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FUNDAMENTALS OF CORPORATE FINANCE

THIRD EDITION

WILEY

Fundamentals of corporate finance

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PREFACE

Fundamentals of corporate finance, 3rd edition, has been developed for use in an introductory course in corporate finance.

Balance between conceptual understanding and computational skills

Fundamentals of corporate finance reflects the reality that finance continues to be challenged by the experiences and events of market activity. Although the teaching of finance may have remained robust as a framework of conceptual thought, it is imperative that you come to realise that 'finance is not physics'. This leads to a consideration of managing risk and risk management approaches as having behavioural aspects that are the outcomes of a manager's or the firm's accumulated experience. They cannot always be reduced to the simple directives of a quantitative algorithm.

Our primary objective in writing this text was to provide you (students) and lecturers with a resource that strikes the best possible balance between helping you develop an intuitive understanding of key financial concepts and providing them with problem-solving and decision-making skills. In our experience, teaching students at all levels, we have found that students who understand the intuition underlying the basic concepts of finance are better able to develop the critical judgement necessary to apply financial tools to a broad range of real-world situations.

Our ultimate goal has been to write a text and develop associated learning tools that help our colleagues succeed in the classroom. Our text offers a level of rigour that is appropriate for finance majors and yet presents the content in a manner that both finance and non-finance students want to read. We have also tried to provide solutions to many of the challenges facing academics in the current environment, such as teaching ever-increasing numbers of students with limited resources. Finance academics need a text and associated learning tools that help them effectively leverage their time. The organisation of this text and the supplemental materials provide such leverage to an extent not found with other textbooks.

A focus on value creation

This text has an important integrating theme — that of value creation. This theme, which is carried throughout the text, provides a framework that helps you understand the relations between the various concepts covered in the text and makes it easier for them to learn these concepts.

The concept of value creation is the most fundamental notion in corporate finance. It is in shareholders' best interests for value maximisation to be at the heart of the financial decisions made within the company. Thus, it is critical that you are able to analyse and make business decisions with a focus on value creation.

The concept of value creation is introduced in the first chapter of the text and is further developed and applied throughout the remaining chapters. By helping you better understand the economic rationale for a decision from the outset, rather than initially focusing on computational skills, our text helps you remain focused on the true purpose of the calculations and the decision at hand.

To support the focus on value creation, we have emphasised three approaches: (1) providing an intuitive framework for understanding fundamental finance concepts, (2) teaching you how to analyse and solve finance problems and (3) helping you develop the ability to use the results from their analyses to make good financial decisions.

Organisation and coverage

Part 1 consists of chapters 1 and 2. Chapter 1 provides an introduction to corporate finance. Chapter 2 describes the financial environment and how the level of interest rates in the economy is determined.

These discussions set the stage and provide a framework that you can use to think about key concepts as the course progresses.

Part 2 presents basic financial concepts and tools and illustrates their application. This part of the text, which consists of chapters 3 to 7, introduces the time value of money and risk and return concepts and extends them to cover the principles underlying the application of present value concepts to bond and share valuation. These chapters provide you with basic financial intuition and computational tools that will serve as the building blocks for analysing investment and financing decisions in subsequent chapters.

Parts 3 and 4 of the text focus on investment and financing decisions. Part 3 covers capital budgeting. Chapter 8 introduces the concept of net present value and illustrates its application. This discussion provides a framework that will help you in the rest of part 3 as they learn the nuances of capital budgeting analysis in realistic settings. Chapter 11 explains using an innovative concept — that of the finance balance sheet, how the discount rates used in capital budgeting are estimated. It also provides a detailed discussion of methods used to estimate the costs of the individual components of capital that are used to finance a company's investments and how these estimates are used in capital budgeting.

Part 4 covers working capital management and financing decisions. It begins, in chapter 12, with a discussion of how companies manage their working capital and the implications of working capital management decisions for financing decisions and company value. This discussion is followed, in chapters 13 and 14, with discussions of how companies raise capital to fund their real activities and what factors affect how firms choose among the various sources of capital available to them. Chapter 15 rounds out the discussion of financing decisions with an introduction to dividends and dividend policy.

