Chapter 2
Cash Flows and Financial Statements at Sunset Boards

Input area:

	2018	2019
Cost of goods sold	$ 224,359	$ 283,281
Cash	32,372	34,394
Depreciation	63,334	71,584
Interest expense	13,783	15,780
Selling & Administrative	44,121	57,586
Accounts payable	57,220	63,479
Fixed assets	279,419	348,508
Sales	440,122	536,483
Accounts receivable	22,939	29,755
Notes payable	26,079	28,474
Long-term debt	141,040	158,368
Inventory	48,272	66,244
New equity	-	27,157
Tax rate	21%	
Dividend percentage	50%	

Output area:

2018 Income Statement

Sales	$	440,122
Cost of goods sold		224,359
Selling & Administrative		44,121
Depreciation		63,334
EBIT	$	108,308
Interest		13,783
EBT	$	94,525
Taxes		19,850
Net income	$	74,675
Dividends	$	37,337
Addition to retained earnings	$	37,337

2019 Income Statement

Sales	$	536,483
Cost of goods sold		283,281
Selling & Administrative		57,586
Depreciation		71,584
EBIT	$	124,032
Interest		15,780
EBT	$	108,252
Taxes		22,733
Net income	$	85,519
Dividends	$	42,760
Addition to retained earnings	$	42,760

Balance sheet as of Dec. 31, 2018

Cash	$	32,372	Accounts payable	$	57,220
Accounts receivable		22,939	Notes payable		26,079
Inventory		48,272	Current liabilities	$	83,299
Current assets	$	103,583			
			Long-term debt	$	141,040
Net fixed assets	$	279,419	Owners' equity	$	158,663
Total assets	$	383,002	Total liab. & equity	$	383,002

Balance sheet as of Dec. 31, 2019

Cash	$	34,394	Accounts payable	$	63,479
Accounts receivable		29,755	Notes payable		28,474
Inventory		66,244	Current liabilities	$	91,953
Current assets	$	130,393			
			Long-term debt	$	158,368
Net fixed assets	$	348,508	Owners' equity	$	228,580
Total assets	$	478,901	Total liab. & equity	$	478,901

		2018		2019
Operating cash flow	$	151,792	$	172,883

Capital Spending

Ending net fixed assets	$	348,508
- Beginning net fixed assets		279,419
+ Depreciation		71,584
Net capital spending	$	140,673

Change in Net Working Capital

Ending NWC	$	38,440
-Beginning NWC		20,284
Change in NWC	$	18,156

Cash Flow from Assets

Operating cash flow	$	172,883
- Net capital spending		140,673
-Change in NWC		18,156
Cash flow from assets	$	14,054

Cash Flow to Creditors

Interest paid	$	15,780
-Net New Borrowing		17,328
Cash flow to Creditors	$	(1,548)

Cash Flow to Stockholders

Dividends paid	$	42,760
-Net new equity raised		27,157
Cash flow to Stockholders	$	15,603

Solutions Manual

Essentials of Corporate Finance

Ross, Westerfield, and Jordan
10^{th} edition

05/07/2019

Prepared by

Brad Jordan
University of Kentucky

Joe Smolira
Belmont University

CHAPTER 1
INTRODUCTION TO CORPORATE FINANCE

Answers to Concepts Review and Critical Thinking Questions

1. Capital budgeting (deciding on whether to expand a manufacturing plant), capital structure (deciding whether to issue new equity and use the proceeds to retire outstanding debt), and working capital management (modifying the firm's credit collection policy with its customers).

2. Disadvantages: unlimited liability, limited life, difficulty in transferring ownership, difficulty in raising capital funds. Some advantages: simpler, less regulation, the owners are also the managers, sometimes personal tax rates are better than corporate tax rates.

3. The primary disadvantage of the corporate form is the double taxation to shareholders of distributed earnings and dividends. Some advantages include: limited liability, ease of transferability, ability to raise capital, and unlimited life.

4. The treasurer's office and the controller's office are the two primary organizational groups that report directly to the chief financial officer. The controller's office handles cost and financial accounting, tax management, and management information systems. The treasurer's office is responsible for cash and credit management, capital budgeting, and financial planning. Therefore, the study of corporate finance is concentrated within the functions of the treasurer's office.

