Introduction

Striking the Right Balance

In 1776, Adam Smith described how an “invisible hand” guides companies as they strive for profits, and that hand leads them to decisions that benefit society. Smith’s insights led him to conclude that profit maximization is the right goal for a business and that the free enterprise system is best for society. But the world has changed since 1776. Firms today are much larger, they operate globally, they have thousands of employees, and they are owned by millions of stockholders. This makes us wonder if the “invisible hand” still provides reliable guidance: Should companies still try to maximize profits, or should they take a broader view and more balanced actions designed to benefit customers, employees, suppliers, and society as a whole?

Many academics and finance professionals today subscribe to the following modified version of Adam Smith’s theory:

A firm’s principal financial goal should be to maximize the wealth of its stockholders, which means maximizing the value of its stock.

Free enterprise is still the best economic system for society as a whole. Under the free enterprise framework, companies develop products and services that people want and that benefit society.

However, some constraints are needed—firms should not be allowed to pollute the air and water, to engage in unfair employment practices, or to create monopolies that exploit consumers.

These constraints take a number of different forms. The first set of constraints is the costs that are assessed on companies if they take actions that harm society. Another set of constraints arises through the political process, where society imposes a wide range of regulations that are designed to keep companies from engaging in harmful practices. Properly imposed, these costs fairly transfer value to suffering parties and help create incentives that help prevent similar events from occurring in the future.

The financial crisis in 2007 and 2008 dramatically illustrates these points. We witnessed many Wall Street firms engaging in extremely risky activities that pushed the financial system to the brink of collapse. Saving the financial system required a bailout of the banks and other financial companies, and that bailout imposed huge costs on taxpayers and helped push the economy into a deep recession. Apart from the huge costs imposed on society, the financial firms also paid a heavy price—a number of leading financial institutions saw a huge drop in their stock price, some failed and went out of business, and many Wall Street executives lost their jobs.

Arguably, these costs are not enough to prevent another financial crisis from occurring. Many maintain that the events surrounding the financial crisis illustrate that markets don’t always work the way they should and that there is a need for stronger regulation of the financial sector. For example, in his recent books, Nobel Laureate Joseph Stiglitz makes a strong case for enhanced regulation. At the same time, others with a different political persuasion continue to express concerns about the costs of excessive regulation.

Beyond the financial crisis, there is a broader question of whether laws and regulations are enough to compel firms to act in society’s interest. An increasing number of companies continue to recognize the need to maximize shareholder value, but they also see their mission as more than just making money for shareholders. Google’s parent company Alphabet’s motto is “Do the right thing—follow the law, act honorably, and treat each other with respect.” Consistent with this mission, the company has its own in-house foundation that each year makes large investments in a wide range of philanthropic ventures worldwide.

Microsoft is another good example of a company that has earned a reputation for taking steps to be socially responsible. The company recently released its 2019 Corporate Social Responsibility Report. In an accompanying letter to shareholders, Microsoft CEO Satya Nadella highlighted its broader mission:

Our mission to empower every person and every organization on the planet to achieve more has never been more important. At a time when many are calling attention to the role technology plays in society broadly, our mission remains constant. It grounds us in the enormous opportunity and responsibility we have to ensure that the technology we create always benefits everyone on the planet, including the planet itself. Our platforms and tools help make small businesses more productive, multinationals more competitive, nonprofits more effective, and governments more efficient. They improve healthcare and education outcomes, amplify human ingenuity, and allow people everywhere to reach higher.

Similarly, the Business Roundtable, a group of leading business executives, made news in 2019 when it put out a statement indicating that companies should explicitly account for the broader interests of stakeholders, not just focus exclusively on shareholders.

While many companies and individuals have taken very significant steps to demonstrate their commitments to being socially responsible, corporate managers frequently face a tough balancing act. Realistically, there will still be cases where companies face conflicts between their various constituencies—for example, a company may enhance shareholder value by laying off some workers, or a change in policy may improve the environment but reduce shareholder value. We also have seen examples where leading tech companies such as Facebook and Google have come under fire for their handling of their users’ private information. In each of these instances, managers have to balance these competing interests and different managers will clearly make different choices. More recently, virtually every organization has faced considerable pressure trying to manage their various constituencies in the midst of the massive personal and economic dislocation resulting from the coronavirus pandemic. At the end of the day, all companies struggle to find the right balance. Enlightened managers recognize that there is more to life than money, but it often takes money to do good things.

Sources: “Microsoft 2019 Corporate Social Responsibility Report,” microsoft.com/en-us/corporate-responsibility/reports-hub, October 16, 2019; “Microsoft 2019 Annual Report,” microsoft.com/investor/reports/ar19/index.html, October 16, 2019; “Business Roundtable Redefines the Purpose of a Corporation to Promote ‘An Economy That Serves All Americans,’” businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans, August 19, 2019; Kevin J. Delaney, “Google: From ‘Don’t Be Evil’ to How to Do Good,” The Wall Street Journal, January 18, 2008, pp. B1–B2; Joseph E. Stiglitz, FreeFall: America, Free Markets, and the Sinking of the World Economy (New York: W.W. Norton, 2010); and Joseph E. Stiglitz, The Price of Inequality (New York: W.W. Norton, 2012).

 Putting Things in Perspective

This chapter will give you an idea of what financial management is all about. We begin the chapter by describing how finance is related to the overall business environment, by pointing out that finance prepares students for jobs in different fields of business, and by discussing the different forms of business organization. For corporations, management’s goal should be to maximize shareholder wealth, which means maximizing the value of the stock. When we say “maximizing the value of the stock,” we mean the “true, long-run value,” which may be different from the current stock price. In the chapter, we discuss how firms must provide the right incentives for managers to focus on long-run value maximization. Good managers understand the importance of ethics, and they recognize that maximizing long-run value is consistent with being socially responsible.

When you finish this chapter, you should be able to do the following:

Explain the role of finance and the different types of jobs in finance.

Identify the advantages and disadvantages of different forms of business organization.

Explain the links between stock price, intrinsic value, and executive compensation.

Identify the potential conflicts that arise within the firm between stockholders and managers and between stockholders and bondholders, and discuss the techniques that firms can use to mitigate these potential conflicts.

Discuss the importance of business ethics and the consequences of unethical behavior.

1-1. What Is Finance?

Finance is defined by Webster’s Dictionary as “the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of banking facilities.” Finance has many facets, which makes it difficult to provide one concise definition. The discussion in this section will give you an idea of what finance professionals do and what you might do if you enter the finance field after you graduate.

1-1A. Areas of Finance

Finance as taught in universities is generally divided into three areas:

(1)

financial management,

(2)

capital markets, and

(3)

investments.

Financial management, also called corporate finance, focuses on decisions relating to how much and what types of assets to acquire, how to raise the capital needed to purchase assets, and how to run the firm so as to maximize its value. The same principles apply to both for-profit and not-for-profit organizations, and as the title suggests, much of this book is concerned with financial management.