Part 5, which consists of chapters 16 and 17, brings together many of the key concepts introduced in the earlier parts of the text. Chapter 16 covers financial aspects of business formation and growth and introduces you to business valuation concepts for both private and public companies. The discussions in this chapter integrate the investment and financing concepts discussed in parts 3 and 4 to provide you with a more complete picture of how all the financial concepts fit together. Chapter 17 covers concepts related to strategic financial planning.

Part 6 introduces you to some important issues that managers must deal with in applying the concepts covered in the text to real-world problems. Chapter 18 introduces call and put options and discusses how they relate to investment and financing decisions and discusses the use of options in risk management. Chapter 19 examines how international considerations affect the application of concepts covered in the text.

KEY FEATURES

Print text

Chapter scene setters

Each chapter begins with a vignette that describes a real company application. The vignettes illustrate concepts that will be presented in the chapter and are meant to heighten your interest, motivate learning and demonstrate the real-life relevance of the material in the chapter.

Learning objectives

At the beginning of the chapter the learning objectives that identify the most important material for you to understand while reading the chapter. At the end of the chapter, the summary of learning objectives summarises the chapter content in the context of the learning objectives.

Demonstration problems

Along with a generous number of in-text examples, most chapters include several demonstration problems. These demonstrations contain quantitative problems with step-by-step solutions to help you better understand how to apply their intuition and analytical skills to solve important problems. By including these exercises, we provide you with additional practice in the application of the concepts, tools and methods that are discussed in the text.

Key points

You must have an intuitive understanding of a number of important principles and concepts to successfully master the finance curriculum. Throughout the text, we emphasise these important concepts by presenting them in key point boxes. These boxes provide a statement of an important finance concept, such as the relation between risk and expected returns, along with an intuitive example or explanation to help you 'get' the concept. These boxes help you develop finance intuition. Collectively the key point boxes cover the most important concepts in corporate finance.

Decision-making examples

Throughout the text, we emphasise the role of the financial manager as a decision maker. To that end, nearly every chapter includes decision-making examples. These examples, which emphasise the decision-making process rather than computation, provide you with experience in financial decision making. Each decision-making example outlines a scenario and asks you to make a decision based on the information presented.

Summary of learning objectives and key equations

At the end of the chapter, you will find a summary of the key chapter content related to each of the learning objectives listed at the beginning of the chapter, as well as a summary of the key equations in the chapter.

Self-study problems

The self-study problems follow the summary and are similar to the in-text demonstration problems. The problems provide additional examples with step-by-step solutions to help you further develop their problem-solving and computational skills.

Critical thinking questions

The critical thinking questions require you to think through their understanding of key concepts and apply those concepts to a problem.

Questions and problems

The questions and problems are primarily quantitative and are classified as Basic, Moderate or Challenging.

Interactive eBook

Students who purchase a new copy of *Fundamentals of Corporate Finance* will have access to an Interactive eBook version of this title via the code on the inside front cover. The eBook integrates the following media and interactive elements into the narrative content of each chapter.

- *Practitioner videos* provide insights into the application of corporate finance concepts in business
- *Video cases* highlight the use of corporate finance techniques within large global corporations
- *Animations of worked examples* walk you through the steps in solving corporate finance problems
- *Interactive 'stepped tutorials'* provide scaffolding for you to solve problems
- *Revision sets* at the end of each chapter help you to understand your strengths and weaknesses and provide feedback to correct misunderstandings.

ABOUT THE AUTHORS

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James Murray has taught at Monash University, Swinburne University of Technology and Lincoln University. He completed his PhD in the area of dividend policy at Monash University. His research interests primarily relate to the role of the legal and tax environment in corporate finance and new developments in financial technology (Fintech), in particular, the development of equity crowdfunding in New Zealand.

PART 1

INTRODUCTION

CHAPTER 1

The financial manager and the company

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1.1 identify the key financial decisions facing the financial manager of any company

1.2 identify the basic forms of business organisation used in Australia, and review their respective strengths and weaknesses

1.3 describe the typical organisation of the financial function in a large company

1.4 explain why maximising the current value of the company's shares is the appropriate goal for management

1.5 discuss how agency conflicts affect the goal of maximising shareholder value

1.6 explain why ethics is an appropriate topic in the study of corporate finance.