5. To maximize the current market value (share price) of the equity of the firm (whether it's publicly traded or not).

6. In the corporate form of ownership, the shareholders are the owners of the firm. The shareholders elect the directors of the corporation, who in turn appoint the firm's management. This separation of ownership from control in the corporate form of organization is what causes agency problems to exist. Management may act in its own or someone else's best interests, rather than those of the shareholders. If such events occur, they may contradict the goal of maximizing the share price of the equity of the firm.

7. A primary market transaction.

8. In auction markets like the NYSE, brokers and agents meet at a physical location (the exchange) to buy and sell their assets. Dealer markets like NASDAQ represent dealers operating in dispersed locales who buy and sell assets themselves, usually communicating with other dealers electronically or literally over the counter.

9. Since such organizations frequently pursue social or political missions, many different goals are conceivable. One goal that is often cited is revenue minimization; i.e., providing their goods and services to society at the lowest possible cost. Another approach might be to observe that even a not-for-profit business has equity. Thus, an appropriate goal would be to maximize the value of the equity.

10. An argument can be made either way. At one extreme, we could argue that in a market economy, all of these things are priced. This implies an optimal level of ethical and/or illegal behavior and the framework of stock valuation explicitly includes these. At the other extreme, we could argue that these are non-economic phenomena and are best handled through the political process. The following is a classic (and highly relevant) thought question that illustrates this debate: "A firm has estimated that the cost of improving the safety of one of its products is $30 million. However, the firm believes that improving the safety of the product will only save $20 million in product liability claims. What should the firm do?"

11. The goal will be the same, but the best course of action toward that goal may require adjustments due to different social, political, and economic climates.

12. The goal of management should be to maximize the share price for the current shareholders. If management believes that it can improve the profitability of the firm so that the share price will exceed $35, then they should fight the offer from the outside company. If management believes that this bidder or other unidentified bidders will actually pay more than $35 per share to acquire the company, then they should still fight the offer. However, if the current management cannot increase the value of the firm beyond the bid price, and no other higher bids come in, then management is not acting in the interests of the shareholders by fighting the offer. Since current managers often lose their jobs when the corporation is acquired, poorly monitored managers have an incentive to fight corporate takeovers in situations such as this.

13. We would expect agency problems to be less severe in other countries, primarily due to the relatively small percentage of individual ownership. Fewer individual owners should reduce the number of diverse opinions concerning corporate goals. The high percentage of institutional ownership might lead to a higher degree of agreement between owners and managers on decisions concerning risky projects. In addition, institutions may be able to implement more effective monitoring mechanisms than can individual owners, given institutions' deeper resources and experiences with their own management. The increase in institutional ownership of stock in the United States and the growing activism of these large shareholder groups may lead to a reduction in agency problems for U.S. corporations and a more efficient market for corporate control.

14. How much is too much? Who is worth more, Michael Rapino or LeBron James? The simplest answer is that there is a market for executives just as there is for all types of labor. Executive compensation is the price that clears the market. The same is true for athletes and performers. Having said that, one aspect of executive compensation deserves comment. A primary reason executive compensation has grown so dramatically is that companies have increasingly moved to stock-based compensation. Such movement is obviously consistent with the attempt to better align stockholder and management interests. In recent years, stock prices have soared, so management has cleaned up. It is sometimes argued that much of this reward is due to rising stock prices in general, not managerial performance. Perhaps in the future, executive compensation will be designed to reward only differential performance, i.e., stock price increases in excess of general market increases.

15. The biggest reason that a company would "go dark" is because of the increased audit costs associated with Sarbanes-Oxley compliance. A company should always do a cost-benefit analysis, and it may be the case that the costs of complying with Sarbox outweigh the benefits. Of course, the company could always be trying to hide financial issues of the company! This is also one of the costs of going dark: Investors surely believe that some companies are going dark to avoid the increased scrutiny from Sarbox. This taints other companies that go dark just to avoid compliance costs. This is similar to the lemon problem with used automobiles: Buyers tend to underpay because they know a certain percentage of used cars are lemons. So, investors will tend to pay less for the company stock than they otherwise would. It is important to note that even if the company delists, its stock is still likely traded, but on the over-the-counter market pink sheets rather than on an organized exchange. This adds another cost since the stock is likely to be less liquid now. All else the same, investors pay less for an asset with less liquidity. Overall, the cost to the company is likely a reduced market value. Whether delisting is good or bad for investors depends on the individual circumstances of the company. It is also important to remember that there are already many small companies that file only limited financial information.

