Introduction to Corporate Finance What Companies Do 3rd Edition Graham Solutions Manual
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Chapter 1 The Scope of Corporate Finance

Chapter Overview

The Opening Focus looks at an issue close to most students' hearts – digital music. It details Apple's successful strategy in selling songs for about a dollar each, downloaded into its iPod MP3 player. Students may not realize that Apple sells more iPods than computers. Apple has found a way to compete in two highly competitive businesses – music and computers. Chapter 1 looks at how financial managers, like those at Apple, interacted with operations, marketing, communications and legal to create shareholder wealth. The importance of the finance function and the financial manager within business organizations has been rising steadily over the past two decades. Financial professionals can do more than just raise the operating efficiency of a company—they can create value in their own right. The primary focus of this textbook will be on the practicing financial manager, working as an integral part of the management team of a modern corporation. As an introduction to what a financial manager's job entails, this chapter includes a description of the principal tasks and responsibilities that a finance professional employed by a large corporation might encounter.

Discussion Questions:

1. What do you imagine were the interactions between the finance function and operations function at Apple when the iPod was being developed? On what business criteria does Apple's strategy depend?
2. What can a firm do to make a low profit margin strategy more successful? What are other examples of tie-ins, like Apple's iTunes and iPod?

This chapter looks at:

1-1. The Role of Corporate Finance in Business Today
1-2. Essentials of Corporate Finance
1-3. Legal Forms of Business Organization
1-4. The Corporate Financial Manager's Goals

Technology

1. **Smart Concepts Video.** The SmartConcepts video is an excellent introduction to a corporate finance course. It talks about Given Industries, an Israeli company that uses high tech imaging in medicine. The video looks at financing, including venture capital financing and an initial public offering, the capital budgeting function, the financial management function, globalization and the stock market.

2. **Smart Practices Video.** This interviews Tom Cole, Deutsche Bank, Leveraged Finance Group, telling how important it is to understand how business works in order to be good at finance.

3. **Smart Practices Video.** This quotes Joshua Haines, senior credit analyst at the Private Bank, concerning how he continues to use basic finance concepts he learned in earlier finance classes.

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4. **Smart Practices Video.** This quotes Bill Eckmann, investment banker, concerning his career in investment banking.

5. **Smart Concepts Video.** This quotes David Nickel, controller for Intel Corp.'s Communications Group, about how finance can help business increase shareholder value.
6. **Smart Ethics Video.** Andy Bryant, executive vice president of finance and enterprise systems and chief financial officer, Intel Corp., discusses that ethical behavior on the part of a company can add value.

7. **Smart Practices Video.** This quotes Vince LoForti, chief financial officer of Overland Storage Inc. about the impact of Sarbanes-Oxley on a company's business.

Lecture Guide

1-1: The Role of Corporate Finance in Modern Business

1-1a: How Finance Interacts with Other Functional Business Areas

1-1b: Career Opportunities in Finance

Give students some examples of jobs they can get as finance graduates. The college career services office may be helpful in giving examples of specific employers who recruit on campus. It may also have information about average pay scales in each area in finance.

1-2: Corporate Finance Essentials
The instructor can use this slide to introduce the topics that will be covered throughout the semester, including when and how much in depth each topic will be covered in this course, and what might be topics for other finance courses.

1-2a: External Financing: Raising Capital, Key Facts

Explain that internal financing – the profits that a firm generates that are not paid to shareholders as dividends are the most important source of firm financing. A company seeks capital market debt and equity finance when it does not generate enough funds for its investment opportunities.

Tell students about the history of finance. For example, raising funds from a large number of investors spread with the legal concept of a corporation. During the 17th century, corporations were first given limited liability. This induced wealthy individuals to invest – they knew the worst that could happen was the loss of their investment; they would not lose all of their wealth in a bad venture. The idea of incorporation was so successful that England freely allowed companies to incorporate by the mid 19th century. Other countries followed England's lead. The verb "to finance," or raising funds for investment, was entered into the English dictionary in 1866.

Student Interaction:

- Ask students how many of them give money directly to a company. Few will (unless they own their own business.) This is a good springboard to how corporations receive money from individuals, for example, through banks that lend their savings deposits to firms. Few, if any of the students will have participated in a company's direct means of obtaining funds (initial public offerings and secondary offerings) and are more likely to have participated in stock investing through the secondary market.

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This section provides an opportunity to bring in current events, while explaining the external financing choices a firm has. The Google IPO made news in the summer of 2004. It was an innovative IPO. For most IPOs, only the favored clients of the investment banking firm can purchase shares at the IPO price. Google specifically structured its IPO so that small investors could participate, buying as few as 5 shares of Google. At the time of the IPO, Google had a great deal of information posted online, at http://www.ipo.google.com. If still available, the instructor can run Google's interactive prospectus

The Capital Budgeting Function

Capital budgeting is the function perhaps most highly associated with corporate finance – what projects should a firm invest in? Note how the nature of investment has changed over time. Investment used to mean building a factory and stocking it with equipment. Today's business model generally requires a high investment in information technology. It is much harder to measure the value of an investment in IT. A factory produces a particular product that is then sold to consumers. Ask students what technology produces. It may be more of preventing a loss; for example, investing in IT may keep consumers coming to a company's online and physical retail stores. The firm has invested in IT to keep customers from shopping at competitors with better Web sites.

The Financial Management Function

Note that this function covers the theory that financial managers put into practice in their jobs.

The Corporate Governance Function

Talk to students about the nexus of stakeholders concerned with a corporation. Corporations must be concerned with

- Shareholders
- Debtholders/Creditors
- Managers
- Employees
- Local community
- Suppliers
- Customers

The idea of a "nexus of stakeholders" is becoming increasingly recognized; for example, Pennsylvania has a law stating that boards of directors must take the concerns of other interested parties into account, not just those of shareholders.

This chapter is a good opportunity to bring in current issues in finance. The after-effects of the current accounting scandals (Enron, Worldcom, Adelphia, etc.) will be in the news for a long time. Define executive stock options, and ask students for their opinion about their usage. Ask for suggestions about what small shareholders can do if they are unhappy about the way their firm is managed (band together, sell shares). Ask if company insiders should be on a company's board of directors.

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Risk Management Function

Note that a great deal of finance is about the risk-return relationship. An investor (or a firm) expects to be compensated for taking on higher risk; in other words, higher risk, then higher return. By the nature of its business a firm is exposed to risk. Most firms have international dealings and will be exposed to exchange rate risk. Firms with commodity inputs will be exposed to commodity risk. There are ways a firm can hedge, or mitigate, this risk and more complex securities developed to help firms manage their risks.

1-2b Debt and Equity: The Two Flavors of Capital

1-2c Financial Intermediation and Modern Finance

Figure 1.1 Growth in Global Security Issues

This section is a graphical depiction of two strong trends – the equity market has grown world wide, and as a corollary, more people are invested in the stock market. First, there are more new companies than existed a decade ago. Many start-up companies, like Microsoft which first issued stock in 1986, have grown substantially. For example, an investment in Microsoft in 1986 would have grown over 34,000% by 2004! While U.S. markets are still the largest, global markets are also increasing in size and importance. The result is 24/7 trading in major securities.

1-3a Business Organizational Forms in the U.S.

For sole Proprietorships, note that the principles of finance apply to all three forms of the business organization. The main advantages to a proprietorship are its ease of formation, subject to few regulations and no corporate income taxes, all of which are at least somewhat quantifiable. Ask students what is another big, but non-quantifiable advantage of a proprietorship. Most students will point to the idea of being one's own boss as an attraction of owning your own business – but one that is very hard to quantify.

- When talking about the advantage of no corporate income taxes, ask student how many of them own stock, and how their income from the stock is taxed. Until a tax law change in 2003, dividends were fully taxed at the individual's marginal tax rate. Under new legislation, dividends are still taxed, but the highest rate is 15%, the same as the long-term capital gains tax rate. Note that most other countries do not double tax dividends.
- When talking about partnerships note that partnerships for the most part have the same advantages and disadvantages of sole proprietorships. Note that limited partnerships have been increasingly used, and provide limited liability to all except the general partners. There are very few large partnerships, except law and accounting firms.
- When talking about corporations point out why firms were "invented", including greater efficiency, collective effort and greater access to capital. Unlimited life is one advantage of a corporation. Go to http://www.hbc.com, the web site of Hudson Bay Company. In its history section, there is a picture of Charles II of England granting a charter to the Hudson Bay Company in 1670. The corporation is still here today. Instead of an exploration company, it is a retail chain in Canada, but it shows when we talk about unlimited life, we mean it! You can either show the picture from the Internet in class if you have a classroom connection, or you can save the picture in a power point presentation.

