggest include minimizing costs or maximizing market share. Both have potential problems. We can minimize costs by not purchasing new equipment today, but that may damage the long-run viability of the firm. Many dot.com companies got into trouble in the late 1990's because their goal was to maximize market share. They raised substantial amounts of capital in IPOs and then used the money on advertising to increase the number of "hits" on their site. However, many firms failed to translate those "hits" into enough revenue to meet expenses, and they quickly ran out of capital. The stockholders of these firms were not happy. Stock prices fell dramatically, and it became difficult for these firms to raise additional funds. In fact, many of these companies have gone out of business.

From a stockholder (owner) perspective, the goal of buying the stock is to gain financially. Thus, **the goal of financial management in a corporation is to maximize the current value per share of the existing stock.**

***Lecture Tip:*** *The validity of this goal assumes "investor rationality." In other words, investors in the aggregate prefer more dollars to fewer and* *less risk to more. Rational investors will act as risk-averse return-seekers in making their purchase and sale decisions and, given different levels of risk aversion and wealth preferences, the only single goal suitable for all shareholders is the maximization of their wealth (which is represented by their holdings of the firm's common stock).*

***Lecture Tip:*** *For those interested in behavioral finance, this may be an opportune time to discuss outside influences that impact share price, many of which are beyond the control of the firm.*

The more general goal is to maximize the market value of shareholders' equity.

Many students think this means that firms should do "anything" to maximize stockholder wealth. It is important to point out that unethical behavior does not ultimately benefit owners.

***Ethics Note:*** *Any number of ethical issues can be introduced for discussion. One particularly good opener to this topic that many students can relate to is the issue of the responsibility of the managers and stockholders of tobacco firms. Is it ethical to sell a product that is known to be addictive and dangerous to the health of the user even when used as intended? Is the fact that the product is legal relevant? Do recent court decisions against the companies matter? What about the way companies choose to market their product? Are these issues relevant to financial managers?*

***Slide 1.20*** ***The Agency Problem and Control of the Corporation***

The agency relationship arises when a principal hires an agent to represent their interest. Stockholders (principals) hire managers (agents) to run a company.

The agency problem is defined by a situation in which there is a conflict of interest between a principal and agent.

***Lecture Tip:*** *This topic also lends itself well to an ethics discussion that could be initiated on a wide variety of potential conflicts.*

***Slide 1.21*** ***Agency Cost***

Agency cost is the cost of the conflict of interest.

For example, if owners want to make a large risky investment in order to harvest long-term profits, managers may object because their short-term objectives are put at risk.

If managers prevail, any foregone long-term cash flow is the agency cost.

***Slide 1.22*** ***Management Goals***

May be different from shareholder goals (expensive perquisites, independence). Increased growth and size lead to management rewards but may not always benefit shareholders.

***Lecture Tip:*** *In the early 1980s, the Burlington Northern Railroad sought to sell off real estate with a value of approximately $778 million. The firm was enjoined from doing so, however, by restrictions written into covenants of the firm's bonds in 1896. These were very long-term bonds with an additional fifty years to maturity. They also were not callable and did not include a sinking fund provision. Management found it necessary to negotiate with the bondholders to release some of the value tied up in the real property originally used to secure these bonds. Following a great deal of legal wrangling, the bondholders settled for payments totaling $35.5 million. Lawyers for the bondholders settled for another $3.4 million. In other words, the cost of addressing this stockholder/bondholder conflict was nearly $40 million—and this doesn't include the opportunity cost of management time spent on this issue instead of running the business. For further discussion of this case, see "Bond Covenants and Foregone Opportunities" by Gene Laber, in the Summer 1992 issue of Financial Management.*

***Ethics Note:*** *When shareholders elect a board of directors to oversee the corporation, the election serves as a control mechanism for management. The board of directors bears legal responsibility for corporate actions. However, this responsibility is to the corporation itself and not necessarily to the stockholders. Although it happened several years ago, the following* *example still makes for an interesting discussion of directors' and managers' duties:*

*In 1986, Ronald Perelman engaged in an unsolicited takeover offer for Gillette (for article discussing this see https://www.latimes.com/archives/la-xpm-1986-11-25-fi-13034-story.html#:~:text=By%20NANCY%20RIVERA%20BROOKS,Advertisement). Gillette's management filed litigation against Perelman and subsequently entered into a standstill agreement with Perelman. This action eliminated the premium that Perelman offered shareholders for their stock in Gillette.*

*A group of shareholders filed litigation against the board of directors in response to its actions. It was subsequently discovered that Gillette had entered into standstill agreements with ten additional companies. When questioned regarding the rejection of Perelman's offer, management responded that there were projects on line that could not be discussed (later revealed to be the "Sensor" razor, which was one of the most profitable new ventures in Gillette's history up to that time). Thus, despite appearances, management's actions may have been in the best interests of the firm, and this case indicates that management may consider factors other than the bid when considering a tender offer.*

***Slide 1.23 Managing Managers***

Managerial compensation can be used to encourage managers to act in the best interest of stockholders. One commonly cited tool is stock options. The idea is that if management has an ownership interest in the firm, they will be more likely to try to maximize owner wealth.