Financial managers are continually faced with making decisions to maximise the current value of the company's shares. Geoff Babidge, CEO of the a2 Milk Company, is targeting developed markets rather than the fast-growing Asian markets. This may appear to be odd considering many consumers are reducing their intake of dairy. However, the a2 milk is not like other dairy products.

The a2 Milk Company produces dairy products from cows' milk that contain only the A2 betacasein, whereas most milk contains both A1 and A2 betacaseins. Studies have shown that A2-only milk digests differently and is therefore a real solution for millions of people who have trouble digesting dairy products. Mr Babidge said that competitors cannot easily mimic its process as it is secured by a series of patents and trademarks. It is this unique feature of their products that differentiate a2 Milk Co. from competitors.

The science behind a2 was identified in New Zealand but its success has been largely due to the Australian market. Its fresh milk and infant formula sell at a premium even though Coles and Woolworths sell home-brand milk for $1 per litre. The New Zealand company expanded into the Australian market in 2007 and now supplies 9 per cent of the Australian fresh milk grocery channel by value. Mr Babidge said he will fund moving into the United Kingdom and the United States from the solid base he's built in Australia. a2 plan on investing US$20 million in the US over the next three years.

Even though the company is listed in New Zealand, its stock began trading on the Australian Securities Exchange on 31 March 2015 to boost the liquidity of a2 shares and broaden the potential investor and capital base in case equity issues are required during this growth phase. The company is currently investing heavily in starting up its business in the UK and US, and expanding its infant formula sales in China, leaving little profit. In addition, a2 is considering launching cheese and ice-cream products in Australia. Its priority, at this time, is growing the business. In 2013–14 a2 Milk reported revenue of NZ$110.6 million ($108 million) and aims to more than double revenue to NZ$230 million by 2015–16.

Company managements use many of the concepts covered in this and later chapters to create the most possible value. Managers create value by investing only in projects whose benefits exceed their costs, by managing the assets of the company as efficiently as possible, and by financing the company with the least expensive combination of debt and equity. This chapter introduces you to the key financial aspects of these activities and the remainder of this text fills in many of the details.[1]

Chapter preview

This text provides an introduction to corporate finance. In it we focus on the responsibilities of the financial manager, who oversees the accounting and treasury functions and sets the overall financial strategy for the company. We pay special attention to the financial manager's role as a decision maker. To that end, we emphasise the mastery of fundamental finance concepts and the use of a set of financial tools, which will result in sound financial decisions that create value for shareholders. These financial concepts and tools apply not only to business organisations but also to other organisations, such as government entities, not-for-profit organisations and sometimes even your own personal finances.

We open this chapter by discussing the three major types of decisions that a financial manager makes: capital budgeting decisions, financing decisions and working capital management decisions. We then describe common forms of business organisation. After next discussing the major responsibilities of the financial manager, we explain why maximising the price of the company's shares is an appropriate goal for a financial manager. We go on to describe the conflicts of interest that can arise between shareholders and managers and the mechanisms that help align the interests of these two groups. Finally, we discuss the importance of ethical conduct in business.

1.1 The role of the financial manager

LEARNING OBJECTIVE 1.1 Identify the key financial decisions facing the financial manager of any company.

The financial manager is responsible for making decisions that are in the best interests of the business's owners, whether it is a start-up business with a single owner or a billion-dollar company owned by thousands of shareholders. The decisions made by the financial manager or owner should be one and the same. In most situations this means that the financial manager should make decisions that maximise the value of the owners' shares. This helps maximise the owners' **wealth**. Our underlying assumption in this text is that most people who invest in businesses do so because they want to increase their wealth. In the following discussion, we describe the responsibilities of the financial manager in a new business in order to illustrate the types of decisions that such a manager makes.