Capital markets relate to the markets where interest rates, along with stock and bond prices, are determined. Also studied here are the financial institutions that supply capital to businesses. Banks, investment banks, stockbrokers, mutual funds, insurance companies, and the like bring together “savers” who have money to invest and businesses, individuals, and other entities that need capital for various purposes. Governmental organizations such as the Federal Reserve System, which regulates banks and controls the supply of money, and the Securities and Exchange Commission (SEC), which regulates the trading of stocks and bonds in public markets, are also studied as part of capital markets.

Investments relate to decisions concerning stocks and bonds and include a number of activities:

(1)

Security analysis deals with finding the proper values of individual securities (i.e., stocks and bonds).

(2)

Portfolio theory deals with the best way to structure portfolios, or “baskets,” of stocks and bonds. Rational investors want to hold diversified portfolios in order to limit risks, so choosing a properly balanced portfolio is an important issue for any investor.

(3)

Market analysis deals with the issue of whether stock and bond markets at any given time are “too high,” “too low,” or “about right.”

Included in market analysis is behavioral finance, where investor psychology is examined in an effort to determine whether stock prices have been bid up to unreasonable heights in a speculative bubble or driven down to unreasonable lows in a fit of irrational pessimism.

Although we separate these three areas, they are closely interconnected. Banking is studied under capital markets, but a bank lending officer evaluating a business’ loan request must understand corporate finance to make a sound decision. Similarly, a corporate treasurer negotiating with a banker must understand banking if the treasurer is to borrow on “reasonable” terms. Moreover, a security analyst trying to determine a stock’s true value must understand corporate finance and capital markets to do his or her job. In addition, financial decisions of all types depend on the level of interest rates; so all people in corporate finance, investments, and banking must know something about interest rates and the way they are determined. Because of these interdependencies, we cover all three areas in this book.

1-1B. Finance within an Organization

 The duties of the CFO have broadened over the years. CFO magazine’s online service, cfo.com, is an excellent source of timely finance articles intended to help the CFO manage those new responsibilities.

Most businesses and not-for-profit organizations have an organization chart similar to the one shown in Figure 1.1. The board of directors is the top governing body, and the chairperson of the board is generally the highest-ranking individual. The chief executive officer (CEO) comes next, but note that the chairperson of the board often also serves as the CEO. Below the CEO comes the chief operating officer (COO), who is often also designated as a firm’s president. The COO directs the firm’s operations, which include marketing, manufacturing, sales, and other operating departments. The chief financial officer (CFO), who is generally a senior vice president and the third-ranking officer, is in charge of accounting, finance, credit policy, decisions regarding asset acquisitions, and investor relations, which involves communications with stockholders and the press.

Figure 1.1 Finance within the Organization

Details

If the firm is publicly owned, the CEO and the CFO must both certify to the SEC that reports released to stockholders, and especially the annual report, are accurate. If inaccuracies later emerge, the CEO and the CFO could be fined or even jailed. This requirement was instituted in 2002 as a part of the Sarbanes-Oxley Act. The act was passed by Congress in the wake of a series of corporate scandals involving now-defunct companies such as Enron and WorldCom, where investors, workers, and suppliers lost billions of dollars due to false information released by those companies.

1-1C. Finance versus Economics and Accounting

Finance, as we know it today, grew out of economics and accounting. Economists developed the notion that an asset’s value is based on the future cash flows the asset will provide, and accountants provided information regarding the likely size of those cash flows. People who work in finance need knowledge of both economics and accounting. Figure 1.1 illustrates that in the modern corporation, the accounting department typically falls under the control of the CFO. This further illustrates the link among finance, economics, and accounting.

SelfTest

What three areas of finance does this book cover? Are these areas independent of one another, or are they interrelated in the sense that someone working in one area should know something about each of the other areas? Explain.

Who is the CFO, and where does this individual fit into the corporate hierarchy? What are some of his or her responsibilities?

Does it make sense for not-for-profit organizations such as hospitals and universities to have CFOs? Why or why not?

What is the relationship among economics, finance, and accounting?

1-2. Jobs in Finance

 To find information about different finance careers, go to allbusinessschools.com/business-careers/finance/job-description. This website provides information about different finance areas.

Finance prepares students for jobs in banking, investments, insurance, corporations, and government. Accounting students need to know marketing, management, and human resources; they also need to understand finance, for it affects decisions in all those areas. For example, marketing people propose advertising programs, but those programs are examined by finance people to judge the effects of the advertising on the firm’s profitability. So to be effective in marketing, one needs to have a basic knowledge of finance. The same holds for management—indeed, most important management decisions are evaluated in terms of their effects on the firm’s value.

It is also worth noting that finance is important to individuals regardless of their jobs. Some years ago most employees received pensions from their employers upon retirement, so managing one’s personal investments was not critically important. That’s no longer true. Most firms today provide “defined contribution” pension plans, where each year the company puts a specified amount of money into an account that belongs to the employee. The employee must decide how those funds are to be invested—how much should be divided among stocks, bonds, or money funds—and how much risk they’re willing to take with their stock and bond investments. These decisions have a major effect on people’s lives, and the concepts covered in this book can improve decision-making skills.

1-3. Forms of Business Organization

 efinancialcareers.com provides finance career news and advice including information on who’s hiring in finance and accounting fields.

The basics of financial management are the same for all businesses, large or small, regardless of how they are organized. Still, a firm’s legal structure affects its operations and thus should be recognized. There are four main forms of business organizations:

(1)

proprietorships,

(2)

partnerships,

(3)

corporations, and

(4)

limited liability companies (LLCs) and limited liability partnerships (LLPs).

In terms of numbers, most businesses are proprietorships. However, based on the dollar value of sales, more than 80% of all business is done by corporations. Because corporations conduct the most business and because most successful businesses eventually convert to corporations, we focus on them in this book. Still, it is important to understand the legal differences between types of firms.

A proprietorship is an unincorporated business owned by one individual. Going into business as a sole proprietor is easy—a person begins business operations. Proprietorships have three important advantages:

(1)

They are easy and inexpensive to form,

(2)

they are subject to few government regulations, and

(3)

they are subject to lower income taxes than are corporations.

However, proprietorships also have three important limitations:

(1)

Proprietors have unlimited personal liability for the business’ debts, so they can lose more than the amount of money they invested in the company. You might invest $10,000 to start a business but be sued for

$

1

million

 if, during company time, one of your employees runs over someone with a car.

(2)

The life of the business is limited to the life of the individual who created it, and to bring in new equity, investors require a change in the structure of the business.

(3)

Because of the first two points, proprietorships have difficulty obtaining large sums of capital; hence, proprietorships are used primarily for small businesses.

However, businesses are frequently started as proprietorships and then converted to corporations when their growth results in the disadvantages outweighing the advantages.

