Chapter 1

Part 1

Introduction to Corporate Finance

A year can be a long time in the life of a corporation. By the end of 2006 high savings rates in countries such as China had led to an influx of money into the developed economies driving interest rates to historic lows. Foreseeing strong levels of corporate growth, executives planned major capital expenditures for their firms. Given the low interest rates, debt was readily available to fund these projects.

However, in mid-2007 the world was stunned by the news that financial institutions in the US were experiencing rapidly increasing levels of foreclosures in home mortgages, with home owners unable to meet their repayment obligations. This led to losses in the firms that had provided the mortgages – losses which turned out to be global in scope. Banks reduced their credit facilities both to their customers and to other banks, resulting in a dramatic drying up of liquidity throughout the developed world's capital markets. This was followed in 2008 by the demise of investment banking giants such as Lehman Brothers, a flight of capital from emerging market currencies, falling commodity prices, and a slowdown in the growth rates of China and India. Companies experienced falling profit margins and it became difficult for them to maintain their levels of funding.

As a consequence of the dramatic events of 2007 and 2008, it has become vital for companies to understand how to value their investments, to choose appropriate funding mixes and manage risk as well as satisfy investor expectations. A good grasp of all these issues and fitting them into a cohesive picture is the goal of this text. The first step is an understanding of what is meant by corporate finance, what a corporate entity looks like and what the appropriate goal of corporate financial management should be. We discuss all these issues in this chapter.

Learning Objectives

After studying this chapter, you should understand:

LO1 The basic types of financial management decisions and the role of the financial manager

LO2 The goal of financial management

LO3 The financial implications of the different forms of business organization

LO4 The conflicts of interest that can arise between managers and owners

LO5 The linkages between the firm and the capital markets.

To begin our study of modern corporate finance and financial management, we need to address two central issues. First, what is corporate finance and what is the role of the financial manager in the company? Second, what is the goal of financial management? To describe the financial management environment, we consider the corporate form of organization and discuss some conflicts that can arise within the company. We also take a brief look at financial markets in South Africa.

1.1 Corporate Finance and the Financial Manager

In this section, we discuss where the financial manager fits in the company. We start by defining corporate finance and the financial manager's job.

What Is Corporate Finance?

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

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

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

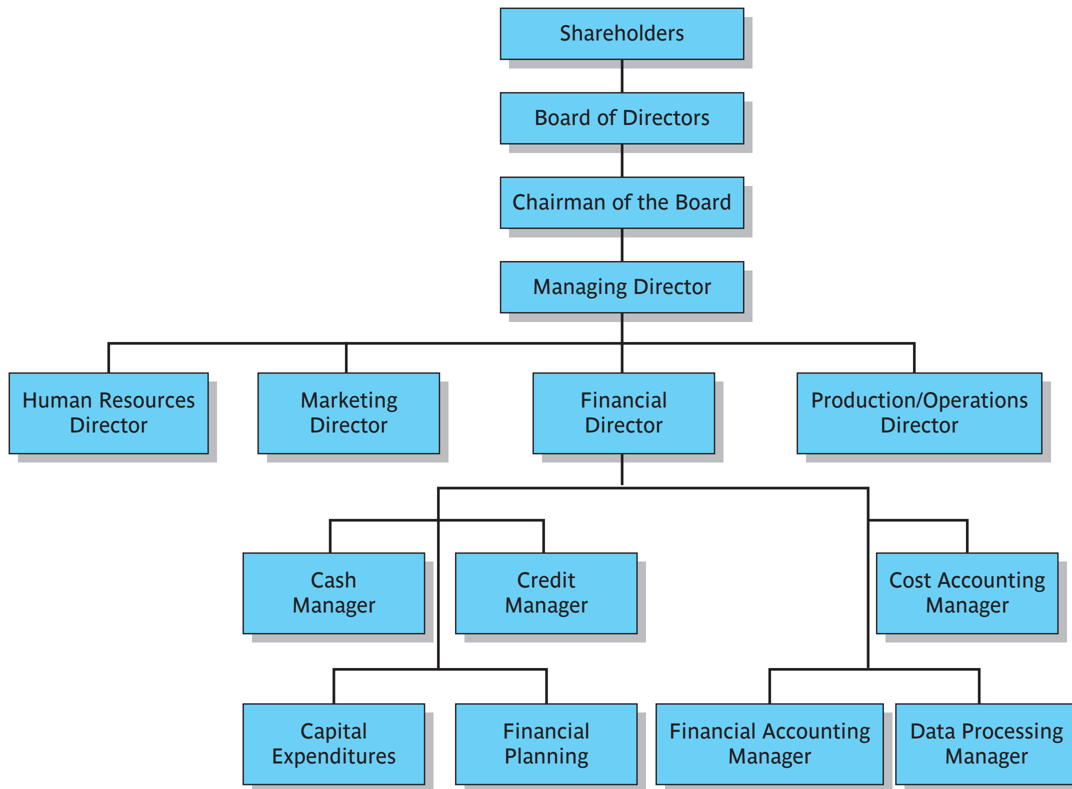
Web note 1 Check out the companion website for this text at www.mcgraw-hill.co.uk/textbooks/firer

The Financial Manager

A striking feature of large companies is that the owners (the shareholders) are usually not directly involved in making business decisions, particularly on a day-to-day basis. Instead, the company employs managers to represent the owners' interests and make decisions on their behalf. In a large company, the financial manager would be in charge of answering the three questions we raised above.

