Chapter 1

The Role of Managerial Finance

Learning Goals

LG1 Define *finance* and the managerial finance function.

LG2 Describe the legal forms of business organization.

LG3 Describe the goal of the firm, and explain why maximizing the value of the firm is an appropriate goal for a business.

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Learning Goals (cont.)

LG4 Describe how the managerial finance function is related to economics and accounting.

LG5 Identify the primary activities of the financial manager.

LG6 Describe the nature of the principle-agent relationship between the owners and managers of a corporation, and explain how various corporate governance mechanisms attempt to manage agency problems.

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What is Finance?

- **Finance** can be defined as the science and art of managing money.
- At the personal level, finance is concerned with individuals' decisions about:
  - how much of their earnings they spend
  - how much they save
  - how they invest their savings
- In a business context, finance involves:
  - how firms raise money from investors
  - how firms invest money in an attempt to earn a profit
  - how firms decide whether to reinvest profits in the business or distribute them back to investors.

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Career Opportunities in Finance: Financial Services

- **Financial Services** is the area of finance concerned with the design and delivery of advice and financial products to individuals, businesses, and governments.
- Career opportunities include:
  - banking
  - personal financial planning
  - Investments
  - real estate
  - insurance

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Career Opportunities in Finance: Managerial Finance

- **Managerial finance** is concerned with the duties of the financial manager working in a business.
- **Financial managers** administer the financial affairs of all types of businesses—private and public, large and small, profit-seeking and not-for-profit. Tasks include:
  - developing a financial plan or budget
  - extending credit to customers
  - evaluating proposed large expenditures
  - raising money to fund the firm's operations.

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Career Opportunities in Finance: Managerial Finance (cont.)

- The recent global financial crisis and subsequent responses by governmental regulators, increased global competition, and rapid technological change also increase the importance and complexity of the financial manager’s duties.
- Increasing globalization has increased demand for financial experts who can manage cash flows in different currencies and protect against the risks that naturally arise from international transactions.

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Focus on Practice

- Professional Certifications in Finance:
  - Chartered Financial Analyst (CFA) – Offered by the CFA Institute, the CFA program is a graduate-level course of study focused primarily on the investments side of finance.
  - Certified Treasury Professional (CTP) – The CTP program requires students to pass a single exam that is focused on the knowledge and skills needed for those working in a corporate treasury department.
  - Certified Financial Planner (CFP) – To obtain CFP status, students must pass a ten-hour exam covering a wide range of topics related to personal financial planning.

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Focus on Practice (cont.)

- Professional Certifications in Finance:
  - American Academy of Financial Management (AAFM) – The AAFM administers certifications including the Charter Portfolio Manager, Chartered Asset Manager, Certified Risk Analyst, Certified Cost Accountant, and Certified Credit Analyst.
  - Professional Certifications in Accounting –Professional certifications in accounting include the Certified Public Accountant (CPA), Certified Management Accountant (CMA), and Certified Internal Auditor (CIA).

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Legal Forms of Business Organization

- A **sole proprietorship** is a business owned by one person and operated for his or her own profit.
- A **partnership** is a business owned by two or more people and operated for profit.
- A **corporation** is an entity created by law. Corporations have the legal powers of an individual in that it can sue and be sued, make and be party to contracts, and acquire property in its own name.

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Table 1.1 Strengths and Weaknesses of the Common Legal Forms of Business Organization

	Sole proprietorship	Partnership	Corporation
Strengths	• Owner receives all profits (and sustains all losses) • Low organizational costs • Income included and taxed on proprietor's personal tax return • Independence • Secrecy • Ease of dissolution	• Can raise more funds than sole proprietorships • Borrowing power enhanced by more owners • More available brain power and managerial skill • Income included and taxed on partner's personal tax return	• Owners have *limited liability*, which guarantees that they cannot lose more than they invested • Can achieve large size via sale of ownership (stock) • Ownership (stock) is readily transferable • Long life of firm • Can hire professional managers • Has better access to financing
Weaknesses	• Owner has *unlimited liability* in that total wealth can be taken to satisfy debts • Limited fund-raising power tends to inhibit growth • Proprietor must be jack-of-all-trades • Difficult to give employees long-run career opportunities • Lacks continuity when proprietor dies	• Owners have *unlimited liability* and may have to cover debts of other partners • Partnership is dissolved when a partner dies • Difficult to liquidate or transfer partnership	• Taxes are generally higher because corporate income is taxed, and dividends paid to owners are also taxed at a maximum 15% rate • More expensive to organize than other business forms • Subject to greater government regulation • Lacks secrecy because regulations require firms to disclose financial results

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Matter of Fact

BizStats.com Total Receipts by Type of U.S. Firm			
	Sole proprietorships	Partnerships	Corporations
Number of firms (millions)	23.1	3.1	7.7
Percentage of all firms	61%	8%	20%
Total receipts ($ billions)	1,324	4,244	50,757
Percentage of all receipts	2%	7%	80%