Case Solutions

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CHAPTER 1
THE McGEE CAKE COMPANY

1. The advantages to an LLC are: 1) Reduction of personal liability. A sole proprietor has unlimited liability, which can include the potential loss of all personal assets. 2) Taxes. Forming an LLC may mean that more expenses can be considered business expenses and be deducted from the company's income. 3) Improved credibility. The business may have increased credibility in the business world compared to a sole proprietorship 4) Ability to attract investment. Corporations, even LLCs, can raise capital through the sale of equity. 5) Continuous life. Sole proprietorships have a limited life, while corporations have a potentially perpetual life. 6) Transfer of ownership. It is easier to transfer ownership in a corporation through the sale of stock.

   The biggest disadvantage is the potential cost, although the cost of forming an LLC can be relatively small. There are also other potential costs, including more expensive record-keeping.

2. Forming a corporation has the same advantages as forming an LLC, but the costs are likely to be higher.

3. As a small company, changing to an LLC is probably the most advantageous decision at the current time. If the company grows, and Doc and Lyn are willing to sell more equity ownership, the company can reorganize as a corporation at a later date. Additionally, forming an LLC is likely to be less expensive than forming a corporation.

Chapter 1
INTRODUCTION TO FINANCIAL MANAGEMENT

Introduction to Financial Management			
1	**Chapter Organization**	**Slide Number**	**Slide Title**
	Introduction	1.2	Key Concepts and Skills
		1.3	Chapter Outline
1.1	**Finance: A Quick Look**		
	The Four Basic Areas	1.4	Basic Areas of Finance
		1.5	Investments
		1.6	Financial Institutions
		1.7	International Finance
		1.8	Basic Areas of Finance
	Why Study Finance?	1.9	Why Study Finance?
1.2	**Business Finance and the Financial Manager**		
	What is Business Finance?	1.10	Business Finance
	The Financial Manager	1.11	Financial Manager
		1.12	Corporate Organization Chart
	Financial Management Decisions	1.13	Financial Management Decisions
1.3	**Forms of Business Organization**	1.14	Forms of Business Organization
	Sole Proprietorship	1.15	Sole Proprietorship
	Partnership	1.16	Partnership
	Corporation	1.17	Corporation
	A Corporation by Another Name . . .	1.18	International Corporate Forms
1.4	**The Goal of Financial Management**	1.19	Goal of Financial Management (1 of 2)
	Profit Maximization The Goal of Financial Management in a Corporation A More General Financial Management Goal	1.2	Goal of Financial Management (2 of 2)
	Sarbanes-Oxley Act	1.21	Sarbanes-Oxley Act
1.5	**The Agency Problem and Control of the Corporation**		
	Agency Relationships Management Goals	1.22	The Agency Problem
	Do Managers Act in the Stockholders' Interests? Stakeholders	1.23	Do Managers Act in the Shareholders' Interests?
		1.24	Example: Work the Web
1.6	**Financial Markets and the Corporation**		
	Cash Flows to and from the Firm	1.25	Cash Flows Between the Firm and the Financial Markets

CHAPTER WEBSITES

Websites may be referenced more than once in a chapter. This table just includes the section for the first reference.

Chapter Section	Web Address
1.1	www.careers-in-business.com
1.2	www.cfo.com
1.3	www.nolo.com
	www.corporateinformation.com/defext.asp
1.4	www.3blassociation.com
	www.soxlaw.com
1.5	finance.yahoo.com
1.6	www.sec.gov
	www.nyse.com
	www.nasdaq.com
	www.jpx.co.jp/english/
	www.londonstockexchange.com
What's On the Web?	www.bizfilings.com

- ***PowerPoint Notes***:
  If there are slides that you do not wish to include in your presentation, choose to "hide" the slide under the "Slide Show" menu, instead of deleting it. If you decide that you would like to use that slide at a later date, you can just "unhide" it.