A partnership is a legal arrangement between two or more people who decide to do business together. Partnerships are similar to proprietorships in that they can be established relatively easily and inexpensively. Moreover, the firm’s income is allocated on a pro rata basis to the partners and is taxed on an individual basis. This allows the firm to avoid the corporate income tax. However, all of the partners are generally subject to unlimited personal liability, which means that if a partnership goes bankrupt and any partner is unable to meet his or her pro rata share of the firm’s liabilities, the remaining partners will be responsible for making good on the unsatisfied claims. Thus, the actions of a Texas partner can bring ruin to a millionaire New York partner who had nothing to do with the actions that led to the downfall of the company. Unlimited liability makes it difficult for partnerships to raise large amounts of capital.

A corporation is a legal entity created by a state, and it is separate and distinct from its owners and managers. It is this separation that limits stockholders’ losses to the amount they invested in the firm—the corporation can lose all of its money, but its owners can lose only the funds that they invested in the company. Corporations also have unlimited lives, and it is easier to transfer shares of stock in a corporation than one’s interest in an unincorporated business. These factors make it much easier for corporations to raise the capital necessary to operate large businesses. Thus, companies such as Hewlett-Packard and Microsoft generally begin as proprietorships or partnerships, but at some point they find it advantageous to become a corporation.

A major drawback to corporations is taxes. Most corporations’ earnings are subject to double taxation—the corporation’s earnings are taxed, and then when its after-tax earnings are paid out as dividends, those earnings are taxed again as personal income to the stockholders. However, as an aid to small businesses, Congress created S Corporations, which are taxed as if they were proprietorships or partnerships; thus, they are exempt from the corporate income tax. To qualify for S corporation status, a firm can have no more than 100 stockholders, which limits their use to relatively small, privately owned firms. Larger corporations are known as C corporations. The vast majority of small corporations elect S status and retain that status until they decide to sell stock to the public, at which time they become C corporations.

A limited liability company (LLC) is a popular type of organization that is a hybrid between a partnership and a corporation. A limited liability partnership (LLP) is similar to an LLC. LLPs are used for professional firms in the fields of accounting, law, and architecture, while LLCs are used by other businesses. Similar to corporations, LLCs and LLPs provide limited liability protection, but they are taxed as partnerships. Further, unlike limited partnerships, where the general partner has full control of the business, the investors in an LLC or LLP have votes in proportion to their ownership interest. LLCs and LLPs have been gaining in popularity in recent years, but large companies still find it advantageous to be C corporations because of the advantages in raising capital to support growth. LLCs/LLPs were dreamed up by lawyers; they are often structured in very complicated ways, and their legal protections often vary by state. So it is necessary to hire a good lawyer when establishing one.

When deciding on its form of organization, a firm must trade off the advantages of incorporation against double taxation. However, for the following reasons, the value of any business other than a relatively small one will probably be maximized if it is organized as a corporation:

Limited liability reduces the risks borne by investors, and, other things held constant, the lower the firm’s risk, the higher its value.

A firm’s value is dependent on its growth opportunities, which are dependent on its ability to attract capital. Because corporations can attract capital more easily than other types of businesses, they are better able to take advantage of growth opportunities.

The value of an asset also depends on its liquidity, which means the time and effort it takes to sell the asset for cash at a fair market value. Because the stock of a corporation is easier to transfer to a potential buyer than is an interest in a proprietorship or partnership and because more investors are willing to invest in stocks than in partnerships (with their potential unlimited liability), a corporate investment is relatively liquid. This too enhances the value of a corporation.

SelfTest

What are the key differences among proprietorships, partnerships, and corporations?

How are LLCs and LLPs related to the other forms of organization?

What is an S corporation, and what is its advantage over a C corporation? Why don’t firms such as IBM, GE, and Microsoft choose S corporation status?

What are some reasons why the value of a business other than a small one is generally maximized when it is organized as a corporation?

1-4. The Main Financial Goal: Creating Value for Investors

In public corporations, managers and employees work on behalf of the shareholders who own the business, and therefore they have an obligation to pursue policies that promote stockholder value. While many companies focus on maximizing a broad range of financial objectives, such as growth, earnings per share, and market share, these goals should not take precedence over the main financial goal, which is to create value for investors. Keep in mind that a company’s stockholders are not just an abstract group—they represent individuals and organizations who have chosen to invest their hard-earned cash into the company and who are looking for a return on their investment in order to meet their long-term financial goals, which might be saving for retirement, a new home, or a child’s education. In addition to financial goals, the firm also has nonfinancial goals, which we will discuss in Section 1-7.

If a manager is to maximize stockholder wealth, he or she must know how that wealth is determined. Throughout this book, we shall see that the value of any asset is the present value of the stream of cash flows that the asset provides to its owners over time. We discuss stock valuation in depth in Chapter 9, where we see that stock prices are based on cash flows expected in future years, not just in the current year. Thus, stock price maximization requires us to take a long-run view of operations. At the same time, managerial actions that affect a company’s value may not immediately be reflected in the company’s stock price.

1-4A. Determinants of Value

Figure 1.2 illustrates the situation. The top box indicates that managerial actions, combined with the economy, taxes, and political conditions, influence the level and riskiness of the company’s future cash flows, which ultimately determine the company’s stock price. As you might expect, investors like higher expected cash flows, but they dislike risk; so the larger the expected cash flows and the lower the perceived risk, the higher the stock’s price.

Figure 1.2 Determinants of Intrinsic Values and Stock Prices

Details

The second row of boxes differentiates what we call “true” expected cash flows and “true” risk from “perceived” cash flows and “perceived” risk. By “true,” we mean the cash flows and risk that investors would expect if they had all of the information that existed about a company. “Perceived” means what investors expect, given the limited information they have. To illustrate, in early 2001, investors had information that caused them to think Enron was highly profitable and would enjoy high and rising future profits. They also thought that actual results would be close to the expected levels and hence that Enron’s risk was low. However, true estimates of Enron’s profits, which were known by its executives but not the investing public, were much lower; Enron’s true situation was extremely risky.

The third row of boxes shows that each stock has an intrinsic value, which is an estimate of the stock’s “true” value as calculated by a competent analyst who has the best available data, and a market price, which is the actual market price based on perceived but possibly incorrect information as seen by the marginal investor. Not all investors agree, so it is the “marginal” investor who determines the actual price.

When a stock’s actual market price is equal to its intrinsic value, the stock is in equilibrium, which is shown in the bottom box in Figure 1.2. When equilibrium exists, there is no pressure for a change in the stock’s price. Market prices can—and do—differ from intrinsic values; eventually, however, as the future unfolds, the two values tend to converge.

1-4B. Intrinsic Value

Actual stock prices are easy to determine—they can be found on the Internet and are published in newspapers every day. However, intrinsic values are estimates, and different analysts with different data and different views about the future form different estimates of a stock’s intrinsic value. Indeed, estimating intrinsic values is what security analysis is all about and is what distinguishes successful from unsuccessful investors. Investing would be easy, profitable, and essentially riskless if we knew all stocks’ intrinsic values—but, of course, we don’t. We can estimate intrinsic values, but we can’t be sure that we are right. A firm’s managers have the best information about the firm’s future prospects, so managers’ estimates of intrinsic values are generally better than those of outside investors. However, even managers can be wrong.

