

## SOLUTIONS

### Learning Goal 28

#### Multiple Choice

1. b Stockholders (owners) do not act by law on behalf of each other or the corporation.
2. c The ultimate authority belongs to the stockholders who elect the board of directors and vote on corporate issues as specified in the bylaws. However, it may be difficult for stockholders to organize in order to obtain a required majority on a specific issue.
3. d The incorporator files the application and articles of incorporation, and the state authorities grant the charter.
4. d
5. a
6. a The board of directors protects the stockholders by supervising the management and setting policy.
7. c
8. b A stock underwriter is a company that pays a corporation for a new issue of stock (thereby guaranteeing the proceeds) and markets the stock to the public. An investment bank is an underwriter but may also provide a range of other consulting services. Often, stock brokerage companies also offer investment banking services.
9. d Stock sold on a stock exchange is available to the general public.
10. b

#### Discussion Questions

1. A person (or business) called the incorporator files an application with the proper authorities of a selected state. The application includes the articles of incorporation, which designates a company name, requests an authorized number of shares, and must disclose detailed information about the potential owners and the company. If the state approves the application, it grants a charter to the company. The charter creates the corporation as a legal entity and authorizes a specified number of shares. After the charter is received, the initial directors as specified in the articles of incorporation approve the bylaws, approve the issuance of stock, and designate the officers of the corporation. The stock is then issued.
2. A corporation has the following features that are different than a proprietorship or partnership:
  - The corporation is a separate legal person that enters into contracts, pays its own tax, and is responsible for its own debts.
  - Ownership of a corporation is divided into units that are shares of stock. A corporation is owned by owning shares of the stock. The owners are called stockholders.
  - Stockholders have limited liability, meaning they are not personally responsible for corporate liabilities. The maximum loss for a stockholder is the amount of money invested.
  - Shares of stock are freely negotiable. Approval from other stockholders is not required to transfer ownership of stock.
  - There is no mutual agency. Stockholders cannot act on behalf of other stockholders or on behalf of the company unless they are company employees.
  - Because a corporation is a separate legal entity, a stockholder (owner) can also be an employee of the company, unlike a proprietorship or partnership.
  - Corporate income is taxed twice.

*Advantages:* The ability to sell shares of a company as negotiable shares of stock to obtain money from investors is a significant advantage of a corporation. Also very advantageous are limited liability, no mutual agency, and continuous life. Also an owner can simultaneously be a stockholder, corporate officer, and employee of the corporation.

## SOLUTIONS

## Learning Goal 28, continued

## 2, continued

*Disadvantages:* A significant disadvantage is the double taxation of corporate income. However, careful tax planning can reduce the impact of this, especially for small, closely held corporations. Also, corporations are subject to greater federal and state regulation than other entities. In large corporations, management can be excessively independent and unresponsive to stockholder interests. Finally, when there are multiple owners, a corporation does not have the flexibility to allocate income or loss in the same way as a partnership.

3. The stockholders are the highest authority; this authority is exercised when stockholders are able to act as a coordinated voting group. The next highest authority is the board of directors, which is elected by the stockholders. The duty of the board of directors is to safeguard stockholders by actively supervising management, creating good corporate policy, and evaluating the effectiveness of business strategies.

The next authority level in the chain of command is corporate management. The top authority in corporate management is usually the company president, who creates short- and long-term company strategies, makes sure they are implemented, and evaluates the outcomes. Under the president are various vice presidents, the secretary, treasurer, and controller. The vice president of finance is the chief financial officer and is responsible for creating and implementing financial strategies (such as obtaining investment capital). The treasurer works with the vice president of finance to implement financial strategies and is responsible for managing corporate cash and investments. The controller is the chief accountant and is responsible for all accounting functions. Under the 2002 federal Sarbanes-Oxley law, the president and the chief financial officer of a publicly traded corporation are personally responsible for the accuracy of financial statements and subject to civil and criminal penalties for non-compliance.

4. In general, fiduciary duty means acting in ways that, first and foremost, place the financial condition of the corporation and the value of the stockholders' investments as top priority. This is primarily a financial duty. It requires honest behavior, competence, and genuine concern for the financial interests of the corporation and for safeguarding and improving the value of the stockholders' investments.

Social responsibility, in the end, always supersedes financial interests. Although social responsibility and fiduciary duty are sometimes interrelated, an ethical duty to society, community, and the environment must be first priority. History demonstrates that in the absence of this attitude, social conditions eventually deteriorate to a destructive contest between the powerful few and powerless many. Regardless of individual outcomes, total quality of life, long-term productivity, and environmental conditions all worsen.