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Corporations in the U.S. Double Taxation Problem

While double taxation is cited as disadvantage of the corporate form, note that this is not necessarily the case, depending on the tax situation of owners and how the firm's profits are going to be used. Here is a numerical example of why double taxation may not be so bad, particularly if the company owner wants to reinvest capital. For example:

Case 1: Business distributes all of its earnings

	Proprietorship	Corporation
Earnings before taxes	$40,000	$40,000
Corporate taxes	--	6,000
Net income	40,000	34,000
Earnings distributed	40,000	34,000
Personal income tax	7,200	6,120
Disposable income	32,800	27,880

It's better to be a proprietorship than a corporation.

Case 2: Business wants to reinvest earnings

	Proprietorship	**Corporation**
Earnings	$40,000	$40,000
Salary to owner	--	20,000
Taxable income	40,000	20,000
Corporate taxes	--	3,000
Net income	40,000	17,000
Earnings distributed	40,000	--
Earnings retained		17,000
Personal income tax	7,200	1,600
Net after personal taxes	32,000	15,400
Amount reinvested	17,000	
Net after reinvesting	15,000	

In this case, it's better to be a corporation – the owner/manager has more disposable income. The decision to incorporate depends on the owner's personal tax situation, need for spendable income, need for reinvestment funds, etc. But double taxation, when a corporation wishes to reinvest its earnings, it can be financial worthwhile to be a corporation.

This computation uses an 18% personal tax rate and a 15% corporate tax rate. The example can be redone using up to date tax schedules. It is usually best to ignore personal tax considerations like deductions, exemptions, etc.

Business Organizational Forms in the U.S. (continued)
S-Corporations and LLCs.

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1-3b Forms of Business Organization Used by Non-U.S. Companies
This section reinforces the section of the text that describes other forms of organization popular among foreign companies. In other words, the "American way" may not work for all corporations in all countries.

- Non-U.S. systems show many common patterns. In almost all capitalist economies, some form of limited liability business structure is allowed, with ownership shares that can be traded freely on national stock markets. See the *Comparative Corporate Finance* feature on The Growth of Stock Market Capitalization, and its accompanying figure.

1-4 The Corporate Financial Manager's Goals

Point out the differences between profit and share price maximization. As the Enron and Worldcom cases (and subsequent criminal prosecutions) showed, it is possible to manipulate accounting statements to deceive shareholders. Shareholders are overwhelmingly concerned with cash flow, not accounting numbers, even though there is a high positive correlation between cash flow and net income.

1-4b Agency Costs in Corporate Finance
Agency costs include:

- Bonding management to the firm
- Monitoring the firm
- Residual loss

Student Interaction:

- Give students examples (or ask them for examples) of how to mitigate these costs. For example, stock options and stock grants were initially designed to bond managers to the firm by giving them a large enough ownership stake so that they would want to increase share price. Boards of directors are charged with monitoring firms. Institutional investors are becoming more active in corporate governance, forcing the firing of chief executives who are not increasing shareholders wealth. Residual loss refers to value lost when management does not act in the best interests of shareholders. An example might be a firm that "empire builds" – purchasing non-valuing adding companies simply to become a larger company, since, on average, chief executive officers of large companies have greater compensation than CEOs of small companies.
- Ask students about a firm's responsibilities. Does a firm have responsibilities to society at large? Do you believe firms should be good corporate citizens? What does it mean to be a good corporate citizen? Is the goal of maximizing shareholder wealth good or bad for society at large? Why? Should firms be ethical? What does this mean?

Point out that when chief financial officers were surveyed, only 38% unequivocally said that their main job was to serve shareholders. Twenty-seven percent said their main responsibility was to the firm as an organization. A firm is a separate entity, able to enter contracts, sue or be sued, own land, make investments, etc. Note that agency cost problems have changed with the advent of new economy firms. For example, in 1994, Maurice Saatchi, chairman of Saatchi and Saatchi, an advertising firm, proposed a very generous compensation package for himself and top executives in the firm. The firm's institutional investors voted this down at the annual meeting, citing the stock's underperformance, and said executives shouldn't be rewarded. Maurice Saatchi and his top man-

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agers left the firm and formed their own advertising agency. The original firm changed its name to Cordiant and was very damaged by the executives' departure. In hindsight, the advertising firm could not be treated like a traditional firm where managers buy and then manage assets. In this case, the managers were the assets. In 1994, this kind of human capital firm was an exception. Now there are many more software, consulting, etc. firms where human capital is more valuable than physical assets. Employees are no longer operating valuable assets – they are the valuable assets.

1-4c Why are Ethics Important in Corporate Finance?
Corporate scandals and bankruptcy have focused attention on the question of ethics, or standards of conduct in business dealings. As a result, the financial community is developing and enforcing higher ethical standards. The U.S. Congress passed the Sarbanes-Oxley Act in 2002 to enforce higher ethical standards and increase penalties for violators.

Financial Management Role
This slide emphasizes the main point of this chapter – that managers' key role is to maximize shareholders' wealth by accepting projects whose marginal benefits exceed marginal costs.

Chapter 1 Resource Articles

Welch, Ivo, "The Top Achievements, Challenges, and Failures of Finance," *Yale ICF Working Paper No. 00-67*, available at http://papers.ssrn.com/abstract=291987. This paper lists Welch's assessment of the top ten achievements of finance and the most important challenges for Finance to work on, as well as its failures to date.

Jensen, Michael C., "Value Maximization, Stakeholder Theory, and the Corporate Objective Function," *European Financial Management*, September 2001. This paper notes that the widely-recognized principle of value maximization has come under attack by the increasingly popular view that managers ought to take account of the interests of all the stakeholders of a firm, not only its suppliers of capital. Jenson believes the conflict between value maximization and stakeholder theory can be brought together under what he calls "enlightened value maximization," in which market value is still the yardstick against which conflicting interests can be gauged. He said the two goals are not dissimilar if stakeholder advocates realize a firm's market value should be used as a measure and value maximization advocates understand that value can only be created when the firm has good relations with all stakeholders.

Grinyer, John R., C. Donald Sinclair and Daing Nasir Ibrahim, "Management Objectives in Capital Budgeting," *Financial Practice and Education*, Fall/Winter 1999. This paper outlines some conflicting perceptions about the objectives of financial management. It considers capital project investment decisions in particular. In that context, it establishes hypotheses that are based on the perception that managers consider the interests of a wider group of stakeholders than just stockholders. These hypotheses are then tested by reference to the responses by managers in a survey of the largest 300 UK corporations. The empirical evidence is consistent with hypotheses based on the perception that many managers do not seek primarily to maximize stockholders' wealth as conventionally defined, but instead emphasize characteristics of total firm risk and of earnings related variables.

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Laux, Paul and Betty J. Simkins, "An Empirical Framework and Teaching Note for Introducing Financial Management in the First MBA Core Class," *Journal of Financial Education*, Fall/Winter 2002. This paper demonstrates one way of introducing finance to first-year MBA students. It explains what firms do about financing, investing, profiting and payout. By introducing these concepts, along with economy-wide financial ratios, students are given intuition and insight into the theory and practice of finance.

Enrichment Exercises

1. Tell the story of corporate finance by making up stories involving students. For example, on the first day I pick a student at random. (I teach very large, introductory finance courses and I have 200+ unknown students from whom to pick.) I say, "John has just invented a cure for cancer. What he has done is invented a process that makes chemotherapy drugs more effective. He's patented his process and formed a corporation. The good thing about John's invention is that it doesn't take much money for him to start it – just $2,000, and he's spent a very frugal 2 years at the university, so he's got that amount in savings. He needs to buy some lab equipment and chemicals with his $2,000. John's corporation issues 100 shares, at $20 a share, and he owns all of the shares. Here's what his book value balance sheet looks like:

Book Value Balance Sheet

Assets		**Liabilities**	
Fixed Assets	$2,000	Common Stock	$2,000

Next, I pick another student and identify him/her as a pre-med student taking finance so he knows how to invest all the money he'll make as a world-class surgeon. He overhears John talking about his invention when he's having lunch in the student union. Since he's taken lots of chemistry and biology courses, he knows John's idea sounds like a very good idea. He offers to buy 10% of John's company for $200. I then ask John if he's willing to sell 10% of his company for this amount. Sometimes John will say he needs the money and will take it. Most of the time John will turn down the offer. If the student doesn't point it out, I'll bring out the fact that the primary value of John's investment is his idea – the patent he has on his new process. The market value of his corporation is worth more than $2,000. Let's say, for example that the value of the idea is $20,000 – the sum of the discounted future cash flows from John's investment. I show students the market value balance sheet, and point out that we use market values in finance more than book values.