The financial management function is usually associated with a top officer of the firm, the financial director. Figure 1.1 is a simplified organizational chart that highlights the finance activity in a large firm. As shown, those activities controlled by the financial director include managing the firm's cash and credit, its financial planning and its capital expenditures. These activities are all related to the three general questions raised above, and the chapters ahead deal primarily with these issues. In addition the

Figure 1.1 A simplified organizational chart (the exact titles and organization differ from company to company)



financial director is responsible for the financial record keeping side of the company. This includes cost and financial accounting, and management information systems.

Financial Management Decisions

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

Capital Budgeting

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

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

The types of investment opportunities that would typically be considered depend in part on the nature of the firm's business. For example, for a large cement manufacturer such as Pretoria Portland Cement Company Ltd, deciding whether or not to open another cement kiln would be an important capital budgeting decision. Similarly, for a software company such as Oracle or Microsoft, the decision to develop and market a new spreadsheet package would be a major capital budgeting decision. Some decisions, such as what type of computer system to purchase, might not depend as much on the nature of the firm's business.

Regardless of the specific nature of an opportunity under consideration, financial managers must be concerned not only with how much cash they expect to receive, but also with when they expect to receive it and how likely they are to receive it. Evaluating the *size, timing* and *risk* of future cash flows is the essence

of capital budgeting. In fact, as we will see in the chapters ahead, whenever we evaluate a business decision, the size, timing and risk of the cash flows will be, by far, the most important things we will consider.

Capital Structure

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

The second question for the financial manager concerns ways in which the firm obtains and manages the long-term financing it needs to support its long-term investments. A firm's **capital structure** refers to the specific mixture of long-term debt and equity the firm uses to finance its operations. The financial manager has two concerns in this area. First, how much should the firm borrow; that is, what mixture of debt and equity is best? The mixture chosen will affect both the risk and value of the firm. Second, what are the least expensive sources of funds for the firm?

If we picture the firm as a pie, then the firm's capital structure determines how that pie is sliced. In other words, what percentage of the firm's cash flow goes to lenders and what percentage goes to shareholders? Firms have a great deal of flexibility in choosing a financial structure. Whether one structure is better than any other for a particular firm is at the heart of the capital structure issue.

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

Working Capital Management

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

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

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

Conclusion

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

Concept Questions

- 1.1a What is the capital budgeting decision?
- 1.1b What do you call the specific mixture of long-term debt and equity that a firm chooses to use?
- 1.1c Into what category of financial management does cash management fall?

1.2 Forms of Business Organization

Almost all large firms in South Africa, such as African Rainbow Minerals Ltd and Tiger Brands Ltd, are organized as companies. We examine four different legal forms of business organization – sole proprietorship, partnership, company and close corporation – to see why this is so. Each of the forms has distinct advantages and disadvantages in terms of the life of the business, its ability to raise cash and how it is taxed. A key observation is that, as a firm grows, the advantages of the company form may come to outweigh the disadvantages.

Sole Proprietorship

A **sole proprietorship** is a business owned by one person. This is the simplest type of business to start and is the least regulated form of organization. You can start up a proprietorship by doing little more than getting a trading licence and opening your doors. For this reason, there are more proprietorships than any other type of business and many businesses that later become large companies start out as small proprietorships.

sole proprietorship *A business owned by a single individual.*

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

The life of a sole proprietorship is limited to the owner's lifespan, and, importantly, the amount of equity that can be raised is limited to the proprietor's personal wealth. This limitation often means that the business cannot exploit new opportunities because of insufficient capital. Ownership of a sole proprietorship may be difficult to transfer since this requires the sale of the entire business to a new owner.

Partnership

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

partnership *A business formed by between two and twenty individuals or entities.*

The advantages and disadvantages of a partnership are basically the same as those for a proprietorship. Partnerships based on a relatively informal agreement are easy and inexpensive to form. The partnership terminates when a partner wishes to sell out or dies. All profits are taxed as personal income to the partners, and the amount of equity that can be raised is limited to the partners' combined wealth. Ownership by a partner is not easily transferred because a new partnership must be formed.

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

Company

The **company** (sometimes referred to as a *corporation*) is the most important form (in terms of size) of business organization in South Africa. A company is a legal 'person', separate and distinct from its owners, and has many of the rights, duties and privileges of an actual person. Companies can borrow money and own property, can sue and be sued and can enter into contracts. A company can even be a partner in a partnership, and a company can own shares in another company.

company *A business created as a distinct legal entity composed of one or more individuals or entities. Also known as a corporation.*

A new Companies Act (No 71 of 2008) came into operation in South Africa during 2011. It identifies two types of companies which may be incorporated. A company can either be a profit company or a non-profit company. A profit company is defined as a company incorporated for the purpose of financial gain for its shareholders.[1] A non-profit company is incorporated for public benefit – we will not deal with non-profit companies in this book.