***Lecture Tip:*** *Stern Stewart & Company developed a tool called EVA®, which measures how much "economic value" is being added to a corporation by management decisions. According to Stern-Stewart's analysis, companies that tie management compensation to EVA® significantly outperform competitors that do not. This example illustrates that carefully crafted compensation packages may reduce the conflict between management and stockholders.*

***Lecture Tip:*** *Stockholders technically have control of the firm, and dissatisfied shareholders can oust management via proxy fights, takeovers (e.g., Carl Icahn), etc. However, this is easier said than done. Staggered elections for board members often make it difficult to remove the board that appoints management. Poison pills and other anti-takeover mechanisms make hostile takeovers difficult to accomplish.*

*Stakeholders are other groups, besides stockholders, that have a vested interest in the firm and potentially have claims on the firm's cash flows. Stakeholders can include creditors, employees, customers, and the government.*

***Lecture Tip:*** *A good practitioner-oriented discussion of the impact of stakeholders on decision-making is found in a 1987 Wall Street Journal article by Charles Exley, Jr., then-chairman and president of NCR Corp. The thrust of Mr. Exley's comments is that giving more consideration to the interests of non-stockholder stakeholders is good business and results in the decentralization of management. Frequently, a discussion of stakeholder interests (as opposed to a discussion exclusively geared toward stockholder interests) leads to a better understanding of the nature of the corporate form of organization, the role of the corporation in society (and the question of "corporate social responsibility"), as well as the role of contracting in the labor and financial markets.*

*A good thing to note is that culture influences the goal of the firm. The US and UK are examples of countries/regions where shareholder wealth maximization is paramount. In countries like Germany and Japan the interests of employees and customers are given emphasis.*

***Ethics Note:*** *A discussion of stakeholder interests leads very nicely into a discussion of ethical decision making. Theories of ethical behavior focus on the rights of all parties affected by a decision, not just one or two. The "utilitarian" model defines an action as acceptable if it maximizes the benefit, or minimizes the harm, to stakeholders in the aggregate. The "golden rule" model deems a decision ethical if all stakeholders are treated as the decision maker would wish to be treated. Finally, the Kantian "basic rights" model defines acceptable actions as those that minimize the violation of stakeholders' rights.*

***Lecture Tip:*** *The antitrust case against Microsoft can generate a healthy discussion of ethical behavior, innovation and the government's role in monitoring business practices. The basic idea behind the case is that: (1) Microsoft stifled competition by imposing stiff penalties on computer manufacturers that chose to install operating systems other than Windows on some of their machines; (2) Microsoft tried to put Netscape out of business by incorporating Internet Explorer into the operating system; and (3) Microsoft has an unfair advantage in the applications programming area because their programmers have access to the source code for the operating system. There were other issues as well, but these were the major ones. The judge in the case originally found that Microsoft did violate antitrust laws and that they continued to operate in a monopolistic fashion. He ordered the break-up of Microsoft into an "operating system" company and an "applications" company. The judge also ordered that Microsoft allow programmers from the company's competitors to come to a secured location and view the source code for Microsoft Windows. Microsoft contended that this would allow other companies to determine the direction that Microsoft is moving with their software and eliminate the competitive advantage that their research and development has afforded the company. The case was appealed and Microsoft was still found in violation of antitrust laws, but not to the extent found in the original case.*

*The Final Judgment was issued on November 12, 2002 and had the following components: (1) Microsoft cannot retaliate against an Original Equipment Manufacturer (OEM) if the OEM "is or is contemplating developing, distributing, promoting, using, selling or licensing any software that competes with Microsoft Platform Software" or ships a computer with more than one operating system; (2) Microsoft must publish and use a consistent licensing agreement schedule with all covered OEMs; (3) Microsoft cannot restrict OEMs from selling computers that include competing products, display competing product icons on the desktop, and launch competing products when a Microsoft application would normally be launched; (4) Microsoft must allow Independent Software Vendors (ISVs), Independent Hardware Vendors (ISDs), Internet Access Providers (IAPs), Internet Content Providers (ICPs) and OEMs* *access to Windows Operating System Product source code as necessary to develop products that will work effectively with the operating system—these companies must demonstrate why they need access and they are limited to access to that code that is required for "interoperating" with the operating system; and (5) Microsoft is not required to disclose any intellectual property rights related to security or that is designed to prevent software piracy.*

*The Final Judgment called for the appointment of a technical committee that will assist in the enforcement and compliance with the judgment and Microsoft was required to appoint an internal compliance officer to make sure that all employees of the firm understand and comply with the judgment. Reports on compliance are routinely filed with the Department of Justice and can be found, along with the Final Judgment, at the U.S. Department of Justice website.*

***Slide 1.24*** ***Regulation***

Regulation of financial activities arises from two substantial sources:

Antitrust legislation governing issuance of securities and creating the SEC; and,

Sarbanes Oxley that requires increased reporting requirements and personal consequences for non-compliance.

***Slide 1.25*** ***Quick Quiz***