Stakeholders

Before we discuss the new business, you may want to look at figure 1.1, which shows the cash flows between a company and its owners (in a company, the shareholders) and various stakeholders. A **stakeholder** is someone other than an owner who has a claim on the cash flows of the company: *managers*, who want to be paid salaries and performance bonuses; *creditors*, who want to be paid interest and principal; *employees*, who want to be paid wages; *suppliers*, who want to be paid for goods or services; and the *government*, which wants the company to pay tax. Stakeholders may have interests that differ from those of the owners. When this is the case, they may exert pressure on management to make decisions that benefit them. We will return to these types of conflict of interest later in the text. For now, though, we are primarily concerned with the overall flow of cash between the company and its shareholders and stakeholders.

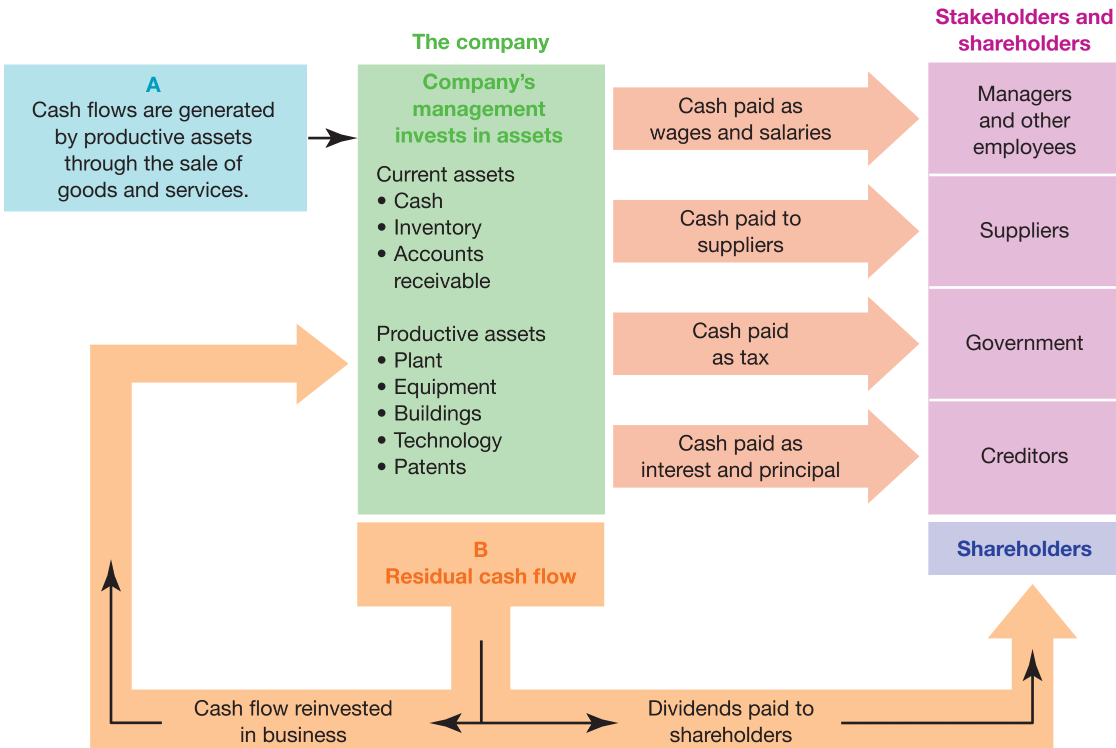
It's all about cash flows

To produce its goods or services, a new company needs to acquire a variety of assets. Most will be long-term assets or **productive assets**. Productive assets can be tangible assets, such as equipment, machinery or a manufacturing facility, or intangible assets, such as patents, trademarks, technical expertise or other types of intellectual capital. Regardless of the type of asset, the company tries to select assets that will generate the greatest profits. The decision-making process through which the company purchases long-term productive assets is called *capital budgeting*, and it is one of the most important decision processes in a company.

FIGURE 1.1 **Cash flows between the company and its stakeholders and owners**

A. Making business decisions is all about cash flows, because only cash can be used to pay bills and buy new assets. Cash initially flows into the company as a result of the sale of goods or services. The company uses these cash inflows in a number of ways: to invest in assets, to pay wages and salaries, to buy supplies, to pay taxes and to repay creditors.