Market Value Balance Sheet

Assets		**Liabilities**	
Fixed Assets	$ 2,000	Common Stock	$20,000
Intangible Assets	18,000		

I ask the class how the market will know that John's company is worth $20,000. Usually someone will say that John must distribute information about his company – balance sheets, income statements, etc. I then tell students that we will be studying how to value a business like John's and how the market assesses risk. I ask how risky John's company is. Most stu-

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dents will believe it is very risky because it is medical in nature and untested. I ask why forming a corporation is a good idea in John's situation, and most students point to limited liability. If his process doesn't work out, he can only lose his initial $2,000 investment.

I then ask the class if they think the IRS is a kind, generous agency out to help others. Most disagree with this. I point out that a company that borrows money adds value. Suppose John borrowed half of the money he needs for his corporation. His new balance sheet is:

Assets		**Liabilities**		
Fixed Assets	$ 2,000	Debt	$ 1,000	
Intangible Assets	18,000	Common Stock	19,000	+ tax shield
Tax shield of debt				

I point out that later in the course, we'll be looking at how debt adds value and we'll learn how to quantify that value added.

Depending on the topics I'm going to cover, I'll tell students that John's corporation will also likely be affected by exchange rates, inflation rates, and interest rates. At some point, John's corporation may be a candidate for an initial public offering, and after that a leveraged buyout or other kind of financial engineering.

This story covers the main topics covered in a corporate finance course.

2. Break students into small groups. Tell them that in a survey of Fortune 500 companies, executives said the following goals were most important to their firms:

   i. Maximization of the percent return on total asset investment
   ii. Achievement of a desired growth rate in earnings per share
   iii Maximization of aggregate dollar earnings

   Questions for groups:

   a. Is each goal a good or bad goal for the firm? Why?
   b. Is each goal consistent with the principle of maximizing shareholder wealth? Why or why not?

   After the discussion, point out to students that while all the goals are good goals for the most part, they can conflict with shareholder wealth. For example, all use net income, an accounting measure. It is possible to legitimately manipulate accounting income to reach a goal. For example, the use of LIFO (last in, first out) inventory control lowers net income but increases cash flow, while FIFO (first in, first out) increases net income but lowers cash flow. Also, there is a relationship between risk and return. Maximizing percent return on total investment could mean taking on very risky, high return projects that don't return enough to compensate for the amount of risk taken.

Answers to Concept Review Questions

1. Many companies have connections between other functional areas and finance. For example, any company with international dealings must look at the impact of foreign exchange on its business. Does the firm generate revenues overseas? Does it have foreign suppliers? What impact do currency changes have on operations? If the dollar weakens, then imports become

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more expensive for U.S. citizens and domestic production companies may benefit. On the other hand, if the firm sells its product abroad, a weaker dollar may increase foreign sales. The finance function may hedge some of the impact of currency fluctuations on the firm's financial statements. Another example of the relationship between finance and operations is seen is the pharmaceutical industry. One estimate said it takes 90 months and 802 million dollars (DiMasi, Hansen and Grabowski (2003) to bring a drug to market – how must finance work to control costs during this phase – long before revenues are even seen?

2. The five most important career paths for finance professionals are in corporate finance, commercial banking, investment banking, money management and consulting. Corporate finance is concerned with the duties of the financial manager in a business firm, while commercial banking involves providing loans and other financial services to a bank's customers. Investment banking involves three main types of activities: (1) helping corporate customers obtain funding via security market issues or complex structured financings, (2) providing advice to corporate clients on a variety of financial issues and transactions, including mergers and acquisitions and derivative products, and (3) trading debt and equity securities for customers or for the firm's own account. Money management involves acting as a fiduciary, investing and managing money on someone else's behalf, while consultants are hired by companies to analyze their business processes and strategies and then to recommend how these should be changed to make the firm more competitive.

3. The five basic corporate functions are financing (or capital raising), capital budgeting, financial management, corporate governance, and risk management. These functions are all related, for example, a company needs financing to fund its capital budgeting choices. The financial management decision concerns management of its internal cash flows and its mix of external debt and equity. Its financing needs are related to how much internal capital the firm can generate and its choice of debt or equity financing. A Board of Directors, which generally makes major financing and investment decisions governs companies, and all of the decisions will depend on the risk involved. With all of the functions, it is important to understand how value is created.

4. Issues in corporate finance and risk management have become more prominent in recent years. For example, executive stock options have been touted as a way to align the interests of managers with shareholders. Now, there is a growing controversy about executive stock options, for example, that these encouraged some executives to take measures, some fraudulent, that pushed up stock prices in the short run, making their options more valuable. With the development of a vast array of derivative securities, risk management has become more complicated.

5. A **financial intermediary** is an institution that raises capital by issuing liabilities against itself, and then uses the funds so raised to make loans to corporations and individuals. Borrowers, in turn, repay the intermediary, meaning that they have no direct contact with the savers who actually funded the loans. Capital markets have grown steadily in importance, principally because the rapidly declining cost of information processing has made it much easier for large numbers of investors to obtain and evaluate financial data for thousands of potential corporate borrowers and issuers of common and preferred stock equity.

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6.

Advantages of Proprietorships and Partnerships	Disadvantages
1. Easy to form	1. Limited life
2. Few regulations	2. Unlimited liability
3. No corporate income taxes	3. Hard to raise capital
4. Being one's own boss	

Advantages of Corporations	Disadvantages
1. Unlimited life	1. Double taxation
2. Easy to transfer ownership	2. Costly set up
3. Limited liability	3. Costly period reports required
4. Easier to raise capital	

Hybrid forms are successful because they can combine the advantages of several forms or organization. For example, the limited liability partnership has the advantages of a partnership, without the disadvantage of unlimited liability.

7. The idea that all successful private companies organized as proprietorships or partnerships must become corporations is largely opinion. There are many proprietorships and partnerships that remain so throughout their lives. However, if a business is to grow, it probably will thrive as a corporation, with better access to capital, less risk of losing everything (limited liability), easy transferability, and unlimited life.

8. An agency cost occurs when a conflict arises between parties within a firm. The primary agency conflicts arise between managers and shareholders and shareholders and bondholders, but there can also be conflicts between top management and operating management, managers and employees, and stockholders and customers, suppliers, the government and the community. Agency costs are the costs of monitoring the firm to make sure that managers act in shareholders interests, bonding or the efforts that managers take to assure shareholders that they are acting in their best interest, and residual loss, losses because managers did not make decisions in the best interests of shareholders. These tend to increase as the firm grows larger because there is a larger, more diverse body of shareholders to satisfy. When there is one owner/manager, by definition whatever choices he/she makes will maximize shareholder wealth. This becomes more difficult as the number of shareholders increases.

9. Advantages of sophisticated compensation packages
   - Allow better alignment among shareholder and management interests
   - When a large part of a manager's wealth is invested in company stock, he/she will work harder to maximize stock price so his/her personal wealth is also maximized.

   Disadvantages
   - Stock price could increase because the overall stock market is rising, not because the manager has done a good job.
   - Compensation packages have raised U.S. executive pay well above that of non-management employees and above that of their counterparts in other countries.
   - Some managers receive high compensation even when the company is performing poorly.

10. Unethical behavior can have severe financial consequences for a company. For example, Arthur Anderson went bankrupt because of the fallout from its involvement in Enron's collapse. For many businesses, reputation is critical to conducting business. A firm with a reputation for

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shady dealing will lose value relative to its ethical competitors. Ethical behavior becomes part of the intangible value of the firm.

11. The U.S Congress passed the *Sarbanes-Oxley Act of 2002* in response to the accounting scandals surrounding Enron, WorldCom and other companies that went bankrupt in 2001, and due to concerns about auditors' conflicts of interest. The law was passed in an effort to improve corporate governance practices in U.S. public companies. The act established a new *Public Company Accounting Oversight Board*, with the power to license auditing firms and regulate accounting and auditing standards. This act also gave the U.S. *Securities and Exchange Commission (SEC)* greater powers to supervise corporate governance practices in public companies. The act requires both the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) of all large companies to *personally* certify their firms' financial statements, meaning that the CEOs and CFOs can be held personally liable for any questionable or misleading numbers reported to public investors. This Act also prevents auditing firms from providing other services – such as consulting, valuation, and tax advisory work – to the companies they are auditing, and mandates the lead auditing partner must rotate off the audit every five years. Perhaps the most crucial internal change the Act mandates is to give the firm's Audit Committee much greater power, responsibility and independence. The Act requires that each member of the audit committee must also be a member of the board of directors – but otherwise be independent (not an officer or employee) – and mandates that at least one of the committee members must be a "financial expert."