- ***End of Annotated Chapter Outline Extended Lecture Notes:***
  - *The Coca-Cola Company*
    - *Recap of article "How Coke Is Kicking Pepsi's Can" from* Fortune*, 1996, describing the difference in strategies between the two firms.*
    - *Full text of former Coca-Cola president, Roberto C. Goizueta's, essay on "Why Share-Owner Value?"*
  - *Gillette*
    - *Ethics note regarding agency issues and a takeover effort.*
  - *Dow Corning*
    - *Ethics note on firm's handling of silicone breast implants issues.*
  - *Microsoft*
    - *The antitrust case against Microsoft as a basis for discussion of ethical behavior, innovation, and government's role in monitoring.*
- ***Videos to Complement Chapter Material:***
  1. *Advice from recent graduates on what it takes to have a career in finance.*
  2. *The changing role of the Chief Financial Officer (CFO) at Abbott Laboratories.*
  3. *"Rightsizing" at ABT Co. of Canada.*
  4. *How capital is raised in financial markets and shows an open-outcry market at the Chicago Board of Trade.*

ANNOTATED CHAPTER OUTLINE

Slide 1.2 Key Concepts and Skills

Slide 1.3 Chapter Outline (Web link)

Introduce students to the website that accompanies the book, including the various features that they can access for study purposes (study guide, quizzes, web links, etc.).

Slide 1.4 Basic Areas of Finance (Video 1: Careers)

Each of these topics are discussed in more detail in the following slides; however, the discussion on corporate finance is deferred until later in the chapter.

Several of the following slides have hot links to a website that provides information about different business jobs including descriptions, skills, and traits, etc. The address is www.careers-in-business.com.

Slide 1.5 Investments (Web link)

"Money Management" discusses careers as portfolio managers, mutual fund analysts, etc. "Financial Planning" discusses careers as financial consultants.

Slide 1.6 Financial Institutions (Web link)

"Commercial Banking," "Insurance," and "Investment Banking" all discuss job opportunities in the Financial Institutions area.

Slide 1.7 International Finance

Slide 1.8 Basic Areas of Finance Chart

Note that International finance is not a separate area but more a specialized area within the three primary areas of finance: Corporate, Investments, and Institutions. With the globalization of business in general, the need to be familiar with both the domestic and international characteristics of finance has escalated.

Slide 1.9 Why Study Finance?

Because this course is generally required of all business majors, it is important to emphasize that everyone needs to have a basic understanding of financial concepts so that they can communicate effectively within an organization. This is the same reason that everyone is required to take marketing courses, management courses, etc.

The field of finance is important to all students regardless of major, for both professional and personal reasons. Most companies want to see a cost/benefit analysis for an increasing number of decisions in all areas of the firm. Consequently, the business students of today will need to be able to use finance principles, even if they are not part of a "finance" functional group. At a personal level, they will be making financial decisions for themselves and their families for the rest of their lives.

Marketing
- Marketing financial products—including entire companies through IPOs and seasoned equity offerings, as well as insurance and other basic financial products

Accounting
- In smaller businesses, accountants often perform both the accounting and finance functions.

Management
- Business strategy—have to understand the goals of the business and how cash flow works

Personal Finance
- For many students, emphasizing the personal finance issues whenever possible can make the material more relevant.

Slide 1.10 Business Finance

"Business finance" is just another name for "corporate finance." Students often get confused by the terminology, especially when different terms are used to refer to the same thing.

Slide 1.11 Financial Manager (Video 2: Role of CFO)

Slide 1.12 Corporate Organization Chart (Figure 1.1)

The CFO or VP of Finance role is usually filled with someone with both an accounting AND finance background, because the position has responsibility for both the controller and treasury functions in a firm.

Slide 1.13 Financial Management Decisions

Capital budgeting
- Key concerns = size, timing, and riskiness of future cash flows
- Examples: What product or service the firm will sell? Should old equipment be replaced with newer equipment? Etc.

Capital structure
- Define *debt* and *equity.*
- Examples: What are the least expensive sources of funds? Is there an optimal mix of debt and equity? When and where should the firm raise funds?

Working capital management
- Examples: How much inventory should the firm carry? What credit policy is best? Where will the firm obtain its short-term loans?

Slide 1.14 Forms of Organization (Web link)

"Choosing the Best Ownership Structure for Your Business." Other "NOLO" links offer additional information about the legal aspects of each form of business, as well as a discussion of the advantages and disadvantages. The address is: http://www.nolo.com/legal-encyclopedia/llc-corporations-partnerships/

Slide 1.15 Sole Proprietorship (Web link)

www: *"—Sole Proprietorship" link = information about husband and wife sole proprietorships.*

Slide 1.16 Partnership (Web link)

General partnership—all partners share in gains or losses; all have unlimited liability for all partnership debts. Written agreements are essential due to the unlimited liability.