Figure 1.3 graphs a hypothetical company’s actual price and intrinsic value as estimated by its management over time. The intrinsic value rises because the firm retains and reinvests earnings each year, which tends to increase profits. The value jumped dramatically in Year 20, when a research and development (R&D) breakthrough raised management’s estimate of future profits before investors had this information. The actual stock price tended to move up and down with the estimated intrinsic value, but investor optimism and pessimism, along with imperfect knowledge about the true intrinsic value, led to deviations between the actual prices and intrinsic values.

Figure 1.3 Graph of Actual Prices versus Intrinsic Values

Details

Intrinsic value is a long-run concept. Management’s goal should be to take actions designed to maximize the firm’s intrinsic value, not its current market price. Note, though, that maximizing the intrinsic value will maximize the average price over the long run but not necessarily the current price at each point in time. For example, management might make an investment that lowers profits for the current year but raises expected future profits. If investors are not aware of the true situation, the stock price will be held down by the low current profit even though the intrinsic value was actually raised. Management should provide information that helps investors make better estimates of the firm’s intrinsic value, which will keep the stock price closer to its equilibrium level. However, there are times when management cannot divulge the true situation because doing so would provide information that helps its competitors.

1-4C. Consequences of Having a Short-Run Focus

Ideally, managers adhere to this long-run focus, but there are numerous examples in recent years where the focus for many companies shifted to the short run. Perhaps most notably, prior to the recent financial crisis, many Wall Street executives received huge bonuses for engaging in risky transactions that generated short-term profits. Subsequently, the value of these transactions collapsed, causing many of these Wall Street firms to seek a massive government bailout.

Apart from the recent problems on Wall Street, there have been other examples where managers have focused on short-run profits to the detriment of long-term value. For example, Wells Fargo implemented incentives to reward employees for signing up customers to new accounts. Unfortunately, to obtain bonuses some employees created fake accounts or signed up customers for unauthorized credit cards. This led to the firing of thousands of employees, as well as its CEO and other senior managers, and millions of dollars in fines for Wells Fargo. In addition, the Fed has limited Wells Fargo’s growth so total assets are no greater than the year end 2017 total until the bank repairs its culture and cleans up its act. On February 21, 2020, Wells Fargo agreed to pay $3 billion to settle claims, including

$

500

million

 that will be returned to investors. Wells Fargo has eliminated all product-based sales goals, restructured its compensation, and strengthened customer consent and oversight systems. With these types of concerns in mind, many academics and practitioners stress the need for boards and directors to establish effective procedures for corporate governance. This involves putting in place a set of rules and practices to ensure that managers act in shareholders’ interests while also balancing the needs of other key constituencies such as customers, employees, and affected citizens. Having a strong, independent board of directors is viewed as an important component of strong governance.

Effective governance requires holding managers accountable for poor performance and understanding the important role that executive compensation plays in encouraging managers to focus on the proper objectives. For example, if a manager’s bonus is tied solely to this year’s earnings, it would not be a surprise to discover that the manager took steps to pump up current earnings—even if those steps were detrimental to the firm’s long-run value. With these concerns in mind, a growing number of companies have used stock and stock options as a key part of executive pay. The intent of structuring compensation in this way is for managers to think more like stockholders and to continually work to increase shareholder value.

Despite the best of intentions, stock-based compensation does not always work as planned. To give managers an incentive to focus on stock prices, stockholders (acting through boards of directors) awarded executives stock options that could be exercised on a specified future date. An executive could exercise the option on that date, receive stock, immediately sell it, and earn a profit. The profit was based on the stock price on the option exercise date, which led some managers to try to maximize the stock price on that specific date, not over the long run. That, in turn, led to some horrible abuses. Projects that looked good from a long-run perspective were turned down because they would penalize profits in the short run and thus lower the stock price on the option exercise day. Even worse, some managers deliberately overstated profits, temporarily boosted the stock price, exercised their options, sold the inflated stock, and left outside stockholders “holding the bag” when the true situation was revealed.

SelfTest

What’s the difference between a stock’s current market price and its intrinsic value?

Do stocks have known and “provable” intrinsic values, or might different people reach different conclusions about intrinsic values? Explain.

Should managers estimate intrinsic values or leave that to outside security analysts? Explain.

If a firm could maximize either its current market price or its intrinsic value, what would stockholders (as a group) want managers to do? Explain.

Should a firm’s managers help investors improve their estimates of the firm’s intrinsic value? Explain.

1-5. Stockholder–Manager Conflicts

It has long been recognized that managers’ personal goals may compete with shareholder wealth maximization. In particular, managers might be more interested in maximizing their own wealth than their stockholders’ wealth; therefore, managers might pay themselves excessive salaries.

Effective executive compensation plans motivate managers to act in their stockholders’ best interests. Useful motivational tools include

(1)

reasonable compensation packages,

(2)

firing of managers who don’t perform well, and

(3)

the threat of hostile takeovers.

1-5A. Compensation Packages

Compensation packages should be sufficient to attract and retain able managers, but they should not go beyond what is needed. Compensation policies need to be consistent over time. Also, compensation should be structured so that managers are rewarded on the basis of the stock’s performance over the long run, not the stock’s price on an option exercise date. This means that options (or direct stock awards) should be phased in over a number of years so that managers have an incentive to keep the stock price high over time. When the intrinsic value can be measured in an objective and verifiable manner, performance pay can be based on changes in intrinsic value. However, because intrinsic value is not observable, compensation must be based on the stock’s market price—but the price used should be an average over time rather than on a specific date.

Are CEOs Overpaid?

The Wall Street Journal regularly evaluates the total compensation of large company CEOs. In a recent report, they found that the median executive in their sample of 143 top CEOs received total compensation of

$

13

million

 in 2019 (up from

$

11.2

million

 in 2018). The total compensation for a top CEO typically includes salary, bonuses, and long-term incentives such as stock options. Many of these stock options became quite valuable in the wake of the stock market’s strong performance in 2019.

Companies have long faced media scrutiny and investor questions about excessive compensation. Frequently, top executives earn many times more than their firm’s average employees, which has fueled continued concerns about income inequality. Recognizing these concerns, the coronavirus pandemic has spurred many companies to restructure their compensation packages. Nearly 600 companies in the Russell 3000 index have cut their top executives’ pay, while 102 S&P 500 companies have reduced CEO base salaries. For some, the pay reductions are for a few months, while for others the reductions are through year end. How boards change performance measures and goals for 2020 executive compensation packages remains to be seen; however, these cuts to executive cash salaries represent a shift from prior economic downturns.

Leaving aside these concessions, average compensation levels are significantly higher than they were a decade or two ago. The large shifts in CEO compensation over time can often be attributed to the increased importance of stock options. On the plus side, stock options provide CEOs with a powerful incentive to raise their companies’ stock prices. Indeed, most observers believe there is a strong causal relationship between CEO compensation procedures and stock price performance.