Answers to End-of-Chapter Questions

Q1-1. Why must a financial manager have an integrated understanding of the five basic finance functions? Why has the risk-management function become more important in recent years? Why is the corporate governance function considered a finance function?

A1-1. A financial manager needs to know all five basic finance areas because they all impact his or her job. While the manager's primary responsibilities may be in raising money or choosing investment projects, the manager also needs to know about capital markets and debt/equity optimal levels, be able to manage risks of the business and governance of the corporation. Corporate governance is a function because a manager wants to act in the best interest of its shareholders. New methods of managing risk have been developed in recent years, and a manager must be aware of these in order to maximize shareholder value.

Q1-2. Enter the home page of the Careers in Business Web site (http://www.careers-in-business.com), and page through the finance positions listed and their corresponding salaries. What skill sets or job characteristics lead to the variation in salaries? Which of these positions generally require prior work experience?

A1-2. Internet exercise.

Q1-3. What are the advantages and disadvantages of the different legal forms of business organization? Could the limited liability advantage of a corporation also lead to an agency problem? Why? What legal form would an upstart entrepreneur likely prefer?

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A1-3. Advantages of Proprietorships and Partnerships
1. Easy to form
2. Few regulations
3. No corporate income taxes
4. Being one's own boss

Disadvantages
1. Limited life
2. Unlimited liability
3. Hard to raise capital

Advantages of Corporations
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2. Easy to transfer ownership
3. Limited liability
4. Easier to raise capital

Disadvantages
1. Double taxation
2. Costly set up
3. Costly period reports required

Q1-4. Can there be a difference between *maximizing profit* and *maximizing shareholder wealth*? If so, what could cause this difference? Which of the two should be the goal of the firm and its management?

A1-4. Profit maximization and maximizing shareholder wealth could conflict. For example, a company could accept very high return (and also very high risk projects) that do not return enough to compensate for the high risk. Profits, or net income, are accounting numbers and therefore subject to manipulation. It would be possible to show positive profits when shareholder wealth was actually being decreased.

Q1-5. Define a corporate *stakeholder.* Which groups are considered stakeholders? Would shareholders also be considered stakeholders? Compare, in terms of economic systems, the principle of maximizing shareholder wealth with the principle of satisfying stakeholder claims.

A1-5. Stakeholders include anyone with an interest in the company, including stockholders. Stakeholders are also management, employees, the government, the community, suppliers, customers, and lenders. Stakeholder wealth preservation appears to favor socialism more than capitalism. Stakeholder wealth, for example, keeping on too many employees for the firm to be efficient, may be preserved at the expense of stockholder wealth.

Q1-6. What is meant by an "agency cost" or "agency problem"? Do these interfere with maximizing shareholder wealth? Why or why not? What mechanisms minimize these costs/problems? Are executive compensation contracts effective in mitigating them?

A1-6. Agency cost or agency conflict refers to any time a decision is made that does not maximize shareholder wealth. For example, managers may want excessive benefits, such as a fleet of company planes, which maximize their person satisfaction, but conflict with maximizing

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shareholder wealth. These costs can be minimized by, for example, tying management's compensation to stock price so they have an incentive to work to maximize stock price. Such contracts can be effective if structured properly, although they have been criticized as providing excessive gains to managers when the entire market was rising.

Q1-7. Are ethics critical to the financial manager's goal of maximizing shareholder wealth? How are the two related? Is establishing corporate ethics policies and requiring employee compliance enough to ensure ethical behavior by employees?

A1-7. Ethics are critical to stockholder wealth maximization. Unethical behavior can have severe financial consequences to a company. For example, Arthur Anderson was unable to continue in its role as a corporate accountant for Enron and its other clients because of the fallout from Enron's collapse. For many businesses, reputation is critical to conducting business. A firm with a reputation for shady dealing will lose value relative to its ethical competitors.

Q1-8. What are the key provisions of the *Sarbanes-Oxley Act of 2002*? How has this act changed the way corporate America conducts business?

A1-8. The U.S Congress passed the *Sarbanes-Oxley Act of 2002* in response to the accounting scandals surrounding Enron, WorldCom and other companies that went bankrupt in 2001, and due to concerns about auditors' conflicts of interest. The law was passed in an effort to improve corporate governance practices in U.S. public companies. The act established a new *Public Company Accounting Oversight Board*, with the power to license auditing firms and regulate accounting and auditing standards. This act also gave the U.S. *Securities and Exchange Commission (SEC)* greater powers to supervise corporate governance practices in public companies. The act requires both the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) of all large companies to *personally* certify their firms' financial statements, meaning that the CEOs and CFOs can be held personally liable for any questionable or misleading numbers reported to public investors. This Act also prevents auditing firms from providing other services – such as consulting, valuation, and tax advisory work – to the companies they are auditing, and mandates the lead auditing partner must rotate off the audit every five years. Perhaps the most crucial internal change the Act mandates is to give the firm's Audit Committee much greater power, responsibility and independence. The Act requires that each member of the audit committee must also be a member of the board of directors – but otherwise be independent (not an officer or employee) – and mandates that at least one of the committee members must be a "financial expert."

The Key Provisions of SOX are: (And this list is not exhaustive)

- Sections 401, 404 and 408: Full Disclosure – was an attempt to improve corporate disclosure and prevent fraudulent use of off balance sheet items. Also required corporate managers to sign-off on the disclosure as accurate and truthful.
- Sections 101, 108, 109, Title II, Sections 302 and 802: Accounting Profession Independence – this section was an attempt to create and maintain auditor independence, hopefully restoring confidence to the accounting profession. This section also includes penalties and criminal actions that can be brought against managers who knowingly falsify or change accounting records.
- Sections 302, 304 306, 402, 403, 406: Manger Control at the TOP – often referred to as the "Tone at the Top" Section – this section places guidelines on top management and their behavior including for example : returning of bonuses within twelve

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months of restatement of earnings and prevention of manager trading during pension blackout periods.

- Sections 301, 407, 307 and 501: "Gatekeeper" clauses – which guides those in charge of SROs (Self Regulating Organizations) and auditing committees.
- Section 1107 (others have some mention of this also): Enhancing the tools of the SEC and protection of the whistleblowers in organizations where unethical behaviors are being reported

The Impact of SOX on American business: SOX literally changed the accounting profession overnight – creating an entirely new area of corporate accounting – SOX regulation and auditing. It increased costs for all firms –with one estimate nearing 23% of revenues during the first year of implantation. Companies were required to change most aspects of accounting procedures and train employees on compliance.

Solutions to End-of-Chapter Problems

LEGAL FORMS OF BUSINESS ORGANIZATION

P1-1. **a.** Calculate the tax disadvantage to organizing a U.S. business today as a corporation, as compared to a partnership, under the following conditions. Assume that all earnings will be paid out as cash dividends. Operating income (operating profit before taxes) will be $500,000 per year under either organizational form. The tax rate on corporate profits is 35 percent (T_c = 0.35), the average personal tax rate for the partners is also 35 percent (T_p = 0.35), and the capital gains tax rate on dividend income is 15 percent (T_{div} = 0.15).
b. Now recalculate the tax disadvantage using the same income but with the maximum tax rates that existed before 2003. (These rates were 35 percent (T_c = 0.35) on corporate profits and 38.6 percent (T_p = 0.386) on personal investment income).

A1-1. a. If the firm is organized as a partnership, operating income will be taxed only once, so investors will receive $500,000 *x* (1-0.35) = $325,000. If the firm is organized as a corporation, operating income will be taxed once at the corporate level and again at the personal level at the capital gains tax rate of 15 percent, so investors will receive only $500,000 *x* (1-0.35)(1-0.15) = $276,250. The "corporate tax wedge" is thus $48,750, or 9.75 percentage points.

b. Using the pre-2003 tax rates, partnership investors would receive $500,000 *x* (1-0.386) = $307,000. If the firm was organized as a corporation, operating income would be taxed once at the corporate level (at 35 percent) and again at the personal level at the personal income tax rate of 38.6 percent, so investors received only $500,000 *x* (1-0.35)(1-0.386) = $199,550. The "corporate tax wedge" was thus $107,450, or 21.49 percentage points.*

*Note that this solution assumes that the corporation is not re-investing any of its profits, but is distributing all of its profits to shareholders as dividends.