Examples of failing to meet corporate fiduciary duty:

- Any corporate fraud
- Careless or uninformed planning
- Excessive executive compensation or expense accounts
- Using company funds for personal purposes
- Well-known companies where this occurred: Enron, WorldCom, Adelphia, Health South, Global Crossing

## SOLUTIONS

## Learning Goal 28, continued

4, *continued*

Examples of failing to meet ethical social responsibility:

- Dangerous working conditions
  - Exploitive (very low) wages
  - Environmental damage and habitat destruction
  - Racial and sexual discrimination
  - Bribery and kickbacks
5. Because a corporation is a separate legal entity, it must file its own tax return and pay the tax on its own income. However, when corporate cash (or other assets) is distributed to stockholders in the form of dividends, the stockholders also pay tax on the distributions they receive.
  6. Corporations potentially have the ability to obtain large amounts of investment capital because a corporation can divide its ownership into millions of shares of stock and sell the shares to the public. Another reason that makes it possible to raise large sums is limited liability—investors know that their maximum loss is limited to the amount that they invest. This makes the investment more attractive because the risk is clear. Finally, the fact that ownership of stock is freely transferable also makes a stock investment attractive because no permission is needed from other owners to buy or sell the stock. This helps create a large and active market of buyers and sellers of the stock. This is known as a secondary market.
  7. A company can sell its stock directly to the public. However, this is generally not practical because of the difficulty in marketing the stock to potential investors and recording all the transactions and transfers of money. Generally, a corporation will use the services of an investment bank to analyze the market and set an initial selling price for the stock. The investment bank frequently acts as an underwriter or joins with brokerage firms to jointly underwrite the sale. The usual procedure is that an underwriter purchases the stock from the corporation at an agreed initial market price, less a commission to the underwriter. The underwriter then assumes the risk of selling all the stock to the public. If the underwriter believes that the stock may become more valuable, it will keep some shares for itself.
  8. The amount of cash a corporation receives from issuing stock in an IPO is whatever the company receives from its agreement with the underwriter. The subsequent market price of the stock as it is traded by investors does not affect the amount received from issuing the stock. However, the price of the stock will affect what the corporation will receive if it decides to issue more stock in the future—in a secondary offering.
  9. No. The number of shares that a corporation is authorized to sell is determined by the charter. If a corporation wants to issue more shares, it must apply to the state for approval for a revised charter authorizing more shares. (And usually the stockholders must also approve.) Authorized shares means the number of shares approved by the charter. Issued shares means the number of shares actually issued.
  10. An initial public offering (IPO) is the first time a company's stock is offered to the public. Any public sale by the corporation after the IPO is a secondary offering. Secondary offering can also refer to the sale of stock by a small group of large investors who are liquidating their investments.

## SOLUTIONS

## Learning Goal 28, continued

11. ■ A small dress shop in a mall probably would not need to incorporate.
- A small chemical manufacturing company would want to incorporate. This type of business has a great deal of potential personal liability because chemicals can be hazardous materials. If the owners become stockholders in a corporation, they will not have personal liability, unless they act negligently or violate laws.
  - A chain of stores probably wants to grow and will need cash to do so. Corporations have the ability to obtain a large amount of investment capital by selling shares of stock.
  - A partnership has the features of mutual agency and personal liability. One partner can potentially create a business liability that affects all the other partners and that also creates personal liability. A corporation could eliminate the mutual agency and personal liability. An LLC entity might be another good option.
  - A company that wants to expand needs cash. This is particularly true of companies that do a great deal of research, such as a biotechnology company. Incorporating the business may be an attractive choice. A corporation has the potential to raise large amounts of investment capital. Limited liability may also be an issue.
12. Yes, an owner (stockholder) of a corporation can also be an employee of that corporation. This is possible because a corporation is a separate legal entity, apart from the individuals who are stockholders. An owner of a proprietorship or a general partnership cannot be an employee because there is no legal distinction between the business and the owner. In these cases, the owner has the final legal authority and responsibility for all business matters. In effect, because they are already the owners, they cannot “employ themselves.”
- 13.

Corporation	Limited Liability Company
■ Owners purchase shares in the entity.	■ Owners purchase percentage interests.
■ Limited liability	■ Limited liability
■ No mutual agency	■ No mutual agency
■ Owners' income and loss is based on shares owned.	■ Owners' income and loss is allocated based on the operating agreement.
■ Double taxation	■ No double taxation
■ Unlimited life	■ Limited life
■ Professional management/board of directors	■ Can be professionally managed or member managed
■ Articles of incorporation	■ Articles of organization
■ Bylaws	■ Operating agreement
■ Owners are called stockholders or shareholders.	■ Owners are called members.

14. *Advantages:* Limited liability, ownership in shares, transfer of ownership and no mutual agency. In general, a corporation insulates the owners from responsibility and makes it easy to own and transfer shares. *Disadvantages:* Double taxation and government regulations. (However, keep in mind that regulations are designed to protect the community and the environment.)