Not surprisingly, starting a company is somewhat more complicated than starting the other forms of business organization. Formation of a company involves preparing a *memorandum of incorporation* which is a document that sets out the rights, duties and responsibilities of shareholders, directors and others within

[1] Profit companies can be (1) a state-owned company; (2) a private company (Proprietary Limited) if it is not state-owned and the Memorandum on Incorporation prohibits it from offering its securities to the public and restricts the transferability of its securities; (3) a personal liability company (Incorporated) if it meets the criteria for a private company and the Memorandum of Incorporation states that it is a personal liability company; (4) a public company (Limited) in any other case.

a company, and by which a company is incorporated in the Act. The memorandum of incorporation must be submitted to the appropriate regulatory agency, the Companies and Intellectual Property Commission.

In order to raise capital, a company issues shares to investors in the company who thus become shareholders (or members) of the company. In a large company, the shareholders and the managers are usually separate groups. The shareholders elect a board of directors who are responsible to the shareholders for the company. The directors then select the managers. Management is charged with the day-to-day running of the company's affairs in the shareholders' interests. In principle, shareholders control the company because they elect the directors.

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

The relative ease of transferring ownership, the limited liability for business debts and the unlimited life of the business are the reasons why the corporate form is superior when it comes to raising cash. If a company needs new equity, for example, it can sell new shares and attract new investors. The number of owners can be huge; larger companies have many thousands of shareholders. For example, Sanlam Ltd had 544 564 shareholders at the end of 2009. In such cases, ownership can change continuously without affecting the continuity of the business.

A company can be designated as a public company (in which case its name ends with the word Limited, abbreviated as Ltd),[2] or as a private company (its name ending with the words (Proprietary) Limited, abbreviated as (Pty) Ltd). A private company is precluded from offering its shares or debt securities to the general public. A public company must have at least seven shareholders and is able to raise capital from the public at large.

As the discussion in this section illustrates, the need of large businesses for outside investors and lenders is such that the corporate form will generally be the best for such firms. We focus on companies in the chapters ahead because of the importance of the corporate form. Also, a few important financial management issues such as dividend policy are unique to companies. However, businesses of all types and sizes need financial management, so the majority of the subjects we discuss relate to any form of business. We will often use the term *firm* to refer to a business when the form of corporate organization is unimportant to the topic under discussion.

Close Corporation

In 1984 a new legal form providing corporate personality for small businesses was introduced in South Africa with the passing of the Close Corporation Act of 1984. Its aim was to provide a simpler and less expensive legal form for the single entrepreneur or a few participants but at the same time retain the concepts of limited liability and continuity of ownership. Like a company, a **close corporation** is a legal person, existing separate from its owners who are called members. Its name must end with the letters 'CC'.

close corporation
A legal form of corporate personality designed for small businesses.

One of the effects of the new Companies Act 71of 2008, is the phasing-out of close corporations. Under the Act, the private company is designed to take the place of the close corporation. However, existing close corporations can elect to continue to exist until they are deregistered, dissolved or converted into a private company governed under the new Companies Act.

Concept Questions

1.2a What are the four forms of business organization?
1.2b What are the primary advantages and disadvantages of sole proprietorships and partnerships?
1.2c Why is the corporate form superior when it comes to raising cash?
1.2d Why was the close corporation established as a form of business organization?

[2] A number of larger companies (for example Anglo American plc) have elected to transfer their main stock exchange listing from the Johannesburg to the London Stock Exchange. This necessitated that they be incorporated in the United Kingdom. Such companies have the letters plc (public limited company) at the end of their names.

Mini-Case: Pearl's Bakery

In early 2007 Pearl Alstadt opened Pearl's Bakery in the up-and-coming suburb of Woodstock in Cape Town. Its specialities included pecan nut pie, melktert, lemon-meringue pie, carrot cake and chocolate-cheese cake. Pearl started the venture as an outside interest, and continued to work at her current job. She did all the baking, and soon asked her best friend Di to handle the marketing and distribution. With good product quality and a sound marketing plan, the bakery grew rapidly. In early 2012 it was featured in a widely distributed entrepreneurial magazine. Later that year the bakery was featured in *Gourmet Desserts*, a leading speciality food magazine. After the article appeared in *Gourmet Desserts*, sales exploded and the bakery began receiving orders from all over the province.

Because of the increased sales, Pearl left her other job. She hired additional workers to meet demand. Unfortunately, the fast growth experienced by the bakery led to cash flow and capacity problems. The bakery is currently producing as many cakes as possible with the assets it owns, but demand for its cakes is still growing. Further, Pearl has been approached by a national supermarket chain with a proposal to put four of her cakes in all of the chain's stores, and a national restaurant group has contacted her about selling Pearl's cakes in its restaurants. The restaurant would sell the cakes without a brand name.

Pearl operated the bakery as a sole proprietorship. She has approached you to help manage and direct the enterprise's growth. Specifically, she has asked you to answer the following questions.