P1-2. Calculate the tax disadvantage to organizing a U.S. business as a corporation versus as a partnership under the following conditions. Assume that all earnings will be paid out as cash dividends. Operating income (operating profit before taxes) will be $3,000,000 per year un-

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der either organizational form. The tax rate on corporate profits is 30 percent (T_c = 0.30); the average personal tax rate for the partners is 35 percent (T_p = 0.35); and the capital gains tax rate on dividend income is 15 percent (T_{div} = 0.15). Then, recalculate the tax disadvantage using the same income but with the maximum tax rates that existed prior to 2003. (These rates were 35 percent (T_c = 0.35) on corporate profits and 38.6 percent (T_p = 0.386) on personal investment income.)

A1-2. **a.** If the firm is organized as a partnership, operating income will be taxed only once, so investors will receive \$3,000,000 × (1–0.35) = \$2,100,000. If the firm is organized as a corporation, operating income will be taxed once at the corporate level, leaving \$3,000,000 × (1–0.30) = \$2,100,000 available for distribution to investors, and then the dividends paid out will be taxed at the investor's capital gains tax rate. This yields net disposable income of \$2,100,000 × (1–0.15) = \$1,785,000. Partners thus pay a total tax rate of 35 percent on business income, while corporate shareholders pay a combined tax rate of 40.5 percent [1–(1–0.30)(1–0.15)] on this income, the "corporate tax wedge" is thus the difference between these two rates, or 5.50 percentage points (40.5%–35%).

b. If the firm is organized as a partnership, operating income will be taxed only once, so investors will receive \$3,000,000 × (1–0.386) = \$1,842,000. If the firm is organized as a corporation, operating income will be taxed once at the corporate level and again at the personal level, so investors will receive only \$3,000,000 × (1–0.35)(1–0.386) = \$1,197,300. Partners thus pay a total tax rate of 38.6 percent on business income, while corporate shareholders pay a combined tax rate of 60.09 percent [1–(1–0.35)(1–0.386)] on this income, the "corporate tax wedge" is thus the difference between these two rates, or 21.49 percentage points (60.09%–38.6%).

THE CORPORATE FINANCIAL MANAGER'S GOALS

P1-3. Consider the following simple corporate example involving one stockholder and one manager. There are two mutually exclusive projects in which the manager may invest and two possible manager compensation plans that the stockholder may choose to employ. The manager may be paid a flat \$300,000 or receive 10 percent of corporate profits. The stockholder receives all profits net of manager compensation. The probabilities and associated gross profits associated with each project are given below:

Project #1		**Project #2**	
Probability	**Gross Profit**	**Probability**	**Gross Profit**
33.33%	\$0	50.0%	\$600,000
33.33%	\$3,000,000	50.0%	\$900,000
33.33%	\$9,000,000		

a. Which project maximizes shareholder wealth? Which compensation plan does the manager prefer if this project is chosen?
b. Which project will the manager choose under a flat compensation arrangement?
c. Which compensation plan aligns the interests of the stockholders and the manager so that the manager will act in the best interest of the stockholders?
d. What do the answers tell you about structuring management pay contracts?

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A1-3. Payoffs to Project #1

Probability	Gross Profit	Manager's Flat Pay	Stockholders Payoff	Manager's 10% Payoff	Stockholders Payoff
1/3	$ 0	$300,000	$ -300,000	$ 0	$ 0
1/3	3,000,000	300,000	2,700,000	300,000	2,700,000
1/3	9,000,000	300,000	8,700,000	900,000	8,100,000
Expected Payoff	$4,000,000	$300,000	$3,700,000	$400,000	$3,600,000

Payoffs to Project #2

Probability	Gross Profit	Manager's Flat Pay	Stockholders Payoff	Manager's 10% Payoff	Stockholders Payoff
1/2	$600,000	$300,000	$300,000	$60,000	$540,000
1/2	900,000	300,000	600,000	90,000	810,000
Expected Payoff	$750,000	$300,000	$450,000	$75,000	$675,000

a. Project #1 has the higher expected gross profit and stockholder's payoff, regardless of the managerial compensation method. If Project #1 is chosen, the manager would prefer the 10% payoff because it provides greater compensation ($400,000 vs. $300,000 flat compensation).

b. Technically under a flat compensation arrangement the manager would be indifferent because his or her compensation would be a flat $300,000 in either case.

c. Under a profit-sharing arrangement, the manager would prefer Project #1 because it would provide him or her with greater compensation ($400,000 vs. $75,000 for Project #2).

d. The profit-sharing arrangement better aligns the interests of the shareholders and manager and provides maximum benefit to both stockholders ($3,600,000 vs. $675,000 for Project #2) and managers ($400,000 vs. $75,000 for Project #2).

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P1-4 Examine the insider activities of Johnson & Johnson (ticker symbol, JNJ). Under the Filings tab, click on the Daily 144 List in the Insider Analytics box. Does there appear to be a preponderance of proposed buying or selling of JNJ shares? Does this suggest that an *agency problem* exists?

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Content Profile

Johnson & Johnson Symbol: JNJ-N (C000002564)

Johnson & Johnson -NYSE - JNJ-N

One Johnson & Johnson Plaza
New Brunswick, NEW JERSEY 08933 USA
http://www.jnj.com

Exchange: NYSE **CUSIP:** 478160104 **S&P GICS:** 35202010
Sector: Health Care **SEDOL:** 2475833 Pharmaceuticals
Industry: Pharmaceuticals **Company Status:** Active

Filings	View Filings List
10-K	12/28/2008
10-Q	3/29/2009
US Annual Report	12/28/2008
Int'l Annual Report	1/29/2008
Proxy	4/23/2009
Registration	3/11/2008

Spreadsheet Financials	
US 10K Current Financials	12/28/2008
US 10Q Current Financials	3/29/2009
Proxy Executive Comp	4/23/2009
US 10Q Historical Financials	4/29/2009
US 10K Historical Financials	4/29/2009

Insider Analytics	
Daily 144 List	5/16/2009
Daily Purchase & Sale	5/8/2009
Flash 144	5/15/2009
Flash Purchase & Sale	5/7/2009

Source: Thomson Financial

Overview Reports	
Extel Reports	
Extel Card (PDF)	5/10/2009
Extel Card (HTML)	5/10/2009
SEC Reports	
SEC Company Full Rpt	4/29/2009

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	Water Street Healthcare	PR

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A1-4. Answers will vary from moment to moment. This is a chance for your students to use a version of a tool that CFAs use every day.

Answer to MiniCase

Minicase: The Scope of Corporate Finance
The potential career paths for a person with expertise in finance are varied and exciting. Career possibilities include the areas of corporate finance, commercial banking, investment banking, money management, and consulting.
Assignment
Find descriptions for these and other finance-related careers on the following Web site: http://www.wetfeet.com/asp/careerlist.asp

Think of ways that the skills described as being vital to success in this chapter can be applied in each career listed. How will the ongoing trends of globalization and increased technological sophistication likely impact these jobs over the next decade?

Answer
The following information is from WetFeet, Incorporated (www.wetfeet.com). Some places in these job descriptions where it may be appropriate to the marginal benefit versus marginal cost relationship are highlighted in italics.

1. Corporate Finance
Career Overview
If you work in private enterprise, your company measures its success at the end of the year by comparing how much money it made to how much it spent. If it made more than it spent, it was a good year. If it made less than it spent, it was a bad year—or the company was in an investment phase. (In other words, like Amazon.com, it spent more than it made because the company and its investors believed it would realize a profit in the near future.)

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People who work in corporate finance and accounting are responsible for managing the money—forecasting where it will come from, knowing where it is, and helping managers decide how to spend it in ways that will ensure the greatest return.

This career profile focuses on opportunities in corporate finance and accounting in private industry. To learn about other areas in financial services, read WetFeet's industry profiles for investment banking, mutual funds and brokerage firms, commercial banking, insurance, and accounting. These profiles detail a variety of specialized financial functions beyond those in private enterprise.

Every company has a corporate finance function. The responsibilities that fall under finance and accounting range from basic activities, such as bill paying, to very sophisticated ones, such as forecasting the value of a potential acquisition. The stakes can amount to hundreds of millions—sometimes billions—of dollars and thousands of jobs. Careful assessment of the financial implications of particular strategic decisions can be critical to a company's success or failure.