B. Any cash that is left over (residual cash flows) can be reinvested in the business or paid as dividends to shareholders.



Once the company has selected its productive assets, it must raise money to pay for them. *Financing decisions* are concerned with the ways in which companies obtain and manage long-term financing to acquire and support their productive assets. There are two basic sources of funds: debt and equity. Every company has some equity because equity represents ownership in the company. It consists of capital contributions by the owners plus earnings that have been reinvested in the company. In addition, most companies borrow from a bank or issue some type of long-term debt to finance productive assets.

After the productive assets have been purchased and the business is operating, the company will try to produce products at the lowest possible cost while maintaining quality. This means buying raw materials at the lowest possible cost, holding production and labour costs down, keeping management and administrative costs to a minimum, and seeing that shipping and delivery costs are competitive. In addition, the company must manage its day-to-day finances so that it will have sufficient cash on hand to pay salaries, purchase supplies, maintain inventories, pay tax and cover the myriad other expenses necessary to run a business. The management of current assets (such as money owed by customers who purchase on credit), inventory, and current liabilities (such as money owed to suppliers) is called *working capital management*.[2]

A company generates cash flows by selling the goods and services it produces. A company is successful when these cash inflows exceed the cash outflows needed to pay operating expenses, creditors and tax. After meeting these obligations, the company can pay the remaining cash, called **residual cash flows**, to the owners as a cash dividend or it can reinvest the cash in the business. The reinvestment of residual cash flows back into the business to buy more productive assets is a very important concept. If these funds are invested wisely, they provide the foundation for the company to grow and provide larger residual cash flows in the future for the owners. The reinvestment of cash flows (earnings) is the most fundamental way that businesses grow in size. Figure 1.1 illustrates how the revenue generated by productive assets ultimately becomes residual cash flow.

A company is unprofitable when it fails to generate sufficient cash inflows to pay operating expenses, creditors and tax. Companies that are unprofitable over time will be forced into **insolvency** by their creditors if the owners do not shut them down first. In insolvency, the company will be reorganised or the company's assets will be liquidated, whichever is more valuable. If the company is liquidated, creditors are paid in a priority order according to the structure of the company's financial contracts and prevailing insolvency law. If anything is left after all creditor and tax claims have been satisfied, which usually does not happen, the remaining cash, or residual value, is distributed to the owners.

KEY POINT

Cash flows matter most to investors

Cash is what investors ultimately care about when making an investment. The value of any asset — shares, bonds or a business — is determined by the future cash flows it will generate. To understand this concept, just consider how much you would pay for an asset from which you could never expect to obtain any cash flows. Buying such an asset would be like giving your money away. It would have a value of exactly zero. Conversely, as the expected cash flows from an investment increase, you would be willing to pay more and more for it.

Three fundamental decisions in financial management

Based on our discussion so far, we can see that financial managers are concerned with three fundamental decisions when running a business:

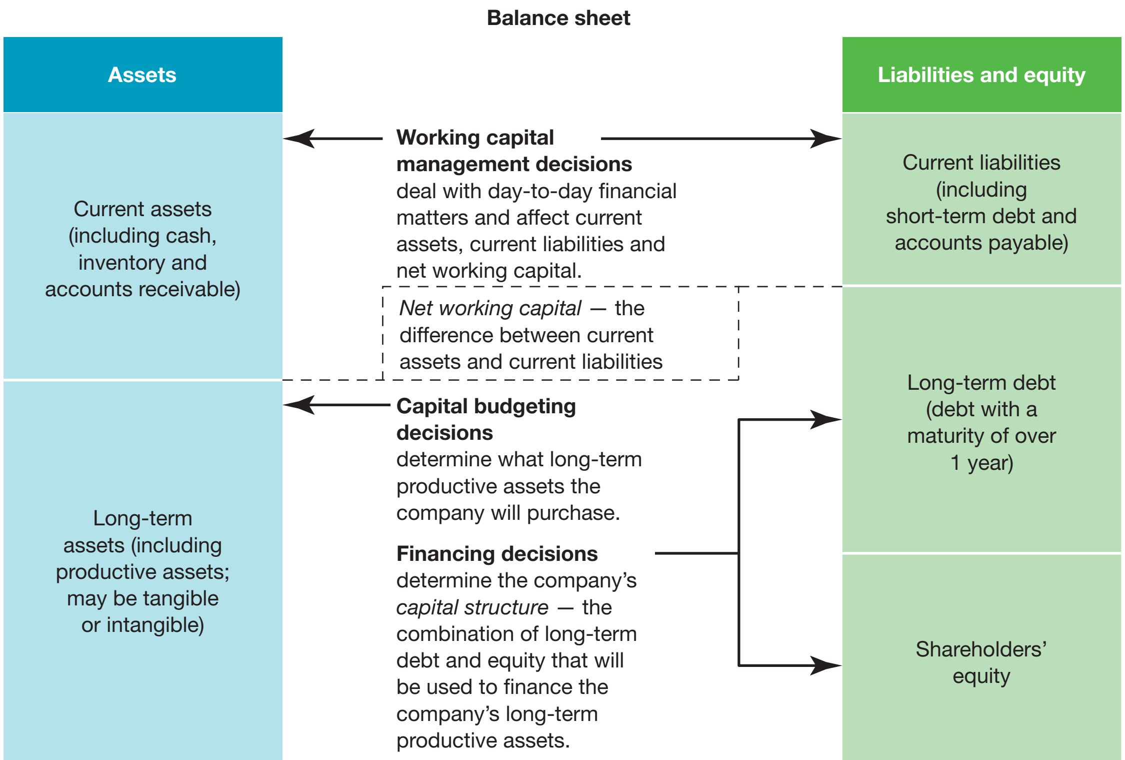
1. *capital budgeting decisions:* identifying the productive assets the company should buy
2. *financing decisions:* determining how the company should finance or pay for assets
3. *working capital management decisions:* determining how day-to-day financial matters should be managed so that the company can pay its bills, and how surplus cash should be invested.

Figure 1.2 shows the impact of each decision on the company's balance sheet. (Note that the balance sheet can also be called the statement of financial position but the term balance sheet will be used throughout this text.) We briefly introduce each decision here and discuss them in greater detail in later chapters.

Capital budgeting decisions

A company's capital budget is simply a list of the productive (capital) assets management wants to purchase over a budget cycle; typically 1 year. The capital budgeting decision process addresses which productive assets the company should purchase and how much money the company can afford to spend. As shown in figure 1.2, capital budgeting decisions affect the asset side of the balance sheet and are concerned with a company's long-term investments. Capital budgeting decisions, as we mentioned earlier, are among management's most important decisions. Over the long run, they have a large impact on the company's success or failure. The reason is twofold. First, capital assets generate most of the cash flows for the company. Second, capital assets are long term in nature. Once they are purchased, the company owns them for a long time, and they may be hard to sell without taking a financial loss.

FIGURE 1.2 **How the financial manager's decisions affect the balance sheet**
Financial managers are concerned with three fundamental types of decisions: capital budgeting decisions, financing decisions and working capital management decisions. Each type of decision has a direct and important effect on the company's balance sheet — in other words, on the company's profitability.



The fundamental question in capital budgeting is this: which productive assets should the company purchase? A capital budgeting decision may be as simple as a movie theatre's decision to buy a popcorn machine or as complicated as Airbus' decision to invest more than $10 billion to design and build the Airbus A380 passenger jet. Capital investments may also involve the purchase of an entire business, such as Woolworths Limited's acquisition of hardware distributor Danks to compete with home-improvement giant Bunnings.