1. What are the advantages and disadvantages of changing the form of organization from a sole proprietorship to a Pty Ltd Company?
2. What are the advantages and disadvantages of changing the form of organization from a sole proprietorship to a public company?
3. Ultimately, what action would you recommend the business undertake? Why?

1.3 The Goal of Financial Management

In order to make appropriate decisions in life, we need to have pre-defined goals. The same is true for businesses. So what might an appropriate goal be for a firm's financial manager? Assuming that we restrict ourselves to for-profit businesses, we might argue that the goal of financial management is to make money or add value for the owners. This goal is a little vague, of course, so we examine some different ways of formulating it in order to come up with a more precise definition. Such a definition is important because it leads to an objective basis for making and evaluating financial decisions.

Possible Goals

If we were to consider possible financial goals, we might come up with some ideas like the following:

- survive
- avoid financial distress and bankruptcy
- beat the competition
- maximize sales or market share
- minimize costs
- maximize profits
- maintain steady growth in profits.

These are only a few of the goals we could list. Furthermore, each of these possibilities presents problems as a goal for the financial manager.

For example, it's easy to increase market share or unit sales; all we have to do is lower our prices or relax our credit terms. Similarly, we can always cut costs simply by doing away with things such as research and development. We can avoid bankruptcy by never borrowing any money or never taking any risks, and so on. It's not clear that any of these actions are in the shareholders' best interests.

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

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

The goals we've listed above are all different, but they do tend to fall into two classes. The first of these relates to profitability. The goals involving sales, market share and cost control all relate, at least potentially, to different ways of earning or increasing profits. The second group, involving bankruptcy avoidance, stability and safety, relates in some way to controlling risk. Unfortunately, these two types of goals are somewhat contradictory. The pursuit of profit normally involves some element of risk, so it isn't really possible to maximize both safety and profit. What we need, therefore, is a goal that encompasses both factors.

The Goal of Financial Management

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

If we assume that shareholders buy shares because they seek to gain financially, then the answer is obvious: good decisions increase the value of the shares, and poor decisions decrease it.

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

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

The goal of maximizing the value of the shares avoids the problems associated with the different goals we listed above. There is no ambiguity in the criterion, and there is no short-run versus long-run issue. We explicitly mean that our goal is to maximize the *current* share value.

If this goal seems a little strong or one-dimensional to you, keep in mind that the shareholders in a company are residual owners. By this we mean that they are entitled only to what is left, after employees, suppliers, lenders and anyone else with a legitimate claim, are paid their due. If any of these groups go unpaid, the shareholders get nothing. So, if the shareholders are winning in the sense that the leftover, the residual portion, is growing, it must be true that everyone else is being satisfied as well.

Because the goal of financial management is to maximize the value of the shares, we need to learn how to identify those investments and financing arrangements that favourably impact the value of the shares. This is precisely what we will be studying. In fact, we could have defined corporate finance as the study of the relationship between business decisions and the value of the shares in the business.

A More General Goal

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

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

With this in mind, it doesn't matter whether the business is a proprietorship, a partnership or a company. For each of these, good financial decisions increase the market value of the owners' equity and poor financial decisions decrease it. In fact, although we choose to focus on companies in the chapters ahead, the principles we develop apply to all forms of business. Many of them even apply to the not-for-profit sector.

However many management decisions have social consequences. For example, developers of golf estates may ultimately cause a drop in the water table such that the surrounding community loses its supply of potable water? How can we reconcile such consequences with the goal of maximizing market value? In many instances the firm is not made to bear the social consequences of its corporate actions, but often managers have to make ethical decisions that may lead to a conflict between their responsibility to the firm's shareholders and the broader interests of society. Arguably many **stakeholders** have an interest in the decisions the firm makes.

stakeholder *Someone other than a shareholder or lender who potentially has a claim on the cash flows of the firm.*

Will the firm be better off in the long run taking stakeholder wealth maximization as its goal? Is it possible for financial managers to take into account all the firm's stakeholders – including employees, suppliers, customers and the community in which the firm operates? Can all the associated costs and benefits be quantified? How best can the competing interests of these diverse groups be reconciled? To whom will the managers be accountable?

Certainly, in cases such as that of golf estates, firms are aware of the social consequences and arguably wealth maximization may need to take second place to the broader interests of society at least from an ethical and moral standpoint. In the long-run firms need the goodwill of the society in which they operate, otherwise they will probably not be able to achieve their goal of long-term, shareholder wealth maximization.

Under the heading of Corporate Social Responsibility on its website, Virgin Active Health Clubs writes: 'Virgin Active is committed to being a responsible and contributing corporate citizen.' Virgin Active's strategy for community investment is therefore designed to enhance the relationships between the clubs and the communities in which they operate and be an added platform to communicate the brand values and vision to key stakeholders.

This commitment to good citizenship not only benefits the community, but obviously also creates an awareness of the Virgin Active brand, leading, hopefully, to increased membership and ultimately to enhanced value for Virgin Active's shareholders.