Of course, a company's size, complexity, economic sector, and stage of development (e.g., start-up or established business) influence what tasks the corporate finance team undertakes every day. All companies need to balance their books. Some large technology companies, for example, hire financial experts to ***valuate potential acquisitions (will the firm earn more from assets purchased than the cost of the acquisition***). Others (e.g., insurance companies) have hundreds of millions of dollars to invest and need financial wizards to manage it.

What You'll Do

Corporate finance includes two key functions: accounting and finance.

Accounting concerns itself with day-to-day operations. Accountants balance the books, track expenses and revenue, execute payroll, and pay the bills. They also compile all the financial data needed to issue a company's financial statements in accordance with government regulations.

Finance pros ***analyze revenue and expenses (is the firm earning more on any particular project than the cost of undertaking that project)*** to ensure effective use of capital. They also advise businesses about project costs, make ***capital investments (corresponds to earning an IRR greater than the WACC***), and structure deals to help companies grow.

In spite of their different roles, finance and accounting are joined at the hip: The higher levels of accounting (budgeting and analysis) blend with financial functions (analysis and projections). Thus, finance and accounting are often treated as one, with different divisions undertaking particular tasks, such as cash management or taxes.

2. Commercial Banking

Industry Overview

Asked why he robbed banks, Willie Sutton replied, "Because that's where the money is." That was in the '30s, but even today, despite changes, a lot of the money is still in commercial banks. Most of us maintain checking accounts at commercial banks and use their ATMs. ***The money we deposit in our neighborhood bank branch or credit union supports local economic activity through small business loans, mortgages, auto loans, and home repair loans (bank managers must make sure that the bank earns higher returns on its loan portfolio than what it pays on deposits***. The bank also provides loans in the form of credit card charges, and it renders local services including safe deposit, notary, and merchant banking. The bank branch or credit union office remains the cornerstone of Main Street economic life.

But that doesn't mean the industry isn't changing. Traditionally a staid business (think: gray suits and conversations conducted in hushed voices and formal tones), banking is now entering a whole new world. For one thing, there's the move of banking onto the Web, where companies like Bank of America now conduct a lot of their banking business with customers. For another, there's the explosion in branch banking, as banks like Washington Mutual attempt to become as ubiquitous

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as 7-Eleven stores in the American landscape. And thanks to the repeal of the Glass-Steagall Act, which limited the businesses commercial banks could operate in, there's the move among banks into nontraditional businesses such as insurance products and securities.

Trends

Consolidation and New Jobs

For decades, banks profited by simply holding customers' money and charging them check-writing fees and interest on loans. Jobs were well defined and stable, and the paths to promotion were clear and secure. Not anymore. Consolidation, competition, and technological change are shaking the industry to its core, f forcing layoffs while creating opportunity.

Since 1995, more than 200 large and small banks have merged. A handful of recently consolidated giants—Citigroup, Bank of America, JP Morgan Chase, Bank One—dominate the banking industry. The new behemoths are entering new markets, while replacing service personnel with online and other technologies. However, hiring by a growing number of nonbanks compensates for this trend to a degree. These firms, which are pioneering new ways of delivering financial services, include MBNA and Capital One, which are credit card lenders, as well as transaction processing and data services like First Data and Fiserv.

Deregulation

The Glass-Steagall Act, passed by Congress in 1933, served as the backbone of banking regulation. During the late '90s, however, banks and other financial institutions found ways around the restrictions placed on them by Glass-Steagall and related legislation. Finally, in late 1999, Glass-Steagall was repealed, eliminating the legal framework for Depression-era boundaries for financial services firms. The big firms were already skirting the Glass-Steagall boundaries—for instance, Citigroup could offer customers insurance through its Travelers subsidiary—when Glass-Steagall was overturned in 1999. But now even smaller players in commercial banking can offer everything from insurance to securities products.

Problem Loans and Lower Profits

Just so you know that it's not all sweetness and light in the commercial banking industry: Bankruptcies at companies like Enron and Kmart and the fact that most companies have been so concerned with cutting costs that they haven't given much thought to purchasing new equipment or building new facilities, as well as other factors, have caused an ongoing slump in commercial lending.

On the consumer side of the business, 2003 saw the largest number of individual bankruptcies in U.S. history, meaning ***underperforming loans for banks (underperforming loans act to squeeze the spread between loan revenues and deposit interest expenses***). And the mortgage-lending boom seems to have come to an end; indeed, some project mortgage lending will be cut in half in 2004.

How It Breaks Down

As a job seeker, the most important distinction to keep in mind is between regional banks and the big global ones. Here we've broken down the industry by type of banking, rather than size of player, since banks are increasingly adding new services to their array of traditional ones.

Consumer or Retail Banking

This is what most people think of when they think of banking: A small to mid-sized branch with tellers and platform officers—the men and women in suits sitting at the nice wooden desks with

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pen sets—to handle customers' day-to-day needs. Although thousands of small community banks, credit unions, and savings institutions still exist, employment opportunities are increasingly coming from a few megaplayers such as Citibank, Bank of America, and J.P. Morgan Chase, most of which seem hell-bent on building national—and even international—banking operations.

One complicating factor in this picture is that the banks mentioned above, in addition to extending their consumer-banking operations, have added to their portfolios by strengthening their investment-banking and asset-management capabilities, among others. So, if you want to work at Citibank, make sure that you're applying to the right part of the organization.

Business or Corporate Banking

Many of the players in this group are the same ones in the consumer-banking business; others you'll find on Wall Street, not Main Street. At the highest level, the larger players (Wells Fargo, Wachovia, and Bank One being three names to add to the list of megaplayers above) provide a wide range of advisory and transaction-management services to corporate clients. Depending on which institution and activity area you join, the work can resemble branch banking or investment banking.

Securities and Investments

Traditionally, this field has been the domain of a few Wall Street firms. However, as federal regulations have eased, many of the biggest commercial banks, including Bank of America, Citibank, and J.P. Morgan Chase, have aggressively added investment-banking and asset-management activities to their portfolios. For anyone interested in corporate finance, securities underwriting, and asset management, many of these firms offer an attractive option. However, hiring for these positions is frequently done separate from that for corporate and consumer banking.

Nontraditional Options

Increasingly, a number of nonbank entities are offering opportunities to people interested in financial services. Players include credit card companies such as American Express, MasterCard, and Visa; credit card issuers like Capital One and MBNA; and credit-reporting agencies such as Experian. Although people at these firms are still in the money business, the specific jobs vary greatly, perhaps more widely than jobs at traditional banks do. In particular, given the volume of transactions that many of these organizations handle, opportunities for people with strong technical skills are excellent.

Job Prospects

Two of the major trends in banking in the past decade or more have been consolidation (e.g., the acquisition of Bank One by J.P. Morgan Chase, or the takeover of FleetBoston by Bank of America) and the increasing use of technology (e.g., online banking, or automated check processing). Both of these trends have had and will continue to have a negative effect on job growth in the industry.

But it’s not all bad news in banking; the U.S. population is growing, and new population centers are emerging all the time, so there will be new jobs available in new locations. And while opportunities for bank tellers and back-office clerical workers stagnate, financial analysts, financial advisors, and trust officers will enjoy growing opportunities as the (now-rich) Baby Boom generation ages.

With the Glass-Steagall Act overturned, and the convergence of the securities, banking, and insurance industries, banks now sell all kinds of financial products and services that they couldn’t in the past—and face new competition for traditional lending business. This means more oppor-

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tunity for financial services sales reps and less opportunity for loan officers and others with only a limited knowledge of the full array of financial products banks can now sell.

Finally, expect strong growth for tech positions in banking, as processes and operations become increasingly automated and companies' networks grow and grow.

3. Investment Banking

Career Overview

You've heard about the legendary long hours, the big bonuses, and the megabillion-dollar deals. You can recite the names of the big firms by heart. You like to imagine yourself a pinstripe-wearing, jetsetting investment banker. But suddenly it dawns on you. What the heck is investment banking? You panic. What do investment bankers do? What's the difference between sales and trading and corporate finance? More to the point, why do you want to be a banker?

What I-Banking Is

Traditionally, commercial banks and investment banks performed completely distinct functions. When Joe on Main Street needed a loan to buy a car, he visited a commercial bank. When Sprint needed to raise cash to fund an acquisition or build its fiber-optic network, it called on its investment bank. Paychecks and lifestyles reflected this division too, with investment bankers reveling in their large bonuses and glamorous ways while commercial bankers worked nine-to-five and then went home to their families. Today, as the laws requiring the separation of investment and commercial banking are reformed, more and more firms are making sure they have a foot in both camps, thus blurring the lines and the cultures.