Limited partnership—one or more general partners run the business and have unlimited liability. A limited partner's liability is limited to his or her contribution to the partnership, but he or she cannot help in running the business. Limited partners cannot be actively involved in the business or else they may be deemed general partners.

Note that unlimited liability applies to all partners in a general partnership but only to the general partner(s) in a limited partnership.

www: *"—Partnerships" link = additional information about limited partnerships, partnership agreements, and buy-sell agreements.*

Slide 1.17 Corporation (Web link)

Corporations account for the largest volume of business (in dollar terms) in the U.S.

Discuss how separation of ownership and management can be both an advantage and a disadvantage:

Advantages

- You can benefit from ownership in several different businesses (diversification).
- You can take advantage of the expertise of others (comparative advantage).
- It is easier to transfer ownership.

Disadvantage

- There can be agency problems if management goals and owner goals are not aligned.

www: *"—Corporations" link = additional information on corporations as well as limited liability corporations.*

Slide 1.18 International Corporate Forms (Web link)

Translation for any business type at www.corporateinformation.com

Slide 1.19 Goal of Financial Management (Video 3: Rightsizing)

Maximize profit: An imprecise goal. Maximize what profit? Long-run or short-run profits, accounting profits, or some measure of cash flow?

Minimize costs: Reducing costs can damage the long-run viability of the firm.

Maximize market share: Many dot-com companies had a goal of maximizing market share. They raised substantial amounts of capital, using the money on advertising to increase the number of "hits" on their site. However, the hits failed to translate into enough revenue to meet expenses. Stockholders were not happy, and the stock price fell dramatically, making it difficult to raise additional funds.

The goal of financial management in a corporation is to *maximize the current value per share of the existing stock.*

The more general goal is to maximize the market value of the existing owners' equity.

Slide 1.20 Goal of Financial Management

Many students think this means that firms should do "anything" to maximize stockholder wealth. It is important to point out that unethical behavior does not ultimately benefit owners.

Slide 1.21 Sarbanes-Oxley Act

Driven by corporate scandals

Intended to strengthen protection against accounting fraud and claims by senior management of having no knowledge of misdeeds

Very costly to publicly traded firms

Slide 1.22 The Agency Problem (Ethics Notes: Gillette; Dow Corning)

Agents tend to act in their own best interest rather than the best interest of firm owners.

Firm incurs a cost, called "agency cost"

Slide 1.23 Do Managers Act in the Shareholders' Interest?

Common incentives = stock options and bonuses tied to profits. Both can have unintended results if managers "game" the system for their own advantage.

Lecture Tip: *An extreme example of tying managerial compensation to performance occurred at Union Carbide. The CEO agreed to forfeit a year's salary if the firm failed to meet earnings goals. Further, 16 senior executives agreed to forgo 65 percent of their annual salaries.*

Lecture Tip: *A 1993 study performed at the Harvard Business School indicates that the total return to shareholders is closely related to the nature of CEO compensation; specifically, higher returns were achieved by CEOs whose pay package included more option and stock components. (See* The Wall Street Journal, *November 12, 1993, p. B1).*

An article by Lisa Meulbroek, formerly of Harvard Business School, points out that if managers are undiversified, then they won't value stock and stock options as highly as investors in the market because they are not fully compensated for the stock's volatility. Therefore, firms must consider the cost of paying managers with stock that they could sell for a higher price in the market versus the incentive alignment available through using stock and stock options as partial compensation. (Meulbroek, Lisa, 2000, "The Efficiency of Equity-Linked Compensation: Understanding the Full Cost of Awarding Executive Stock Options," Harvard Business School Working Papers, *No. 00-056.)*

Corporate Control:
Stockholders technically have control of the firm and, if dissatisfied, can oust management via proxy fights, takeovers, etc. However, this is easier said than done. Staggered elections for board members often make it difficult to remove the board that appoints management. Poison pills and other anti-takeover mechanisms make hostile takeovers difficult to accomplish.

Stakeholders:
Stakeholders are other groups, besides stockholders, that have a vested interest in the firm and potentially have claims on the firm's cash flows. Stakeholders can include creditors, employees, and customers.