Finally, our goal does not imply that the financial manager should take illegal or unethical actions in the hope of increasing the value of the equity in the firm. What we mean is that the financial manager best serves the owners of the business by identifying goods and services that add value to the firm because they are desired and valued in the free marketplace.

Concept Questions

1.3a What is the goal of financial management?

1.3b What are some shortcomings of the goal of profit maximization?

1.3c Can you give a definition of corporate finance?

1.4 The Agency Problem and Control of the Firm

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

Agency Relationships

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

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

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

Management Goals

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

More generally, *agency costs* refer to the costs of the conflict of interest between shareholders and management. These costs can be indirect or direct. An indirect agency cost is a lost opportunity, such as the one we have just described.

Direct agency costs come in two forms. The first type is a corporate expenditure that benefits management but costs the shareholders. Perhaps the purchase of a luxurious and unneeded corporate jet would fall under this heading. The second type of direct agency cost is an expense that arises from the need to monitor management actions. Paying outside auditors to assess the accuracy of information in financial statements could be one example.

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

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

Do Managers Act in the Shareholders' Interests?

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

Managerial Compensation

Management will frequently have a significant economic incentive to increase share value for two reasons. First, managerial compensation, particularly at the top, is usually tied to financial performance in general and sometimes to share value in particular. For example, managers are frequently given the option to buy shares in the firm, usually at a bargain price. The more the share is worth, the more valuable is this option. In fact options are sometimes used to motivate employees of all types, not just top managers. If all employees are issued with share options, the entire workforce would have a stake in the firm's share price and may better align employee and shareholder interests.

The second incentive managers have relates to job prospects. Better performers within the firm will tend to get promoted. More generally, those managers who are successful in pursuing shareholder goals will be in greater demand in the labour market and thus command higher salaries.

In fact, managers who are successful in pursuing shareholder goals can reap enormous rewards. For example, the CEO of Shoprite Holdings Ltd, Whitey Basson earned R627,5 million in the 2010 financial year, after he exercised R594,5 million worth of share options. As of 6 April 2010 Larry Ellison, CEO of Oracle, was the US's highest paid company boss taking home $6 100 000 cash and $78 400 000 in shares and options.

Web note 2 Visit the ethics institute of South Africa at www.ethicsa.org

Control of the Firm

Control of the firm ultimately rests with shareholders. They elect the board of directors, who, in turn, hire and fire management.

An important mechanism by which unhappy shareholders in widely held firms can act to replace existing management is called a *proxy fight*. A proxy is the authority to vote someone else's shares. A proxy fight develops when a group solicits proxies in order to replace the existing board, and thereby replace existing management.

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

Conclusion

The available theory and evidence are consistent with the view that shareholders control the firm and that maximization of shareholder wealth is the relevant goal of the company. Even so, there will undoubtedly be times where management goals are pursued at the expense of the shareholders, at least temporarily.

Stakeholders

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

Taken together, these various groups are called **stakeholders** in the firm. In general, a stakeholder is someone other than a shareholder or creditor who potentially has a claim on the cash flows of the firm.

stakeholder
Someone other than a shareholder or lender who potentially has a claim on the cash flows of the firm.

Arguably many stakeholders have an interest in the decisions the firm makes. Management decisions do have social consequences. For example, oil companies seeking to extract oil from shale deposits in the Karoo (a process known as fracking) may ultimately cause pollution in the water table such that the surrounding community loses its supply of potable water. How can we reconcile such consequences with the goal of maximizing market value? In many instances the firm is not made to bear the social consequences of its corporate actions, but often managers have to make ethical decisions that may lead to a conflict between their responsibility to the firm's shareholders and the broader interests of society.

Will the firm be better off in the long-run taking stakeholder wealth maximization as its goal? Is it possible for financial managers to take into account all the firm's stakeholders – including employees, suppliers, customers and the community in which the firm operates? Can all the associated costs and benefits be quantified? How best can the competing interests of these diverse groups be reconciled? To whom will the managers be accountable? Certainly in cases such as that of fracking, firms are aware of the social consequences and arguably wealth maximization may need to take second place to the broader interests of society at least from an ethical and moral standpoint. In the long-run, firms need the goodwill of the society in which they operate, otherwise they will probably not be able to achieve their goal of long-term shareholder wealth maximization.

The King Reports

In 1992 the King Committee (chaired by former South African Supreme Court judge Mervyn King) was established with the specific aim of researching and making recommendations into corporate governance in South Africa. It reported in 1994. The report was developed to provide organizations and, in particular, the board of directors with guidance on good corporate governance practices. This report was followed by further reports in 2002 and 2009. These reports have become known as King I, II and III.

Web note 3 Go to the Institute of Directors website http://www.iodsa.co.za to read the King reports

The King I report was based on the notion that companies do not act independently from the broader society. The report suggested that a wide range of stakeholders' interests should be considered as they relate to the fundamental principles of good financial, social, ethical and environmental practice. King II was focused on introducing the idea of corporate citizenship and the exercise of the corporate governance function with due regard to the company's actions on people, planet, and profit. Some of the recommended practices of the King II report were incorporated into the Companies Act 71 of 2008 and some have become requirements for companies listed on the JSE.