Other critics argue that although performance incentives are entirely appropriate as a method of compensation, the overall level of CEO compensation is just too high. The critics ask such questions as these: Would these CEOs have been unwilling to take their jobs if they had been offered only half as many stock options? Would they have put forth less effort, and would their firms’ stock prices have not increased as much? It is hard to say. Other critics lament that the exercise of stock options not only has dramatically increased the compensation of truly excellent CEOs but has also dramatically increased the compensation of some pretty average CEOs, who were lucky enough to have had the job during a stock market boom that raised the stock prices of even poorly performing companies. In addition, huge CEO salaries are widening the gap between top executives and middle management salaries, leading to employee discontent and declining employee morale and loyalty.

Stock returns and corporate financial results are only two factors impacting CEO pay. The correlation between executive compensation and firm performance is not always strong. Other factors that influence CEO pay are the size of the firm (larger companies pay their CEOs more) and the type of industry (energy companies pay their CEOs more).

Sources: Inti Pacheco, “Coronavirus Caps Years of Rich Pay for Many CEOs,” The Wall Street Journal (wsj.com), March 23, 2020; Chip Cutter and Theo Francis, “Coronavirus Crisis Dents Salaries, Not Stock Awards, for Many CEOs,” The Wall Street Journal (wsj.com), June 3, 2020; Louis Lavelle, Frederick F. Jespersen, and Michael Arndt, “Executive Pay,” BusinessWeek, April 15, 2002, pp. 80–86; Jason Zweig, “A Chance to Veto a CEO’s Bonus,” The Wall Street Journal (wsj.com), January 29, 2011; and Emily Chasan, “Early Say-On-Pay Results Show Rising Support, Few Failures,” The Wall Street Journal (wsj.com), April 2, 2014.

1-5B. Direct Stockholder Intervention

Years ago most stock was owned by individuals. Today, however, the majority of stock is owned by institutional investors such as insurance companies, pension funds, hedge funds, and mutual funds, and private equity groups are ready and able to step in and take over underperforming firms. These institutional money managers have the clout to exercise considerable influence over firms’ operations. Given their importance, they have access to managers and can make suggestions about how the business should be run. In effect, institutional investors such as CalPERS (California Public Employees’ Retirement System, with about $330 billion of assets) and TIAA-CREF (Teachers Insurance and Annuity Association-College Retirement Equities Fund, a retirement plan originally set up for professors at private colleges that now has more than $1,059 billion of assets under management) act as lobbyists for the body of stockholders. When such large stockholders speak, companies listen. For example, Coca-Cola Co. revised its compensation package after hearing negative feedback from its largest stockholder, Warren Buffett.

At the same time, any shareholder who has owned $2,000 of a company’s stock for 1 year can sponsor a proposal that may be voted on at the annual stockholders’ meeting, even if management opposes the proposal. Although shareholder-sponsored proposals are nonbinding, the results of such votes are heard by top management.

There has been an ongoing debate regarding how much influence shareholders should have through the proxy process. As a result of the passage of the Dodd-Frank Act, the SEC was given authority to make rules regarding shareholder access to company proxy materials. On August 25, 2010, the SEC adopted changes to federal proxy rules to give shareholders the right to nominate directors to a company’s board. Rule 14a-11 under the 1934 SEC Act requires public companies to permit any shareholder owning at least 3% of a public company’s voting stock for at least 3 years to include director nominations in the company’s proxy materials.

Years ago, the probability of a large firm’s management being ousted by its stockholders was so remote that it posed little threat. Most firms’ shares were so widely distributed and the CEO had so much control over the voting mechanism that it was virtually impossible for dissident stockholders to get the votes needed to overthrow a management team. However, that situation has changed. In recent years, the top executives of WeWork, Under Armour, EBay, Juul, Uber, Mattel, Citigroup, Coca-Cola, IBM, and Target, to name a few, were forced out due to poor corporate performance.

Relatedly, a 2015 article in The Wall Street Journal documents the growing importance of shareholder activists. It points out that in 2014, activists established a record level of influence when they were granted a board seat in 73% of the proxy fights that occurred that year. Likewise, a 2015 cover story in The Economist highlights the important role that activists play in ensuring that managers act in shareholders’ interests—their article labels these activists as “Capitalism’s Unlikely Heroes.” In another high-profile example, GE became one of a small group of companies that has voluntarily made it easier for shareholders to secure a board seat. GE’s new plan allows shareholder groups holding at least 3% of the company’s stock to directly nominate candidates for its board.

More recently, a 2019 article in The Wall Street Journal highlights activist investors’ growing tendency to pressure companies to become more socially responsible. The article begins by pointing to an activist hedge fund, which has pressured a company that it invests in to reduce its carbon footprint. Other well-publicized examples include the recent steps that large institutional investors such as BlackRock and Vanguard have taken to leverage their stock holdings to help accomplish a variety of social goals.

These actions are part of a broader movement to evaluate company performance along a number of environmental, social, and governance (ESG) measures. Indeed, many individual investors are looking for ways to invest in socially responsible companies and/or to avoid companies with low ESG ratings. Not surprisingly, a large number of mutual funds and exchange-traded funds now focus on companies that are viewed as being more socially responsible. However, as you can imagine, there is not always a consensus on whether a company is being responsible. Some investors, for example, may be very concerned about carbon emissions and climate change, which may lead them to want to avoid investing in traditional energy companies. But should this restriction also apply to energy companies that are “greener than average” but still have a substantial carbon footprint? Other investors may be more concerned about gun manufacturers or companies with less employee diversity. Relatedly, a 2019 Bloomberg article discusses in detail the large number of different ESG ratings that are available and how the differences in these ratings often lead to confusion among investors in socially responsible funds.

1-5C. Managers’ Response

If a firm’s stock is undervalued, corporate raiders will see it as a bargain and will attempt to capture the firm in a hostile takeover. If the raid is successful, the target’s executives will almost certainly be fired. This situation gives managers a strong incentive to take actions to maximize their stock’s price. In the words of one executive, “If you want to keep your job, never let your stock become a bargain.”

Note that the price managers should be trying to maximize is not the price on a specific day. Rather, it is the average price over the long run, which will be maximized if management focuses on the stock’s intrinsic value. However, managers must communicate effectively with stockholders (without divulging information that would aid their competitors) to keep the actual price close to the intrinsic value. It’s bad for stockholders and managers when the intrinsic value is high but the actual price is low. In that situation, a raider may swoop in, buy the company at a bargain price, and fire the managers. To repeat our earlier message:

Managers should try to maximize their stock’s intrinsic value and then communicate effectively with stockholders. That will cause the intrinsic value to be high and the actual stock price to remain close to the intrinsic value over time.

Because the intrinsic value cannot be observed, it is impossible to know whether it is really being maximized. Still, as we will discuss in Chapter 9, there are procedures for estimating a stock’s intrinsic value. Managers can use these valuation models to analyze alternative courses of action and thus see how these actions are likely to impact the firm’s value. This type of value-based management is not precise, but it is the best way to run a business.

SelfTest

What are three techniques stockholders can use to motivate managers to maximize their stock’s long-run price?

Should managers focus directly on the stock’s actual market price or its intrinsic value, or are both important? Explain.

