a decision designed to generate momentum for the company as it came out of bankruptcy reorganization in July of 2009. Similarly, marketing majors need to understand and decide how aggressively to price products and how much to spend on advertising those products. Because aggressive marketing costs money today but generates rewards in the future, it should be viewed as an investment that the firm needs to finance. Production and operations management majors need to understand how best to manage a firm's production and control its inventory and supply chain. These are all topics that involve risky choices that relate to the management of money over time, which is the central focus of finance.

Although finance is primarily about the management of money, a key component of finance is the management and interpretation of information. Indeed, if you pursue a career in management information systems or accounting, finance managers are likely to be your most important clients.

For the student with entrepreneurial aspirations, an understanding of finance is essential—after all, if you can't manage your finances, you won't be in business very long.

Finally, an understanding of finance is important to you as an individual. The fact that you are reading this book indicates that you understand the importance of investing in yourself. By obtaining a college degree, you are clearly making sacrifices in the hopes of making yourself more employable and improving your chances of having a rewarding and challenging career. Some of you are relying on your own earnings and the earnings of your parents to finance your education, whereas others are raising money or borrowing it from the **financial markets**, institutions that facilitate financial transactions.

Financial decisions are everywhere, both in your personal life and in your career. Although the primary focus of this book is on developing the corporate finance tools and techniques that are used in the business world, you will find that much of the logic and many of the tools we develop and explore along the way will also apply to decisions you will be making in your own personal life. In the future, both your business and personal lives will be spent in the world of finance. Because you're going to be living in that world, it's time to learn about its basic principles.

We will take an in-depth look at these principles at the end of this chapter. As you will see, you do not need an extensive knowledge of finance to understand these principles; and, once you know and understand them, they will help you understand the rest of the concepts presented in this book. When you are looking at more complex financial concepts, think of these principles as taking you back to the roots of finance.

Before you move on to 1.2

Concept Check | 1.1

1. What are the three basic types of issues that arise in business that are addressed by the study of business finance?
2. List three non-finance careers to which the study of finance applies.

1.2 Three Types of Business Organizations

Although numerous and diverse, the legal forms of business organization fall into three categories: the sole proprietorship, the partnership, and the corporation. Figure 1.1 provides a quick reference guide for organizational forms.

Sole Proprietorship

The **sole proprietorship** is a business owned by a single individual who is entitled to all of the firm's profits and who is also responsible for all of the firm's **debt**; that is, what the firm owes. In effect, there is no separation between the business and the owner when it comes to debts or being sued. If sole proprietors are sued, they can lose not only all they invested in the proprietorship, but also all of their personal assets. Sole proprietorships are often used in

Figure 1.1

Characteristics of Different Forms of Business

Business Form	Number of Owners	Are Owners Liable for the Firm's Debts?	Do Owners Manage the Firm?	Does an Ownership Change Dissolve the Firm?	Access to Capital	Taxation
Sole Proprietorship	One	Yes	Yes	Yes	Very limited	Personal Taxes
Partnership	Unlimited	Yes; each partner has unlimited liability	Yes	Yes	Very limited	Personal Taxes
Limited Partnership (with General Partners (GPs) and Limited Partners (LPs))	At least one GP, but no limit on LPs	GPs—unlimited liability LPs—limited liability	GPs—manage the firm LPs—no role in management	GPs—Yes LPs—No, can change[1]	Limited	Personal Taxes
Limited Liability Company	Unlimited	No	Yes	No	Dependent upon size	Personal Taxes
Corporation	Unlimited	No	No—although managers generally have an ownership stake[2]	No	Very easy access	Double Taxation: Earnings taxed at corporate level Dividends taxed at personal level

[1]It is common for LLCs to require approval from the other partners before a partner's ownership can be transferred.

[2]Owners are not prohibited from managing the corporation.

>> END FIGURE 1.1

the initial stages of a firm's life. This in part is because forming a sole proprietorship is very easy; there are no forms to file and no partners to consult—the founder of the business is the sole owner. However, these organizations typically have limited access to outside sources of financing. The owners of a sole proprietorship typically raise money by investing their own funds and by borrowing from a bank. However, because there is no difference between the sole proprietor and the business he or she runs, there is no difference between personal borrowing and business borrowing. The owner of the business is personally liable for the debts of that business. In addition to banks, personal loans from friends and family are important sources of financing for sole proprietorships.