The King III code emphasized the need for integrated sustainability reporting over and above simple financial reporting and is aimed at all entities regardless of the manner or form of incorporation or establishment. It is a voluntary code offering no statutory obligation on organisations to comply with the code. However, JSE regulations now require that all listed companies produce an integrated report of their social, environmental and economic performance along with their annual financial and sustainability reports. King III stipulates that the board is responsible for creating and sustaining an ethical corporate culture which is a key driver for an organization's continuing viability. Corporate citizenship is about doing business ethically and in a responsible manner which has become an intrinsic feature of sustainability.

Concept Questions

1.4a What is an agency relationship?

1.4b What are agency problems and how do they come about? What are agency costs?

1.4c What incentives do managers in large corporations have to maximize share value?

Small Firms

The goal of maximizing share value is only applicable to firms which are publicly traded. In South Africa, 406 companies were listed on the Johannesburg Stock Exchange at the end of 2010, whereas there were estimated to be about 300 000 small and medium-sized enterprises employing more than one person in the country.[3] Maximizing the value of the firm is an appropriate, although difficult-to-measure, objective for most of these small unlisted firms. Often the only time the owners of such firms are able to establish a value for their firms is when they offer the firm up for sale.

In many small businesses, ownership and management are not separated. In these circumstances, issues of agency do not apply, and there should be complete alignment between management actions and the interests of shareholders.[4]

A useful definition of a small business is one in which shares are not publicly traded, it is unlikely that the firm will list its equity on a stock exchange, and the owners are required to personally guarantee any borrowings of the firm. Thus, the financial concerns of these firms are very different from those of large companies. They have limited access to funds, they may have high debt ratios, since owners often put in their capital in the form of loan accounts. Owners are often not diversified, having most of their personal wealth tied up in their firms.

Small businesses may exist in order to provide income to the founding family and non-financial goals, such as 'being one's own boss', may be an important motivator of owner behaviour. This

[3] 1.0 million SMMEs in SA [Ntsika Enterprise Promotion Agency 'The State of Small Business Development in SA'. Annual Review 2002].

[4] Our discussion of small firm finance is drawn in part from *Small Firm Finance* by Oysteryoung, Newman and Davies, Dryden Press, 1997.

may, for example, override growth considerations, and new capital may not be introduced if it means dilution of control. Wealth maximization is thus not necessarily an appropriate objective of such small firms.

Much of the theory of corporate finance has developed around large listed companies, and the focus of this book is on the application of theory to achieve value creation through the firm's financial decisions. The principles we will be discussing in the coming chapters relating to the three main areas of concern of corporate finance apply equally to listed and unlisted firms, although it is often more difficult to apply these principles to unlisted firms because of the lack of appropriate market data.

We will, however, from time to time point out the challenges that arise when attempting to apply the theory to small firms, and how financial decisions may have to be made in this context. Look out for our 'Small Firm' boxes in the chapters that follow.

1.5 Financial Markets and the Corporation

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

Cash Flows to and from the Firm

The interplay between the company and the financial markets is illustrated in Figure 1.2. The arrows in Figure 1.2 trace the passage of cash from the financial markets to the firm and from the firm back to the financial markets. We use the term *securities* to refer to the various types of equity and debt that may be issued by a firm.

Suppose we start with the firm selling shares and borrowing money to raise cash. Cash flows to the firm from the financial market (A). The firm invests the cash in current and non-current assets (B). These assets generate cash (C), some of which goes to pay company taxes (D). After taxes are paid, some of the remaining cash flow is reinvested in the firm (E). The rest (F) goes back to the financial markets as cash paid to lenders (interest and repayment of capital) and shareholders (dividends).

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

Money versus Capital Markets

Financial markets can be classified as either **money markets** or **capital markets**. Short-term debt securities of many varieties are bought and sold in money markets. These short-term debt securities are often called money market instruments and are essentially IOUs. For example, bankers' acceptances represent short-term borrowing by large companies and are money market instruments. Treasury bills are an IOU of the government of South Africa.