1-6. Stockholder–Debtholder Conflicts

Conflicts can also arise between stockholders and debtholders. Debtholders, which include the company’s bankers and its bondholders, generally receive fixed payments regardless of how well the company does, while stockholders do better when the company does better. This situation leads to conflicts between these two groups, to the extent that stockholders are typically more willing to take on risky projects.

To illustrate this problem, consider the example in Table 1.1, where a company has raised $2,000 in capital, $1,000 from bondholders, and $1,000 from stockholders. To keep things simple, we assume that the bonds have a 1 year maturity and pay an 8% annual interest rate. The company’s current plan is to invest its $2,000 in Project L, a relatively low-risk project that is expected to be worth $2,400 one year from now if the market is good and $2,000 if the market is bad. There is a 50% chance that the market will be good and a 50% chance the market will be bad. In either case, there will be enough cash to pay the bondholders their money back plus the 8% annual interest rate that they were promised. The stockholders will receive whatever is left over after the bondholders have been paid. As expected, because they are paid last, the stockholders are bearing more risk (their payoff depends on the market), but they are also earning a higher expected return.

Table 1.1 Stockholder-Debtholder Conflict Example

Details

Now assume that the company discovers another project (Project H) that has considerably more risk. Project H has the same expected cash flow as Project L, but it will produce cash flows of $4,400 if the market is good but $0 if the market is bad. Clearly, the bondholders would not be interested in Project H, because they wouldn’t receive any additional benefits if the market is good and they would lose everything if the market is bad. Notice, however, that Project H provides a higher rate of return for stockholders than Project L, because they capture all of the extra benefits if the market turns out to be good. While Project H is clearly riskier, in some circumstances managers acting on behalf of the stockholders may decide that the higher expected return is enough to justify the additional risk, and they would proceed with Project H despite the strong objections of the bondholders.

Notice, however, that astute bondholders understand that managers and stockholders may have an incentive to shift to riskier projects. Recognizing this incentive, they will view the bonds as being riskier and will demand a higher rate of return, and in some cases the perceived risk may be so great that they will not invest in the company, unless the managers can credibly convince bondholders that the company will not pursue excessively risky projects.

Another type of stockholder–debtholder conflict arises over the use of additional debt. As we see later in this book, the more debt a firm uses to finance a given amount of assets, the riskier the firm becomes. For example, if a firm has

$

100

million

 of assets and finances them with

$

5

million

 of bonds and

$

95

million

 of common stock, things have to go terribly badly before the bondholders suffer a loss. On the other hand, if the firm uses

$

95

million

 of bonds and

$

5

million

 of stock, the bondholders suffer a loss even if the value of the assets declines only slightly.

Bondholders attempt to protect themselves by including covenants in the bond agreements that limit firms’ use of additional debt and constrain managers’ actions in other ways. We address these issues later in this book, but they are quite important and everyone should be aware of them.

SelfTest

Why might conflicts arise between stockholders and debtholders?

How might astute bondholders react if stockholders take on risky projects?

How can bondholders protect themselves from managers’ actions that negatively impact bondholders?

1-7. Balancing Shareholder Interests and the Interests of Society

Throughout this book, we focus primarily on publicly owned companies; hence, we operate on the assumption that management’s primary financial goal is shareholder wealth maximization. At the same time, the managers know that this does not mean maximize shareholder value “at all costs.” Managers have an obligation to behave ethically, and they must follow the laws and other society-imposed constraints that we discussed in the opening vignette to this chapter.

Investing in Socially Responsible Funds

The same societal pressures that have encouraged consumers to buy products of companies that they believe to be socially responsible have also led some investors to search for ways to limit their investments to firms they deem to be socially responsible. Indeed, today there are a large number of mutual funds that only invest in companies that meet specified social goals. Each of these socially responsible funds applies different criteria, but typically they consider a company’s environmental record, its commitment to social causes, and its employee relations. Many of these funds also avoid investments in companies that are involved with alcohol, tobacco, gambling, and nuclear power. Investment performance varies among funds from year to year. The accompanying chart compares the past performance of a representative socially responsible fund, the Domini Impact Equity Investor Fund, with that of the S&P 500 during the past 20+ years. Although the general shape of each is similar, in the last 18 years or so the S&P 500 has outperformed this fund.

A 2015 article in The Wall Street Journal cites a study that suggests that investors may be able to profit by buying stocks that other investors choose to avoid. The study by professors Elroy Dimson, Paul Marsh, and Mike Staunton of the London Business School found that over the past century, U.S. tobacco stocks have dramatically outperformed the overall market. As a possible explanation, the article provides a quote from one of the authors:

“It appears that when the people who abhor such stocks have shunned them, they have depressed the share prices but haven’t managed to destroy the industries,” Prof. Marsh says. “So investors who don’t have the same scruples have been able to pick up [these stocks] at a cheaper price.”

Recent Performance of Domini Impact Equity Investor Fund versus S&P 500

Details

Source: finance.yahoo.com, March 25, 2020.

To understand how corporate managers balance the interests of society and shareholders, it is helpful to first look at those issues from the perspective of a sole proprietor. Consider Larry Jackson, the owner of a local sporting goods store. Jackson is in business to make money, but he likes to take time off to play golf on Fridays. He also has a few employees who are no longer very productive, but he keeps them on the payroll out of friendship and loyalty. Jackson is running the business in a way that is consistent with his own personal goals. He knows that he could make more money if he didn’t play golf or if he replaced some of his employees. But he is comfortable with his choices—and because it is his business, he is free to make those choices.

By contrast, Linda Smith is CEO of a large corporation. Smith manages the company; however, most of the stock is owned by shareholders who purchased it because they were looking for an investment that would help them retire, send their children to college, pay for a long-anticipated trip, and so forth. The shareholders elected a board of directors, which then selected Smith to run the company. Smith and the firm’s other managers are working on behalf of the shareholders, and they were hired to pursue policies that enhance shareholder value.

Most managers understand that maximizing shareholder value does not mean that they are free to ignore the larger interests of society. Consider, for example, what would happen if Linda Smith narrowly focused on creating shareholder value, but in the process her company was unresponsive to its employees and customers, hostile to its local community, and indifferent to the effects its actions had on the environment. In all likelihood, society would impose a wide range of costs on the company. It may find it hard to attract top-notch employees, its products may be boycotted, it may face additional lawsuits and regulations, and it may be confronted with negative publicity. These costs would ultimately lead to a reduction in shareholder value. So clearly, when taking steps to maximize shareholder value, enlightened managers need to also keep in mind these society-imposed constraints.

From a broader perspective, firms have a number of different departments, including marketing, accounting, production, human resources, and finance. The finance department’s principal task is to evaluate proposed decisions and judge how they will affect the stock price and thus shareholder wealth. For example, suppose the production manager wants to replace some old equipment with new automated machinery that will reduce labor costs. The finance staff will evaluate that proposal and determine whether the savings seem to be worth the cost. Similarly, if marketing wants to spend

$

10

million

 of advertising during the Super Bowl, the financial staff will evaluate the proposal, look at the probable increase in sales, and reach a conclusion as to whether the money spent will lead to a higher stock price. Most significant decisions are evaluated in terms of their financial consequences, but astute managers recognize that they also need to take into account how these decisions affect society at large.