Partnership

A **general partnership** is an association of two or more persons who come together as co-owners for the purpose of operating a business for profit. Just as with the sole proprietorship, there is no separation between the general partnership and its owners with respect to debts or being sued. Its primary point of distinction from a sole proprietorship is that the **partnership** has more than one owner. Just like with a proprietorship, the profits of the partnership are taxed as personal income. An important advantage of the partnership is that it provides access to **equity**, or ownership, as well as financing from multiple owners in return for partnership **shares**, or units of ownership.

In **limited partnerships**, there are two classes of partners: general and limited. The **general partner** actually runs the business and faces unlimited liability for the firm's debts, whereas the **limited partner** is only liable up to the amount the limited partner invested. The life of the partnership, like that of the sole proprietorship, is tied to the life of the general partner. In addition, it is difficult to transfer ownership of the general partner's interest in the business—this generally requires the formation of a new partnership. However, the limited partner's shares can be transferred to another owner without the need to dissolve the partnership, although finding a buyer may be difficult.

Corporation

If very large sums of money are needed to build a business, then the typical organizational form chosen is the **corporation**. As early as 1819, U.S. Supreme Court Chief Justice John Marshall set forth the legal definition of a corporation as "an artificial being, invisible, intangible, and existing only in the contemplation of law."[1] The corporation legally functions separately and apart from its owners (the **shareholders**, also referred to as the **stockholders**). As such, the corporation can individually sue and be sued, purchase, sell, or own property, and its personnel are subject to criminal punishment for crimes committed in the name of the corporation.

There are three primary advantages of this separate legal status. First, the owners' liability is confined to the amount of their investment in the company. In other words, if the corporation goes under, the owners can only lose their investment. This is an extremely important advantage of a corporation. After all, would you be willing to invest in US Airways if you would be held liable if one of its planes crashed? The second advantage of separate legal status for the corporation is that the life of the business is not tied to the status of the investors. The death or withdrawal of an investor does not affect the continuity of the corporation. The management continues to run the corporation when the ownership shares are sold or when they are passed on through inheritance. For example, the inventor Thomas Edison founded General Electric (GE) over a century ago. Edison died in 1931, but the corporation lives on. Finally, these two advantages result in a third advantage, the ease of raising capital. It is much easier to convince investors to put their money in a corporation knowing that the most they can lose is what they invest, and that they can easily sell their stock if they wish to do so.

The corporation is legally owned by its current set of stockholders, or owners, who elect a board of directors. The directors then appoint management who are responsible for determining the firm's direction and policies. Although even very small firms can be organized as corporations, most often larger firms that need to raise large sums of money for investment and expansion use this organizational form. As such, this is the legal form of business that we will be examining most frequently in this textbook.

One of the drawbacks of the corporate form is the double taxation of earnings that are paid out in the form of **dividends**. When a corporation earns a profit, it pays taxes on that profit (the first taxation of earnings) and pays some of that profit back to the shareholders in the form of dividends. Then the shareholders pay personal income taxes on those dividends (the second taxation of earnings). In contrast, the earnings of proprietorships and partnerships are not subject to double taxation. Needless to say, this is a major disadvantage of corporations.[2]

When entrepreneurs and small business owners want to expand, they face a tradeoff between the benefits of the corporate form and the potential loss of control and higher taxes that accompany it. For this reason, an attractive alternative to the corporation for such a small business is the **limited liability company (LLC)**, a cross between a partnership and a corporation. An LLC combines the tax benefits of a partnership (no double taxation of earnings) with the limited liability benefit of a corporation (the owners' liability is limited to what they invested).[3] Thus, unlike a proprietorship or partnership, there is a separation between the LLC and the owners with respect to debts or being sued. As a result, the most a limited partner can lose is what he

[1]*The Trustees of Dartmouth College v. Woodward,* 4 Wheaton 636 (1819).

[2]Before the 2003 tax law changes, you paid your regular tax rate on dividend income, which could be as high as 35 percent. However, since the 2003 tax law, qualified dividends from domestic corporations and qualified foreign corporations are taxed at a maximum rate of 15 percent. Moreover, if you're in the 10 percent or 15 percent rate brackets, your tax rate on these dividends drops to 0 percent. However, on January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012 which kept the reduced tax rate on dividend income for all but those in the highest tax bracket and raised the tax rate on qualified dividends from 15 to 20 percent for individuals with taxable income over $450,000 (married filing jointly) and $400,000 (individual filers).