Slide 1.24 Example: Work the Web (Web link)

www: *Follow the link to Yahoo Finance. Finding information on the listed companies will give students an idea of the breadth of information easily available on the web.*

Slide 1.25 Cash Flow Between the Firm and the Financial Markets (Figure 1.2)

Main point: Cash comes into the firm from the sale of debt and equity. The money is used to purchase assets. Those assets generate cash that is used to pay stakeholders, reinvest in additional assets, repay debtholders, and pay dividends to stockholders.

Slide 1.26 Financial Markets (Video 4: Markets)

Primary market

- Market in which securities are sold by the company
- Public and private placements of securities, SEC registration, and underwriters are all part of the primary market.
- Key feature: Money raised goes to the issuing company.

Secondary market
- Market where securities that have already been issued are traded between investors
- The stock exchanges, such as the New York Stock Exchange, and the over-the-counter market, such as NASDAQ, are part of the secondary market.
- Funds are exchanged between buyer and seller with no participation by the issuing company.

Dealer versus auction markets:

Dealer market
- One with several traders who maintain an inventory in securities they trade and provide prices at which they stand ready to buy (bid) and sell (ask) the securities
- NASDAQ is an example of a dealer market.

Auction market
- Generally has a physical location where buyers and sellers are matched by a broker, with little dealer activity
- A stock that trades on an exchange is said to be "listed."

The term "broker/dealer" is frequently used to indicate that the trader may, on some transactions, act as a dealer, trading from his own inventory, while at other times, he or she may act as a broker, bringing together a buyer and seller. NYSE specialists act as broker/dealers, while NASDAQ market makers act only as dealers.

Lecture Tip: *Students are often confused by the fact that NASDAQ is an OTC market. Explain that the NASDAQ market site is just a convenient place for reporters to show how the stocks are moving, but that trading does not actually take place there.*

www: *Click on the NYSE and NASDAQ hyperlinks to go to their websites.*

Slide 1.27 Quick Quiz

Answers are on linked slides, which have return arrows (⬅) to return to the Quick Quiz slide.

Extended Lecture Notes:

***Lecture tip:* THE COCA-COLA COMPANY**

The late Roberto Goizueta, former chairman and CEO of the Coca-Cola Company, wrote an essay entitled "Why Share-Owner Value?" that appeared in the firm's 1996 annual report and is reprinted below. It is an excellent introduction to the goal of financial *management at any level. It may also be useful to discuss how Mr. Goizueta's vision transferred to the stock market's valuation of the company. The following article illustrates the difference in strategy between Coca-Cola and Pepsi-Co in the mid-1990s.*

"How Coke Is Kicking Pepsi's Can," Fortune, *October 28, 1996. The following website provides the full text of the article:*
http://fortune.com/2015/11/10/coca-cola-pepsi-fortune-1996/

Coke focused on soft drinks while Pepsi-Co diversified into other areas. Pepsi-Co's goal was to double revenues every 5 years, while Mr. Goizueta focused on return on investment and stock price. The article states that Goizueta "has created more wealth for stockholders than any other CEO in history." In mid-1996, Pepsi-Co sold at 23 times earnings with return on equity of about 23% and Coke sold at 36 times earnings with a return on equity of around 55%. The article goes on to discuss the differing strategies in more detail. It provides a nice validation of Mr. Goizueta's remarks in his letter to the shareholders.

Since this article was written, Pepsi-Co has divested itself of its restaurants and has performed much better. Unfortunately, Mr. Goizueta died unexpectedly and Coke has had a hard time maintaining its edge.

Why Share-Owner Value?

At The Coca-Cola Company, our publicly stated mission is to create value over time for the owners of our business. In fact, in our society, that is the mission of any business: to create value for its owners.

Why? The answer can be summed up in three reasons.

First, **increasing share-owner value over time is the job our economic system demands of us.** *We live in a democratic capitalist society, and here, people create specific institutions to help meet specific needs. Governments are created to help meet civic needs. Philanthropies are created to help meet social needs. And companies are created to help meet economic needs. Business distributes the lifeblood that flows through our economic system not only in the form of goods and services, but also in the form of taxes, salaries and philanthropy.*

Creating value is a core principle on which our economic system is based; it is the job we owe to those who have entrusted us with their assets. We work for our share owners. That is—literally—what they have put us in business to do.