Investment banking isn't one specific service or function. It is an umbrella term for a range of activities: ***underwriting, selling, and trading securities (stocks and bonds); providing financial advisory services, such as mergers and acquisition advice; and managing assets (many of these services help managers of client firms to better reach their goals of assuring their firm's marginal benefits are greater than their marginal costs***). Investment banks offer these services to companies, governments, non-profit institutions, and individuals.

The action and players in investment banking are still centered in New York City and a few other money centers around the world, but the list of players is getting smaller as the industry consolidates. Today, leading banks include Merrill Lynch, Goldman Sachs, Morgan Stanley, Citigroup's Corporate and Investment Bank (whose investment banking arm was until recently known as Salomon Smith Barney), Credit Suisse First Boston, and JPMorgan Chase. These and other firms are regular visitors to campus career centers.

What You'll Do

The intensely competitive, action-oriented, profit-hungry world of investment banking can seem like a bigger-than-life place where deals are done and fortunes are made. In fact, it's a great place to learn the ins and outs of corporate finance and pick up analytical skills that will remain useful throughout your business career. But investment banking has a very steep learning curve, and chances are you'll start off in a job whose duties are more Working Girl than Wall Street.

Wall Street is filled with high-energy, hardworking young hotshots. Some are investment bankers who spend hours hunched behind computers, poring over financial statements and churning out spreadsheets by the pound. Others are traders who keep one eye on their Bloomberg screen, a phone over each ear, and a buyer or seller on hold every minute the market's in session. Traders work hand in hand with the institutional sales group, whose members hop from airport to airport trying to sell big institutions a piece of the new stock offering they have coming down the pipeline. Then there are the analytically minded research analysts, who read, write, live, and breathe whichever industry they follow, 24/7.

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Who Does Well

You shouldn't go into banking just for the money—the lifestyle is too demanding. To survive in investment banking, much less to do well, you'll need to like the work itself. And, quite honestly, even if you love the work, an investment banking career can still be a tough road. If the market or your industry group is in a slump (or if your firm suddenly decides to get out of a certain segment of the business), there's always the chance that you may find a pink slip on your desk Monday morning.

But, if you like fast-paced, deal-oriented work, are at ease with numbers and analysis, have a tolerance for risk, and don't mind putting your personal life on hold for the sake of your job, then investment banking may be a great career choice. But if this doesn't sound like you, a job in investment banking could turn out to be a bad dream come true.

More Investment Banking

Industry Overview

The intensely competitive, action-oriented, profit-hungry world of investment banking can seem like a bigger-than-life place where deals are done and fortunes are made. In fact, it's a great place to learn the ins and outs of corporate finance and pick up analytical skills that will remain useful throughout your business career. But investment banking has a very steep learning curve, and chances are you'll start off in a job whose duties are more Working Girl than Wall Street.

Wall Street is filled with high-energy, hardworking young hotshots. Some are investment bankers who spend hours hunched behind computers, poring over financial statements, and churning out spreadsheets by the pound. Others are traders who keep one eye on their Bloomberg screen, a phone over each ear, and a buyer or seller on hold every minute the market's in session. Traders work hand in hand with the institutional sales group, whose members hop from airport to airport trying to sell big institutions a piece of the new stock offering they have coming down the pipeline. Then there are the analytically minded research analysts, who read, write, live, and breathe whichever industry they follow.

So where do you begin, and how do you focus your job search? Let's begin with an important reminder: Investment banking isn't one specific service or function. It is an umbrella term for a range of activities: underwriting, selling, and trading securities (stocks and bonds); providing financial advisory services, such as mergers and acquisition advice; and managing assets. Investment banks offer these services to companies, governments, nonprofit institutions, and individuals.

Traditionally, commercial banks and investment banks performed completely distinct functions. When Joe on Main Street needed a loan to buy a car, he visited a commercial bank. When Sprint needed to raise cash to fund an acquisition or build its fiber-optic network, it called on its investment bank. Paychecks and lifestyles reflected this division too, with investment bankers reveling in their large bonuses and glamorous ways while commercial bankers worked nine to five and then went home to their families. Today, as the laws requiring the separation of investment and commercial banking are reformed, more and more firms are making sure they have a foot in both camps, thus blurring the lines and the cultures. The action and players are still centered in New York City and a few other money centers around the world, but the list of players is getting smaller as the industry consolidates. Today, leading banks include Merrill Lynch, Goldman Sachs, Morgan Stanley, Citigroup (whose investment banking arm was until recently known as Salomon Smith Barney), Credit Suisse First Boston, and JPMorgan Chase. These and other firms are regular visitors to campus career centers.

4. Asset Management

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Career Overview
If money makes the world go 'round, the Earth would grind to a screeching halt without the asset management industry. Asset management is the business of making money with money—or at least trying to. When we say "money," we're not talking about salaries and bonuses (which can indeed be significant), but the gains you endeavor to make for investors who have forked over their cash in hopes that you, through your market savvy and keen instincts, can turn their nest egg into a fancy omelet with toast and hash browns on the side.

What You'll Do
Asset managers ***manage money—other people's money (the return earned on these investments is the marginal benefit, whereas the marginal cost is can oftentimes be viewed as the return on any possible alternative investments***), and gobs of it. Generally, they convert that money into assets—stocks, bonds, derivatives, and other types of investments—and try to make that money make more money as fast as possible. Mutual funds, for instance, hire asset managers; so do corporations with lots of money sitting around, banks, and high-net-worth individuals.

Asset managers have one simple goal: to invest other people's money wisely and profitably. Asset managers use a combination of investment theory, quantitative tools, market experience, research, and plain dumb luck to pick investments for their portfolios, ranging from high-risk stocks to commercial real estate to cash accounts.

Who Does Well
As an asset manager, you can't just bet your hunches. The profession requires excellent quantitative and analytical skills—if you hated statistics, you may want to look for a career elsewhere. But asset management isn't just a matter of adding up the numbers. It requires the organizational skills—and nerve—to make split-second decisions with millions of dollars riding on the line. The profession is notoriously tough to break into, especially for those who only have an undergraduate degree. MBAs most often start as analysts to prove they have the right combination of caution and chutzpah to make a great asset manager.

Competition for jobs is fierce at all levels, but if you have strong quantitative and analytical skills, good nerves, and can consistently beat the market, there's probably a place for you. Networking and a single-minded pursuit of your goal are big helps, too.

5. Mutual Funds & Brokerage
Industry Overview
When a large amount of money is needed for any enterprise, from building a factory to funding a corporation to drilling wells in a new oil field, that money is raised from investors—usually a large number of them. Commonly, the enterprise raises that money by either selling ownership shares in itself or simply borrowing the money. When ownership is sold, the investor gets stock shares. When money is borrowed, the investor gets bonds. Stocks and bonds are both securities. Investors buy and sell individual securities through brokers, also called securities dealers.

Additionally, mutual fund companies—and other so-called asset management firms—form funds, which consist of a variety of securities. The asset management company buys and sells the securities in a fund, seeking to maximize its value, and it sells shares in these funds to investors directly and through securities brokers.

More people invest in securities today than ever before, and they have more choices. Not only are there more investments to choose from, including stocks, bonds, real estate trusts, limited partnerships, and an ever-growing diversity of mutual funds; there are also more ways to invest: full-service brokerages, discount brokerages, and electronic trading for most of us; exclusive opportunities such as hedge funds and venture capital funds for so-called high-net-worth individuals, such as

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multimillionaires, and institutional investors, such as pension funds, insurance companies, and university endowments.

There is an unimaginably large amount of money chasing investments these days, which is part of the reason that the stock market rose so steeply during the 1990s. Brokerages and mutual funds are the two primary means by which all these investments are made.

6. Insurance

Industry Overview

If you want to impress your friends and family with a job full of glamour, sizzle, and prestige, insurance is the wrong game for you. But if you want to work in an industry where there's always going to be demand for your services, you'd have a hard time finding a better candidate than insurance.

About 1,800 U.S. insurance companies offer personal and commercial product lines including basic health/life and property/casualty protection as well as a long list of other coverage ranging from automobiles to mortgages to insurance for insurance companies (known as reinsurance). These products ***protect customers from losses (the marginal benefit of insurance is the coverage of a potential large liability or loss, which is compared to the marginal cost of the insurance premiums)*** resulting from illegal actions, medical needs, theft, earthquakes and hurricanes, and a variety of other causes.

Insurance companies calculate the likely cost of a given loss, divide it by the number of people who want protection against it, add something for profit, and reach an amount that they charge each customer for a policy guaranteeing compensation should the loss occur. But that's only the beginning. Insurance companies also mount huge marketing campaigns to convince customers that they need protection in general and the company's products in particular.