[3]In addition, there is the S-type corporation, which provides limited liability while allowing the business owners to be taxed as if they were a partnership—that is, distributions back to the owners are not taxed twice as is the case with dividends in the standard corporate form. Unfortunately, a number of restrictions that accompany the S-type corporation detract from the desirability of this business form. As a result, the S-type corporation has been losing ground in recent years in favor of the limited liability company.

or she invested. Because LLCs operate under state laws, both the states and the Internal Revenue Service (IRS) have rules for what qualifies as an LLC, and different states have different rules. The bottom line is that if an LLC looks too much like a corporation, it will be taxed as one.

Figure 1.1 describes some major characteristics of the different forms of business. As you can see, the corporation is the business form that provides the easiest access to capital, and as such it is the most common choice for firms that are growing and need to raise money.

How Does Finance Fit into the Firm's Organizational Structure?

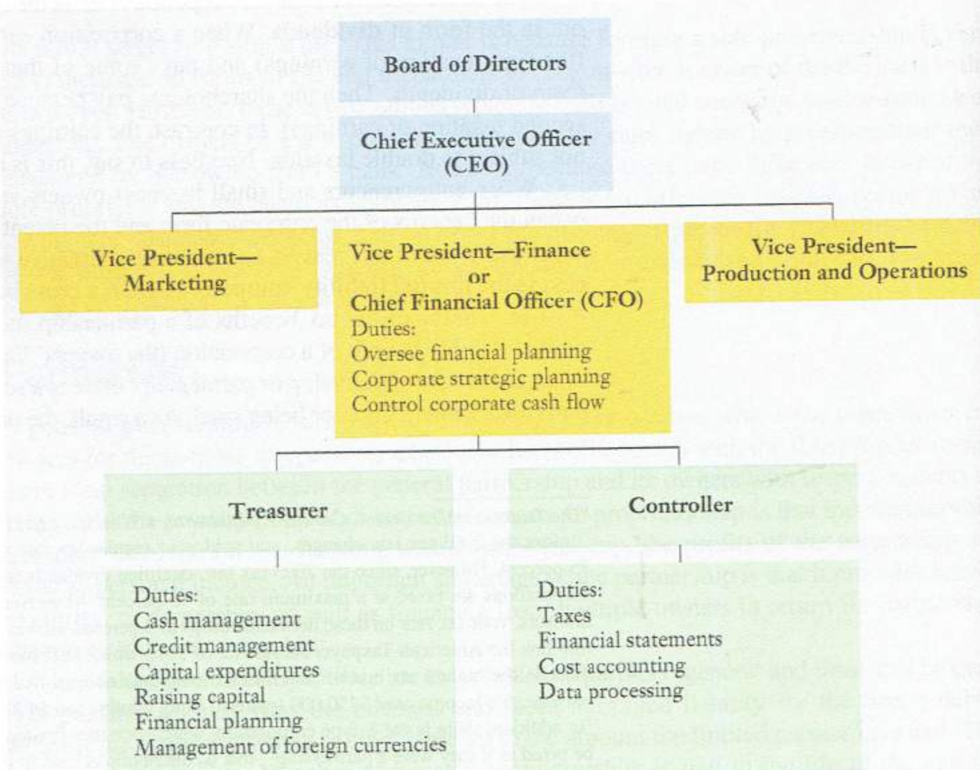
Finance is intimately woven into any aspect of the business that involves the payment or receipt of money in the future. For this reason it is important that everyone in a business have a good working knowledge of the basic principles of finance. However, within a large business organization, the responsibility for managing the firm's financial affairs falls to the firm's chief financial officer (CFO).

Figure 1.2 shows how the finance function fits into a firm's organizational chart. In the typical large corporation, the CFO serves under the corporation's chief executive officer (CEO) and is responsible for overseeing the firm's finance-related activities. Typically, both a treasurer and controller serve under the CFO, although in a small firm the same person may fulfill both roles. The treasurer generally handles the firm's financing activities. These include managing its cash and credit, exercising control over the firm's major spending decisions, raising money, developing financial plans, and managing any foreign currency the firm receives. The firm's controller is responsible for managing the firm's accounting duties, which include producing financial statements, paying taxes, and gathering and monitoring data that the firm's executives need to oversee its financial well-being.

Figure 1.2

How the Finance Area Fits into a Corporation

A firm's vice president of finance is many times called its chief financial officer, or CFO. This person oversees all of the firm's financial activities through the offices of the firm's treasurer and controller.



>> END FIGURE 1