Regardless of the project, a good capital budgeting decision is one in which the benefits are worth more to the company than the cost of the asset. For example, in 2015 Stockland purchased a 143-hectare development site in the Redcliffe Peninsula for $67 million. Work began on the development in 2016. When complete, the site will have 1500 new homes and a village centre. Stockland expects that the project will produce a stream of cash flows worth $590 million. Is the acquisition a good deal for Stockland? The answer is yes if the value of the cash flow benefits from the project exceeds the cost. If the project works out as planned, the value of Stockland will be increased by the amount recouped above the total cost of the project.[3]

Not all investment decisions are successful. Just open the business section of any newspaper on any day, and you will find stories of bad decisions. For example, Disney's movie *Mars Needs Moms* turned out to be a flop. The film cost US$150 million to make but grossed only US$39 million worldwide. After flopping at the box office, it is unlikely that the movie's overall cash flow (from box office takings, DVD sales, merchandise and so on) will be worth more than its $150 million cost. When, as in this case, the cost exceeds the value of the future cash flows, the project will decrease the value of the company by that amount.

KEY POINT

Sound investments are those where the value of the benefits exceeds their costs

Financial managers should invest in a capital project only if the value of its future cash flows exceeds the cost of the project (benefits > cost). Such investments increase the value of the company and thus increase shareholders' (owners') wealth. This rule holds whether you are making the decision to purchase new machinery, build a new plant or buy an entire business.

Financing decisions

Financing decisions concern how companies raise cash to pay for their investments, as shown in figure 1.2. Productive assets, which are long term in nature, are financed by long-term borrowing, equity investment or both. Financing decisions involve trade-offs between advantages and disadvantages to the company.

A major advantage of debt financing is that debt payments are tax deductible for many companies. However, debt financing increases a company's risk because it creates a contractual obligation to make periodic interest payments and, at maturity, to repay the amount that is borrowed. Contractual obligations must be paid regardless of the company's operating cash flow, even if the company suffers a financial loss. If the company fails to make payments as promised, it defaults on its debt obligation and could be forced into insolvency.

In contrast, equity has no maturity, and there are no guaranteed payments to equity investors. In a company, the board of directors has the right to decide whether dividends should be paid to shareholders. This means that if the board decides to omit or reduce a dividend payment, the company will not be in default. Unlike interest payments, however, dividend payments to shareholders are not tax deductible.

The mix of debt and equity on the balance sheet is known as a company's **capital structure**. The term *capital structure* is used because long-term funds are considered capital, and these funds are raised in **capital markets** — financial markets where equity and debt instruments with maturities greater than 1 year are traded.

KEY POINT

Financing decisions affect the value of the company

How a company is financed with debt and equity affects the value of the company. The reason is that the mix between debt and equity affects the tax the company pays and the probability that the company will become insolvent. The financial manager's goal is to determine the combination of debt and equity that minimises the cost of financing the company.

Working capital management decisions

Management must also decide how to manage the company's current assets, such as cash, inventory and accounts receivable, and its current liabilities, such as trade credit and accounts payable. The dollar difference between current assets and current liabilities is called **net working capital**, as shown in figure 1.2. As mentioned earlier, working capital management is the day-to-day management of the company's short-term assets and liabilities. The goals of managing working capital are to ensure that the company has enough money to pay its bills and to profitably invest any spare cash to earn interest.

The mismanagement of working capital can cause a company to default on its debt and become insolvent even though, over the long term, the company may be profitable. For example, a company that makes sales to customers on credit but is not diligent about collecting the accounts receivable can quickly find itself without enough cash to pay its bills. If this condition becomes chronic, trade creditors can force the company into insolvency if the company cannot obtain alternative financing.

A company's profitability can also be affected by its inventory level. If the company has more inventory than it needs to meet customer demands, it has too much money tied up in non-earning assets. Conversely, if the company holds too little inventory, it can lose sales because it does not have products to sell when customers want them. The company must therefore determine the optimal inventory level.

BEFORE YOU GO ON

1. What are the three most basic types of financial decisions managers must make?
2. Why are capital budgeting decisions among the most important decisions in the life of a company?
3. Explain why you would accept an investment project if the value of the expected cash flows exceeds the cost of the project.

1.2 Forms of business organisation

LEARNING OBJECTIVE 1.2 Identify the basic forms of business organisation used in Australia, and review their respective strengths and weaknesses.

In this section we look at the way companies organise to conduct their business activities. The owners of a business usually choose the organisational form that will help management to maximise the value of the company. Important considerations are the size of the business, the manner in which income from the business is taxed, the legal liability of the owners, and the ability to raise cash to finance the business.