Interestingly, some companies have taken more explicit steps to recognize the broader needs of society. A fairly small but rapidly growing number of companies have become certified as “B” or “benefit” corporations. While these companies are still focused on making a profit, they are committed to putting other stakeholders such as employees, customers, and their communities on an equal footing with shareholders. To qualify as a B corporation, the company must subject itself to an annual audit in which its practices regarding social responsibility, corporate governance, and transparency are reviewed. A 2015 Time magazine article points out that 26 states now provide a legal framework for companies to be certified as a B corporation. The article also estimates that roughly 1,200 companies (mostly small) have qualified as B corporations.

As you might imagine, there is a very wide range of opinions regarding the appropriate balance between the interests of shareholders and other societal stakeholders. For example, a mutual fund manager attracted a lot of attention when he characterized shareholder wealth maximization as the “world’s dumbest idea.” Later on, a high-profile columnist for The Wall Street Journal offered a strong criticism of this viewpoint and laid out his argument for why maximizing shareholder value is the appropriate goal. Likewise, there has been considerable debate regarding the Business Roundtable’s 2019 statement urging companies to focus more on stakeholder interests. While these arguments will no doubt continue, there is a broader consensus emphasizing that maximizing shareholder value doesn’t mean that corporate managers should ignore other societal interests. Indeed, our discussion in this chapter is meant to illustrate that companies striving to increase shareholder value have to be ever mindful of these broader interests.

SelfTest

Is maximizing shareholder value inconsistent with being socially responsible? Explain.

When Boeing decides to invest $5 billion in a new jet airliner, are its managers certain of the project’s effects on Boeing’s future profits and stock price? Explain.

1-8. Business Ethics

As a result of the financial scandals occurring during the past decade, there has been a strong push to improve business ethics. This is occurring on many fronts—actions begun by former New York Attorney General and former Governor Elliot Spitzer and others who sued companies for improper acts; Congress’s passing of the Sarbanes-Oxley Act of 2002 to impose sanctions on executives who sign financial statements later found to be false; Congress’s passing of the Dodd-Frank Act to implement an aggressive overhaul of the U.S. financial regulatory system aimed at preventing reckless actions that would cause another financial crisis; and business schools trying to inform students about proper versus improper business actions.

As noted earlier, companies benefit from having good reputations and are penalized by having bad ones; the same is true for individuals. Reputations reflect the extent to which firms and people are ethical. Ethics is defined in Webster’s Dictionary as “standards of conduct or moral behavior.” Business ethics can be thought of as a company’s attitude and conduct toward its employees, customers, community, and stockholders. A firm’s commitment to business ethics can be measured by the tendency of its employees, from the top down, to adhere to laws, regulations, and moral standards relating to product safety and quality, fair employment practices, fair marketing and selling practices, the use of confidential information for personal gain, community involvement, and the use of illegal payments to obtain business.

For the past 14 years, Ethisphere, an organization based out of Scottsdale, Arizona, has focused on evaluating ethical business practices and has published a list of “The World’s Most Ethical Companies.” It honors companies that promote ethical business standards and practices internally, enable managers and employees to make good choices, and shape industry standards by introducing best practices. Those companies that have made the list in every year are Aflac, Ecolab, Fluor Corporation, International Paper, Kao Corporation, Milliken & Company, and Pepsico.

1-8A. What Companies are Doing

Most firms today have strong written codes of ethical behavior; companies also conduct training programs to ensure that employees understand proper behavior in different situations. When conflicts arise involving profits and ethics, ethical considerations sometimes are so obviously important that they dominate. In other cases, however, the right choice is not clear. For example, suppose that Norfolk Southern’s managers know that its coal trains are polluting the air, but the amount of pollution is within legal limits and further that reduction would be costly. Are the managers ethically bound to reduce pollution? Similarly, several years ago Merck’s research indicated that its Vioxx pain medicine might be causing heart attacks. However, the evidence was not overly strong, and the product was clearly helping some patients. Over time, additional tests produced stronger evidence that Vioxx did pose a health risk. What should Merck have done, and when should Merck have done it? If the company released negative but perhaps incorrect information, this announcement would have hurt sales and possibly prevented some patients benefitting from the product. If the company delayed the release of this additional information, more patients might have suffered irreversible harm. At what point should Merck have made the potential problem known to the public? There are no obvious answers to questions such as these, but companies must deal with them, and a failure to handle them properly can lead to severe consequences.

1-8B. Consequences of Unethical Behavior

Over the past few years, ethical lapses have led to a number of bankruptcies. The collapses of Enron and WorldCom as well as the accounting firm Arthur Andersen dramatically illustrate how unethical behavior can lead to a firm’s rapid decline. In all three cases, top executives came under fire because of misleading accounting practices that led to overstated profits. Enron and WorldCom executives were busily selling their stock at the same time they were recommending the stock to employees and outside investors. These executives reaped millions before the stock declined, while lower-level employees and outside investors were left “holding the bag.” Some of these executives are now in jail, and Enron’s CEO had a fatal heart attack while awaiting sentencing after being found guilty of conspiracy and fraud. Moreover, Merrill Lynch and Citigroup, which were accused of facilitating these frauds, were fined hundreds of millions of dollars.

In other cases, companies avoid bankruptcy but face a damaging blow to their reputation. Safety concerns tarnished Toyota’s once sterling reputation for reliability. Ethical questions were raised regarding when the company’s senior management became aware of the problems and whether they were forthcoming in sharing these concerns with the public. Similarly, GM agreed to pay a

$

900

million

 settlement for its delay in addressing defective ignition switches, which have been connected to 57 deaths and the recall of 2.6 million vehicles.

Likewise, in April 2010, the SEC brought forth a civil fraud suit against Goldman Sachs. The SEC contended that Goldman Sachs misled its investors when it created and marketed securities that were backed by subprime mortgages. In July 2010, Goldman Sachs ultimately reached a settlement where it agreed to pay

$

550

million

 . While just one example, many believe that too many Wall Street executives in recent years have been willing to compromise their ethics. In May 2011, Raj Rajaratnam, the founder of the hedge fund Galleon Group LLC, was convicted of securities fraud and conspiracy in one of the government’s largest insider trading cases. Mr. Rajaratnam traded on information (worth approximately

$

63.8

million

 ) from insiders at technology companies and others in the hedge fund industry. On October 13, 2011, he was sentenced to 11 years in prison. On March 14, 2014, the Federal Deposit Insurance Corporation (FDIC) sued 16 big banks (including Bank of America, Citigroup, and JPMorgan Chase) for actively manipulating the London Interbank Offered Rate (the LIBOR rate) to make additional profits on their trades. This is particularly important because the LIBOR rate is used to set the terms in many financial contracts. The banks are accused of rigging LIBOR from August 2007 to mid-2011. Five of the banks, Barclays, RBS, UBS, Deutsche Bank, and Rabobank of the Netherlands, together have paid $5 billion to settle the charges and avoid criminal prosecution if they meet certain conditions. It is worth noting that in the wake of these scandals, regulators have pushed banks to de-emphasize LIBOR and to begin developing alternative benchmark rates by 2021.