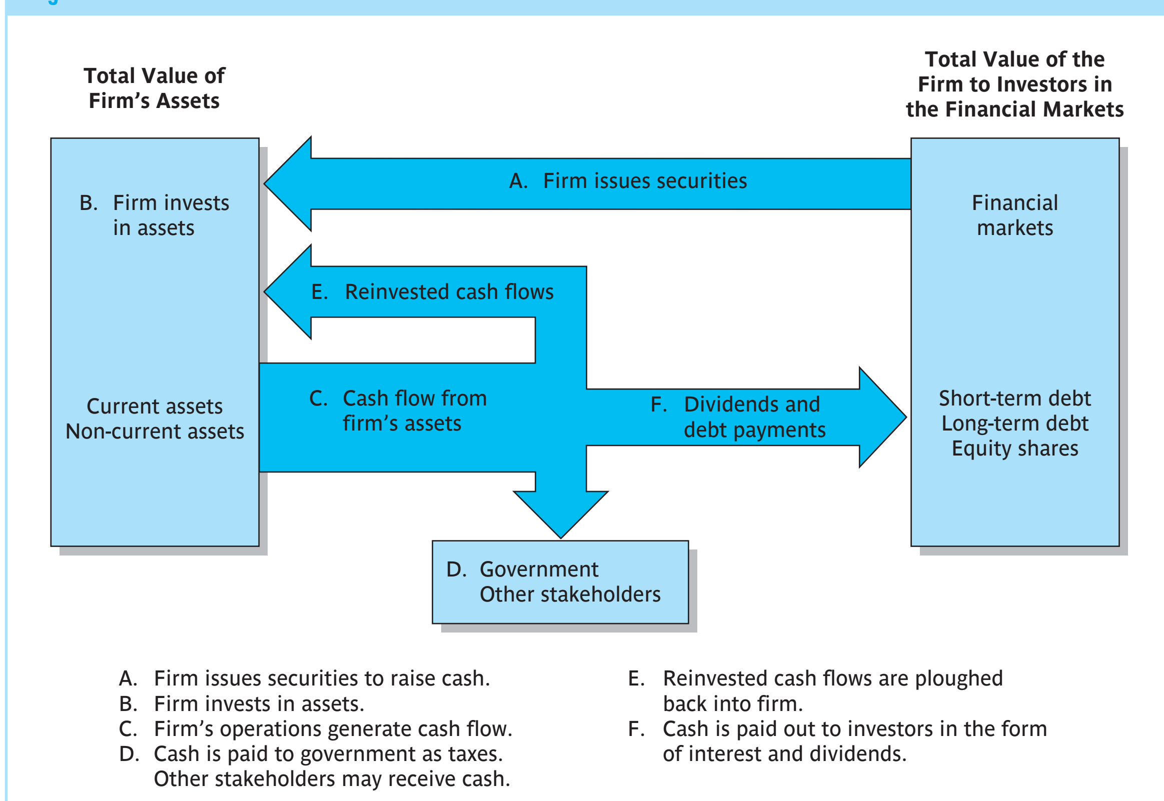
The main participants in the South African money markets are banks, other financial institutions and large companies. Their trading facilities are connected electronically via telephone and computer, so the money market has no actual physical location.

Capital markets are the markets for the raising and trading of securities of a long-term nature. Company shares are traded on a stock exchange, the JSE. Company and government bonds, the bonds of quasi-government institutions such as Eskom are traded on the interest rate division of the JSE.

money markets
Financial markets where short-term debt securities are bought and sold.

capital markets
Financial markets where long-term debt and equity securities are bought and sold.

Figure 1.2 Cash flows between the firm and the financial markets



Purchasers of such securities in the primary markets (see below) include insurance companies, pension funds, unit trusts, banks and the Public Investment Commissioners. These same institutions, in addition to the Reserve Bank and stockbrokers on the JSE, trade in the secondary capital markets.

Primary versus Secondary Markets

Financial markets function as both primary and secondary markets for debt and equity securities. The term 'primary market' refers to the original sale of securities by governments and companies. The secondary markets are where these securities are bought and sold after the original sale. Equities are, of course, issued solely by companies. Debt securities are issued both by governments and companies. In the following discussion, we focus only on corporate securities.

Primary Markets

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

By law, the prospectus that accompanies public offerings of debt and equity must be registered with the Companies and Intellectual Property Commission. Registration requires the firm to disclose a great deal of information before selling any securities. The accounting, legal and underwriting costs of public offerings can be considerable. Partly to avoid the various regulatory requirements and the expense of public offerings, debt and equity are often sold privately to large financial institutions such as life insurance companies.

Secondary Markets

A secondary market transaction involves one owner or lender selling to another. Therefore, the secondary markets provide the means for transferring ownership of corporate securities. The JSE is the largest stock exchange in Africa. The shares of over 400 companies are traded on the JSE using an automated trading system and all trades are executed electronically.

Listing Shares

Firms that trade on an organized exchange are said to be listed on that exchange. To be listed, firms must meet certain minimum criteria concerning, for example, asset size and number of shareholders. The equity shares of many of the large firms in South Africa trade on the JSE. Towards the end of 2010 the JSE was the world's 20th largest stock exchange ranked by market capitalization.

Web note 4 To learn more about the exchange, visit www.jse.co.za. Other major exchange websites include www.nyse.com, www.nasdaq.com, www.londonstockexchange.co.uk, www.euronext.com, www.tse.or.jp/english/

Concept Questions

1.5a Differentiate between the money and capital markets?
1.5b The JSE is both a primary and a secondary capital market. Explain.
1.5c What role do financial institutions play in the raising of capital?