Saying that we work for our share owners may sound simplistic—but we frequently see companies that have forgotten the reason they exist. They may even try in vain to be all things to all people and serve many masters in many different ways. In any event, they *miss their primary calling, which is to stick to the business of creating value for their owners.*

Furthermore, we must always be mindful of the fact that while a healthy company can have a positive and seemingly infinite impact on others, a sick company is a drag on the social order of things. It cannot sustain jobs, much less widen the opportunities available to its employees. It cannot serve customers. It cannot give to philanthropic causes.

And it cannot contribute anything to society, which is the second reason we work to create value for our share owners: **If we do our jobs, we can contribute to society in very meaningful ways.** *Our Company has invested millions of dollars in Eastern Europe since the fall of the Berlin Wall, and people there will not soon forget that we came early to meet their desires and needs for jobs and management skills. In the process, they are becoming loyal consumers of our products, while we are building value for our share owners—which was our job all along.*

Certainly, we—as a Company—take it upon ourselves to do good deeds *that directly raise the quality of life in the communities in which we do business. But the real and lasting benefits we create don't come because we do good deeds, but because we do good* work—*work focused on our mission of creating value over time for the people who own the Company. Among those owners, for example, are university endowments, philanthropic foundations, and other similar nonprofit organizations. If The Coca-Cola Company is worth more, those endowments are similarly enriched to further strengthen the educational institutions' operations; if The Coca-Cola Company is worth more, those foundations have more to give, and so on. There is a beneficial ripple effect throughout society.*

Please note that I said creating value "over time," not overnight. Those two words are at the heart of the third reason behind our mission: **Focusing on creating value over the long term keeps us from acting shortsighted.**

I believe share owners want to put their money in companies they can count on, day in and day out. If our mission were merely to create value overnight, we could suddenly make hundreds of decisions that would deliver a staggering short-term windfall. But that type of behavior has nothing to do with sustaining value creation over time. To be of unique value to our owners over the long haul, we must also be of unique value to our consumers, our customers, out bottling partners, our fellow employees, and all other stakeholders—over the long haul.

Accordingly, that is how the long-term interests of the stakeholders are served—as the long-term interests of the share owners are served. Likewise, unless the long-term interests of the share owners are served, the long-term interests of the stakeholders will not be served. The real possibility for conflict, then, is not between share owners and stakeholders, but between the long-term and the short-term interests of both. Ultimately, everyone benefits when a company takes a long-term view. Ultimately, no one benefits when a company takes a short-term view.

The creation of unique value for all stakeholders, including share owners, over the long haul, presupposes a stable, healthy society. Only in such an environment can a company's profitable growth be sustained. Thus, the exercise of what is commonly referred to as "corporate responsibility" is a supremely rational, logical corollary of a company's essential responsibility to the long-term interests of its share owners. A company will only exercise this essential responsibility effectively if it promotes that social well-being necessary for a healthy business environment. It is as irrational to suppose that a company is primarily a welfare agency as it is to suppose that a company should not be concerned at all about the social welfare. Both views sacrifice the long-term common good to short-term benefits—whether share-owner benefits or stakeholder benefits.

Certainly, harsh competitive situations can sometimes call for harsh medicine. But in the main, our share owners look to us to deliver sustained, long-term value. We do that by building our businesses and growing them profitably.

At The Coca-Cola Company, we have built our business and grown it profitably for more than 110 years, because we have remained disciplined to our mission.

Not long ago, we came up with an interesting set of facts: A billion hours ago, human life appeared on Earth. A billion minutes ago, Christianity emerged. A billion seconds ago, the Beatles changed music forever. **A billion Coca-Colas ago was yesterday morning.**

The question we ask ourselves now is: What must we do to make a billion Coca-Colas ago be this morning? By asking that question, we discipline ourselves to the long-term view.

Ultimately, the mission of this Atlanta soft-drink salesman—and my 26,000 associates—is not simply to sell an extra case of Coca-Cola. Our mission is to create value over the long haul for the owners of our Company.

That's what our economic system demands of us. That's what allows us to contribute meaningfully to society. That's what keeps us from acting shortsighted. As businessmen and businesswomen, we should never forget that the best way for us to serve all our stakeholders—not just our share owners, but our fellow employees, our business partners, and our communities—is by creating value over time for those who have hired us.