More recently, Mylan, a pharmaceutical company, agreed to pay the U.S. Department of Justice a

$

465

million

 settlement for overcharging Medicaid for its allergy shot EPIPen. In early 2018, Theranos founder Elizabeth Holmes agreed to a settlement with the SEC after being charged with fraud. The settlement included a financial penalty, eliminated her voting control of the company, and barred her for 10 years from serving as an officer or director of a public company. In another high-profile case, Wells Fargo fired its CEO, other senior managers, and 5,000 employees, and paid

$

185

million

 in government fines and customer refunds because employees created fake accounts and signed up customers for unauthorized credit cards to reach sales quotas for bonuses. In February 2020, the company agreed to pay an additional $3 billion to settle claims. The Fed has placed an additional penalty on Wells Fargo by limiting its growth. These recent problems are not unique to U.S. companies. Volkswagen (VW) recently admitted to selling cars that were installed with software to cheat emissions tests. Approximately 11 million cars worldwide, including 8 million in Europe, have the software installed in them. VW has set aside 6.7 billion euros (roughly $7.6 billion) to cover the cost of recalling millions of cars, which resulted in its first quarterly loss (third quarter, 2015) in 15 years. Its CEO resigned and several of its top executives were fired because of this scandal. In another recent scandal, Canadian drug maker Valeant has been accused of improper accounting and predatory price hikes to boost its growth. In addition, it appears that Philidor (an undisclosed affiliate of Valeant) may have changed patients’ prescriptions to push Valeant’s high-priced drugs. Near the end of 2016, two Philidor executives (one of whom had been an executive with Valeant) had been arrested and charged with a multimillion-dollar fraud and kickback scheme.

A firm’s CEO is the face of the corporation. When a CEO is accused of illegal activity, the Board of Directors conducts an independent investigation, and if the allegation is verified, it takes corrective action. In most cases, the CEO is terminated. It’s much less obvious what the board should do when the CEO is accused of questionable but not illegal behavior. When a CEO is accused of misconduct, the board must investigate the situation, take proactive steps to ensure that the situation is properly dealt with, and, most importantly, ensure that the corporate reputation, culture, and long-term performance are not damaged.

The perception of widespread improper actions has caused many investors to lose faith in American business and to turn away from the stock market, which makes it difficult for firms to raise the capital they need to grow, create jobs, and stimulate the economy. So unethical actions can have adverse consequences far beyond the companies that perpetrate them.

All this raises a question: Are companies unethical, or is it just a few of their employees? That was a central issue that came up in the case of Arthur Andersen, the accounting firm that audited Enron, WorldCom, and several other companies that committed accounting fraud. Evidence showed that relatively few of Andersen’s accountants helped perpetrate the frauds. Its top managers argued that while a few rogue employees did bad things, most of the firm’s 85,000 employees, and the firm itself, were innocent. The U.S. Justice Department disagreed, concluding that the firm was guilty because it fostered a climate where unethical behavior was permitted and that Andersen used an incentive system that made such behavior profitable to both the perpetrators and the firm. As a result, Andersen was put out of business, its partners lost millions of dollars, and its 85,000 employees lost their jobs. In most other cases, individuals, rather than firms, were tried, and though the firms survived, they suffered damage to their reputations, which greatly lowered their future profit potential and value.

1-8C. How should Employees Deal with Unethical Behavior?

Far too often the desire for stock options, bonuses, and promotions drives managers to take unethical actions such as fudging the books to make profits in the manager’s division look good, holding back information about bad products that would depress sales, and failing to take costly but needed measures to protect the environment. Generally, these acts don’t rise to the level of an Enron or a WorldCom, but they are still bad. If questionable things are going on, who should take action and what should that action be? Obviously, in situations such as Enron and WorldCom, where fraud was being perpetrated at or close to the top, senior managers knew about the illegal activities. In other cases, the problem is caused by a mid-level manager trying to boost his or her unit’s profits and thus his or her bonus. In all cases, though, at least some lower-level employees are aware of what’s happening; they may even be ordered to take fraudulent actions. Should the lower-level employees obey their boss’s orders, refuse to obey those orders, or report the situation to a higher authority, such as the company’s board of directors, the company’s auditors, or a federal prosecutor?

As you might imagine, these issues are often tricky, and judgment comes into play when deciding on what action to take and when to take it. If a lower-level employee thinks that a product should be pulled, but the boss disagrees, what should the employee do? If an employee decides to report the problem, trouble may ensue regardless of the merits of the case. If the alarm is false, the company will have been harmed, and nothing will have been gained. In that case, the employee will probably be fired. Even if the employee is right, his or her career may still be ruined because many companies (or at least bosses) don’t like “disloyal, troublemaking” employees.

Such situations arise fairly often, ranging from accounting fraud to product liability, sexual harassment, and environmental cases. Employees jeopardize their jobs if they come forward over their bosses’ objections. However, if they don’t speak up, they may suffer emotional problems and contribute to the downfall of their companies and the accompanying loss of jobs and savings. Moreover, if employees obey orders regarding actions they know are illegal, they may end up going to jail. Indeed, in most of the scandals that have gone to trial, the lower-level people who physically entered the bad data received longer jail sentences than the bosses who presumably gave the directives. So employees can be “stuck between a rock and a hard place,” that is, doing what they should do and possibly losing their jobs versus going along with the boss and possibly ending up in jail. This discussion shows why ethics is such an important consideration in business and in business schools—and why we are concerned with it in this book.

SelfTest

How would you define business ethics?

Can a firm’s executive compensation plan lead to unethical behavior? Explain.

Unethical acts are generally committed by unethical people. What are some things companies can do to help ensure that their employees act ethically?

 Tying it All Together

This chapter provides a broad overview of financial management. Management’s primary goal should be to maximize the long-run value of the stock, which means the intrinsic value as measured by the stock’s price over time. To maximize value, firms must develop products that consumers want, produce the products efficiently, sell them at competitive prices, and observe laws relating to corporate behavior. If firms are successful at maximizing the stock’s value, they will also be contributing to social welfare and citizens’ well-being.

Businesses can be organized as proprietorships, partnerships, corporations, limited liability companies (LLCs), or limited liability partnerships (LLPs). The vast majority of all business is done by corporations, and the most successful firms become corporations, which explains the focus on corporations in this book.

The primary tasks of the CFO are

(1)

to make sure the accounting system provides “good” numbers for internal decision making and for investors,

(2)

to ensure that the firm is financed in the proper manner,

(3)

to evaluate the operating units to make sure they are performing in an optimal manner, and

(4)

to evaluate all proposed capital expenditures to make sure they will increase the firm’s value.

In the remainder of this book, we discuss exactly how financial managers carry out these tasks.