Most start-ups and small businesses operate as either sole traders or partnerships because of their small operating scale and capital requirements. Large businesses in Australia, such as Woolworths Limited, are most often organised as companies. As a business grows larger, the benefits to organising as a company become greater and are more likely to outweigh any disadvantages.

Sole traders

A **sole trader** is a business owned by one person, typically consisting of the trader and a handful of employees. Becoming a sole trader offers several advantages. It is the simplest type of business to start, and it is the least regulated. In addition, sole traders keep all the profits from the business and do not have to share decision-making authority. From the taxation point of view, business losses can be written off against the sole trader's tax from other employment under certain circumstances.

On the downside, a sole trader has unlimited liability for all the business's debts and other obligations. This means that creditors can look beyond the assets of the business to the trader's personal wealth for payment. Another disadvantage is that the amount of equity capital that can be invested in the business is limited to the owner's personal wealth, which may restrict the possibilities for growth. Finally, it is difficult to transfer ownership of a sole trader because there are no shares or other such interest to sell.

Partnerships

A **partnership** consists of two or more owners who have joined together legally to manage a business. Partnerships are typically larger than sole trader businesses. In forming a partnership, it is recommended that a formal partnership agreement is drawn up on the roles and authority of each partner, how much capital each partner will contribute to the partnership, how key management decisions will be made, how the profits will be divided, who has limited liability, how the partnership will be closed down and assets distributed, and how disputes will be dealt with.

The key advantages of partnerships are similar to those of sole traders. In addition, partnerships have access to more capital, and the pooling of knowledge, experience and skills. The key drawbacks of partnership are possible disputes among the partners over profit sharing, administration and business development. Also, each partner is personally responsible for business debts and liabilities incurred by the other partners. The problem of unlimited liability can be avoided in a limited partnership, which consists of general and limited partners. Here, one or more general partners have unlimited liability and actively manage the business, while each limited partner is liable for business obligations only up to the amount of capital he or she contributed to the partnership. In other words, the limited partners have **limited liability**. To qualify for limited partner status, a partner cannot be actively engaged in managing the business.

Companies

Most large businesses are companies. A **company** is an independent legal entity able to do business in its own right. In a legal sense, it is a 'person' distinct from its owners. Companies can sue and be sued, enter into contracts, issue debt, borrow money and own assets. The owners of a company are its shareholders.

Starting a company is more costly than starting a business as a sole trader or partnership. Those starting the company, for example, must set out a 'memorandum' that details its powers, and the 'articles of association' to describe who can use these powers. All companies are registered with and regulated by the Australian Securities and Investments Commission (ASIC).

A major advantage of the company form of business structure is that shareholders have limited liability for debts and other obligations of the company. However, directors and employees are personally liable under the *Corporations Act 2001* if found to be committing fraudulent, negligent or reckless acts. The major disadvantages of the company form are the cost to establish and register, and the higher compliance costs and stricter record-keeping requirements as compared to other forms of business structure.

A company can also list on a stock exchange, such as the Australian Securities Exchange (ASX), as a **public company** to attract investors. In contrast, private companies are typically owned by a small number of key managers and shareholders. Over time, as the company grows in size and needs larger amounts of capital, management may decide that the company should 'go public' in order to gain access to the public markets.

BEFORE YOU GO ON

1. Why are many businesses operated as sole traders?
2. What are some advantages and disadvantages of operating as a partnership?
3. What are some advantages and disadvantages of operating as a company?

1.3 Managing the financial function

LEARNING OBJECTIVE 1.3 Describe the typical organisation of the financial function in a large company.

As we discussed earlier in the chapter, financial managers are concerned with a company's investment, financing and working capital management decisions. The senior financial manager holds one of the top executive positions in the company. In a large company, the senior financial manager usually has the rank of deputy chief executive or senior executive and goes by the title of **chief financial officer**, or **CFO**. In smaller companies, the job tends to focus more on the accounting function, and the top financial officer may be called the controller or chief accountant. In this section we focus on the financial function in a large company.