They also function as financiers, deriving a large part of their revenues from investments. Insurance companies must maintain enormous reserves of capital to back up potential claims obligations. They invest those reserves in stocks, bonds, and real estate, within the U.S. and overseas, providing an enormous amount of liquidity to financial markets and giving the industry an influence on the national economy far out of proportion to its size. That can be a risk, as when industry-wide over-investment in Latin America during the 1970s led to huge losses for the entire industry and repercussions far beyond the insurance industry itself.

Trends

The Good News

The market swoon ended in 2003, with stock markets posting impressive returns on the year. This is good news for anybody who trades in equities, of course, but it's particularly good news for the insurance industry. Insurance companies are major investors in the markets, and the rise in stocks means their reserve of assets has also increased—something which is important because those reserves can help a company pay off policies AND stay in business in the event of unforeseen catastrophes.

Terrorism and Insurance

In the wake of September 11, 2001, insurance companies were faced with tremendous claims. As a result, reinsurers stopped writing terrorism policies in the United States. Primary insurers, as a result, started stripping terrorism coverage out of policy renewals, in states where that was legal, and stopped offering and/or renewing policies that included terrorism insurance in states where it was not. In response, the Bush administration stepped into the picture with the Terrorism Risk Insurance Act of 2002, which acts as a kind of safety net for writers of commercial insurance. The Act

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requires insurers to pay terrorism-related claims up to a ceiling; beyond that ceiling, the government will pay the bulk of claims, thus limiting the insurance industry's risk exposure.

But the Terrorism Risk Insurance Act is set to expire in 2005. What this means for the industry is that, from that point on, insurers will have to be prepared to absorb the full cost of claims on policies it's written covering terrorist acts. What that means for the pricing of policies that include coverage of terrorist acts, and for revenue from those types of policies, remains to be seen.

Deregulation

Deregulation is redefining who can offer insurance. Repeal, in late 1999, of the 1933 Glass-Steagall Act (which formerly separated all arenas of financial services) promised a major facelift for the insurance industry. Insurers, banks, and securities brokers are now free to merge and cross-sell each others' products. This clears the way for financial service superstores that will offer insurance as well as investment and savings options. Commercial banks have been making modest inroads on traditional insurance markets for several years, but repeal of Glass-Steagall could lead to much greater and quicker changes in the role of traditional insurance agents.

Shift in Demand

The shape of the life insurance sector has morphed over the past generation. Nowadays, demand goes beyond straightforward life insurance. Rather, the market is looking to the insurance industry to provide investment products, such as annuities, which provide the consumer with regular payments for life or for a fixed period. What this means in macro terms is that the life insurance sector has had to shift its primary capability from analyzing and predicting mortality rates to a more investment-management capability. In a creative move, insurers are building a market for products that protect the investor against a variety of risks simultaneously while allowing them to draw down a death benefit while still alive.

Consolidation

Continuing the trend that essentially began 30 years ago, insurance companies are responding to global competition and the need for cost efficiency by forming strategic alliances, merging into conglomerates, and buying smaller companies. This trend is doing away with the independent agencies that used to define the industry. Consolidation also means that companies will offer a full range of insurance products instead of specializing in certain realms such as property or casualty.

How It Breaks Down

Life and Health Insurance

The policies in this sector provide benefits packages that policyholders pay a premium to enjoy. Health insurance has gone through some major overhauls, including the replacement of fixed-fee Blue Cross/Blue Shield-inspired policies with managed care networks. The life insurance business is experiencing slow growth, and life insurance companies are likely to be merging with banks and securities firms. Hartford, Prudential, and Metropolitan Life are U.S. leaders in the life insurance game, while Aetna and CIGNA rule the HMO realm.

Property and Casualty (P/C) Insurance

The focus in this sector is on protection for owners of cars, homes, and businesses from loss, damage, and injury. Competition is fierce in this sector, and profits are falling. Only the strong will survive as weaker companies continue to tank and even more secure ones sell off this line.

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Insurance Brokers
Brokers act as go-betweens, uniting buyers and sellers of insurance and creating the contracts that bind them. Furthermore, they play the role of risk consultants for large clients, researching industry information to advise companies how to manage risk exposure. Major players include Aon and Marsh & McLennan Companies.

Reinsurance
In the most simple terms, reinsurance is the insurance of insurance companies. Insurance companies pay reinsurers to assume some or all of the risk the insurers have taken on in writing policies for their clients. Insurers use reinsurance to protect against the risk of unusual losses. Reinsurers write reinsurance because their business allows them to pool enormous numbers of individual insurance risks, making their risks even more predictable than the risks faced by primary insurers.

Job Prospects
The insurance industry enjoys more demand for its products today than ever before. As the U.S. population grows and the Baby Boomers reach old age, demand in areas like health insurance, auto insurance, and homeowners insurance will be especially strong.

However, ongoing consolidation and technology advances make it unlikely that job opportunities in many functional areas will grow at a strong rate in the insurance industry. When companies combine, redundant positions tend to be eliminated. And as interactions with insurance clients, as well as internal business processes, become increasingly automated, there will be less demand for employees in the roles the new technologies have replaced; insurance agents and underwriters are among those most expected to be negatively impacted by the increasing role of technology in the industry.

Job opportunities in some functional roles in the industry are expected to grow, though. For instance, adjusters will not be replaced by technology; face-to-face interaction with the customer is key to this job function—so this area should see solid employment growth. And agents who can sell a variety of types of insurance or financial services will face much better prospects than traditional insurance agents.

7. Real Estate
Industry Overview
The real estate industry's pared-down definition is land. However, it's much more complicated than that. The industry involves the ***buying, selling, renting, leasing, and management of commercial, residential, agricultural, and other kinds of property (the return on any real estate investment and be compared to the cost of financing, such that MB > MC***), including all the functions that support such activity, such as appraising and financing. The successful realtor is necessarily a shrewd salesperson with a deep knowledge of real estate markets and a broad understanding of the contracts, laws, and tax regulations that apply to real estate transactions.

Thinking big is part of the real estate industry, and grandiose speculation has created some of America's greatest fortunes. John Jacob Astor traded in his empire of beaver pelts for a gamble on uptown Manhattan real estate and in the process became the richest man in America. More recently, moguls like Sam "the grave dancer" Zell and the perennially overreaching Donald Trump have made fantastic fortunes on real estate gambles. Even for nonbillionaires in the industry, the thrill of deal making, the potential for financial reward, and the sociability make real estate a rewarding profession.

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Job Prospects
Unlike much of the rest of the economy, the real estate industry has been doing quite well, with many leading firms chalking up double-digit top-line growth in 2003. Though the robustness varies between sectors, with the residential side of real estate doing best, the industry is hardly in the hangdog state that nearly every other part of the economy seems to be in.

This overview is excerpted from The WetFeet Insider Guide to Careers in Real Estate. To get the whole story, from the major players to what it's like to work in the industry, buy the book!

8. Venture Capital
Industry Overview
Underneath their moneyed mystique, venture capitalists are essentially glorified middlemen, and their modus operandi is easily explained. In a nutshell, a VC firm acts as a broker for institutional or "limited partner" investors such as pension funds, universities, and high-net-worth individuals, all of whom pay annual management fees to have their money invested in high-risk, high-potential-yield start-up companies.

After amassing a certain sum from the limited partner investors—usually between $10 million and $1 billion—the VC firm parcels out the fund to a portfolio of fledgling private companies, each of which hands over an equity stake in its business. In other words, the VC industry is predicated on a simple swap of the VC's financing for an ownership stake in the company's success, often (but by no means always) before the company has begun generating revenues. VC funding has nourished some of corporate America's greatest success stories when they were still baby businesses—FedEx, Intel, Sun Microsystems, and Apple, to name a few. ***(Venture capitalist will typically enter into a venture with an expectation of earning extremely high returns on successful investments. The high returns on successful deals are necessary to balance out against a large number of unsuccessful or unprofitable deals. Venture fund managers strive to have the marginal benefit of their portfolio of successful deals to be greater than the marginal costs of their failed deals.)***

Since the VC firm has a vested interest in its start-ups' success, partners will generally sit on several boards of directors, offering advice and additional resources to help businesses grow. In the event that one of its start-ups merges with or is bought out by a larger company or goes public, any windfall is divvied up between the company, the VC firm, and the limited partner investors. Typically, the VC firm distributes 70 to 80 percent of the return on its investments to the various limited partners and keeps the rest for itself.

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