1.6 Summary and Conclusions

This chapter has introduced you to some of the basic ideas in corporate finance. In it, we saw that:

1. Corporate finance has three main areas of concern:
   a. What long-term investments should the firm take? This is the capital budgeting decision.
   b. Where will the firm get the long-term financing to pay for its investments? In other words, what mixture of debt and equity should we use to fund our operations? This is the capital structure decision.
   c. How should the firm manage its everyday financial activities? This is the working capital decision.
2. The goal of financial management in a for-profit business is to make decisions that increase the value of the shares or, more generally, increase the market value of the equity.
3. The corporate form of organization is superior to other forms when it comes to raising money and transferring ownership interest, but is has the significant disadvantage of double taxation.
4. There is the possibility of conflicts between shareholders and management in a large company. We called these conflicts *agency problems* and discussed how they might be controlled and reduced.
5. The advantages of the corporate form are enhanced by the existence of financial markets. Financial markets function as both primary and secondary markets for corporate securities.

Of the topics we've discussed thus far, the most important is the goal of financial management: maximizing the value of the firm's shares. Throughout the text, as we analyse financial decisions, we always ask the same question: how does the decision under consideration affect the value of the equity?

Concepts Review and Critical Thinking Questions

1. **The Financial Management Decision Process [LO1]** What are the three types of financial management decisions? For each type of decision give an example of a business transaction that would be relevant.
2. **Sole Proprietorships and Partnerships [LO3]** What are the primary disadvantages to the sole proprietorship and partnership forms of business organization? What benefits are there to these types of business organization as opposed to the corporate form?
3. **Corporations [LO3]** What is the primary disadvantage of the corporate (or company) form of organization? Name at least two advantages of corporate organization.
4. **Corporate Finance Organization [LO4]** Describe the activities of the two distinct groups that report to the Financial Director in a large company.
5. **Goal of Financial Management [LO2]** What goal should always motivate the actions of the firm's financial manager?
6. **Agency Problems [LO6]** Who owns a company? Describe the process whereby the owners control the firm's management. What is the main reason that an agency relationship exists in the corporate form of organization? In this context, what kinds of problems can arise?
7. **Primary versus Secondary Markets [LO5]** You've probably noticed coverage in the financial press of the initial public offering (IPO) of a company's securities. Is an IPO a primary market transaction or a secondary market transaction?
8. **Money versus Capital Markets [LO5]** What is the main difference between securities traded on the money market and those traded in the bond market?
9. **Not-for-Profit Firm Goals [LO2]** Suppose you were the financial manager of a not-for-profit hospital. What kinds of goals do you think would be appropriate?
10. **Goal of the Firm [LO2]** Evaluate the following statement: 'Managers should not focus on the current share price because doing so will lead to an overemphasis on short-term profits at the expense of long-term profits.'
11. **Ethics and Firm Goals [LO2]** Can our goal of maximizing share value conflict with other goals such as avoiding unethical or illegal behaviour? In particular, do you think subjects like customer and employee safety, the environment, and the general good of society fit into this framework, or are they essentially ignored? Think of some specific scenarios to illustrate your answer.
12. **International Firm Goal [LO2]** Would our goal of maximizing share value be different if we were thinking about financial management in a foreign country? Why or why not?
13. **Agency Problems [LO4]** The Cape Town Philharmonic Orchestra is in desperate financial straits. It has lost its subsidy from government and is appealing to the corporate world for sponsorships in order to keep going. A company of which you are a shareholder announces it is providing the orchestra with R500 000 a year for the next five years. What is your reaction to this news?
14. **Agency Problems [LO4]** Suppose you own shares in a company. The current price per share is R25. Another company has just announced that it wants to buy your company and will pay R35 per share to acquire all the shares in issue. Your company's management immediately begins fighting off this hostile bid. Is management acting the shareholders' best interests? Why or why not?
15. **Agency Problems and Corporate Ownership [LO4]** Corporate ownership varies around the world. Historically, individuals have owned the majority of shares in public corporations in the US. In South Africa ownership is more often spread across institutions or concentrated in the hands of a majority shareholder. In Germany and Japan, banks, other financial institutions and large companies own most of the shares in public corporations. How do you think these differences in ownership affect the severity of agency costs in different countries?
16. **Executive Compensation [LO3]** Critics have charged that compensation to top management is simply too high and should be cut back. During 2010 we discovered that Whitey Basson, the Chief Executive of Shoprite Holdings Ltd, earned a remuneration package of R627,5 million which included the exercise of R594,5 million worth of share options. Larry Ellison of Oracle was one of the best compensated CEOs in the United States, earning about $84 million (about R630 million) in 2009. Are such amounts excessive? In answering, it might be helpful to recognize that superstar golfers such as Ernie Els, top entertainers such as Beyoncé and Oprah Winfrey, and many others at the top of their respective fields earn at least as much, if not a great deal more.

What's on the Web?

1.1 The Web is a great place to learn more about individual companies, and there are a slew of sites available to help you. Try pointing your web browser to www.moneyweb.co.za for South African information and to http://finance.yahoo.com for data on US companies. There is a lot of information there and lots of links to explore so put on your explorer's hat and have a look. By the end of your finance course, we hope it will all make sense to you.

When you have read this chapter, log on to the Online Learning Centre website at ***www.mcgraw-hill.co.uk/textbooks/firer*** to explore chapter-by-chapter test questions, further reading and more online study tools.