That, ultimately, is our job.

Roberto C. Goizueta
Chairman, Board of Directors,
and Chief Executive Officer
February 20, 1997

[This essay originally appeared in the Coca-Cola Company's 1997 annual report.]

Ethics Note: Gillette

When shareholders elect a board of directors to oversee the corporation, the election serves as a control mechanism for management. The board of directors bears legal responsibility for corporate actions. However, this responsibility is to the corporation itself and not necessarily to the stockholders. The following is an interesting springboard for a discussion of directors' and managers' duties.

In 1986, Ronald Perelman engaged in an unsolicited takeover offer for Gillette. Gillette's management filed litigation against Perelman and subsequently entered into a standstill agreement with Perelman. This action eliminated the premium that Perelman offered shareholders for their stock in Gillette.

A group of shareholders filed litigation against the board of directors in response to its actions. It was subsequently discovered that Gillette had entered into standstill agreements with ten additional companies. When questioned regarding the rejection of Perelman's offer, management responded that there were projects on line that could not be discussed (later revealed to be the "Sensor" razor, which has proven to be one of the most profitable new ventures in Gillette's history). Thus, despite appearances, management's actions may not have been in the best interests of the firm, this case indicates that management may consider factors other than the bid when considering a tender offer.

Ethics Note: Dow Corning

Dow Corning, in conjunction with research done at Dow Chemical, knew that there were potential health risks associated with the rupture of silicone breast implants. It settled at least 21 cases with women complaining of health problems after their implants ruptured. Part of the agreement was that the women could not discuss the case with anyone. The potential problems finally became public when one woman refused to settle.

Dow Corning filed for Chapter 11 bankruptcy, primarily due to the class action lawsuits filed by women with silicone breast implants. The FDA forced silicone breast implants off the market, and Dow Corning filed a $3.2 billion settlement. Ironically, following further scientific research that did not find a significant link between the silicone in the breast implants and connective tissue disease, the most cited illness by the claimants, the FDA gave approval on November 17, 2006, to allow two companies to reintroduce silicone implants. The FDA did acknowledge that the implants may still lead to other complications that require surgery, and required a 10-year follow-up study.

Dow Corning made a decision early on to hide the research that indicated that there might be a medical problem and it had gag orders placed on settlements. If it had been more forthright from the start, the research that ultimately vindicated its position could have been done sooner and the company might have avoided bankruptcy. Decisions that many would view as unethical certainly did not maximize shareholder value.

Lecture Tip: Microsoft Antitrust Case
The antitrust case against Microsoft can generate a healthy discussion of ethical behavior, innovation, and the government's role in monitoring business practices. The basic idea behind the case is that (1) Microsoft stifled competition by imposing stiff penalties on computer manufactures that chose to install operating systems other than Windows on some of their machines; (2) Microsoft tried to put Netscape out of business by incorporating Internet Explorer into the operating system; and (3) Microsoft has an unfair advantage in the applications programming area because its programmers have access to the source code for the operating system. There were other issues as well, but these were the major ones. The judge in the case found that Microsoft did violate antitrust laws and that it continued to operate in a monopolistic fashion. He ordered the break-up of Microsoft into an "operating system" company and an "applications" company. The judge also ordered that Microsoft allow programmers from the Company's competitors to come to a secured location and view the source code for Microsoft Windows. Microsoft contended that this would allow other companies to determine the direction that Microsoft is moving with its software and eliminate the competitive advantage that its research and development has afforded the company.

Microsoft appealed the ruling in November 2000. The appeals court had harsh words for the judge in the original trial, primarily for remarks that he made to the media. In June 2001, the U.S. Court of Appeals in the District of Columbia agreed that Microsoft did maintain a monopoly but rejected the order to break the company into two parts. It ordered a new judge to determine an appropriate remedy.

Microsoft appealed to the Supreme Court to overrule the antitrust ruling, but the request was rejected. A deal was reached with the Department of Justice in November 2001, but several states opposed the settlement. Talks continued until November 2002, when the judge finally approved a settlement between Microsoft and the government. Most of the states that opposed the earlier settlement dropped their opposition.

Some features involve the restructuring of pricing to level the playing field for resellers, sharing technical data, and allowing for the removal of Microsoft icons from the desktop in Windows XP.