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Figure 1.1 Corporate Organization

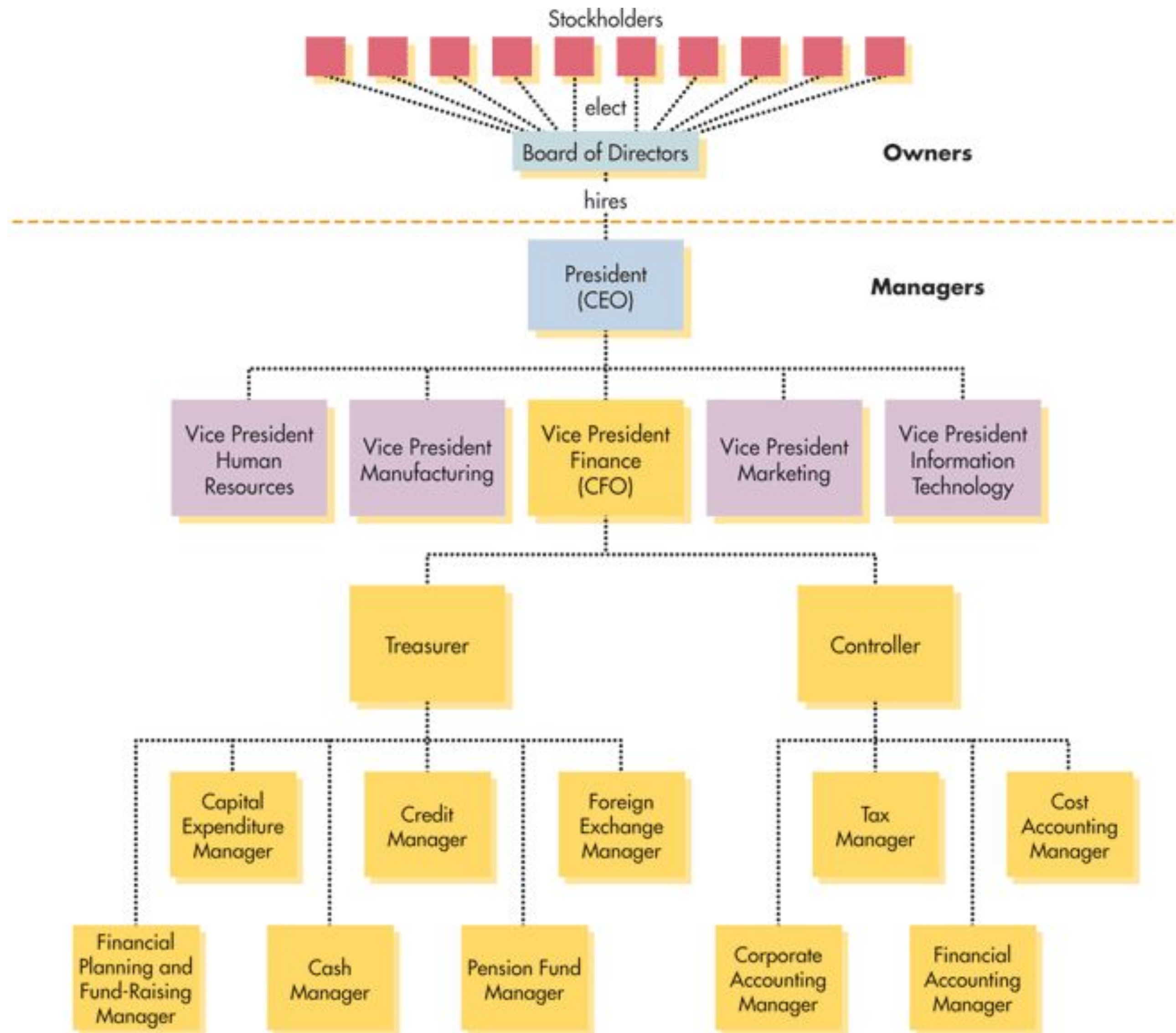

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Table 1.2 Career Opportunities in Managerial Finance

Position	Description
Financial analyst	Prepares the firm's financial plans and budgets. Other duties include financial forecasting, performing financial comparisons, and working closely with accounting.
Capital expenditures manager	Evaluates and recommends proposed long-term investments. May be involved in the financial aspects of implementing approved investments.
Project finance manager	Arranges financing for approved long-term investments. Coordinates consultants, investment bankers, and legal counsel.
Cash manager	Maintains and controls the firm's daily cash balances. Frequently manages the firm's cash collection and disbursement activities and short-term investments and coordinates short-term borrowing and banking relationships.
Credit analyst/manager	Administers the firm's credit policy by evaluating credit applications, extending credit, and monitoring and collecting accounts receivable.
Pension fund manager	Oversees or manages the assets and liabilities of the employees' pension fund.
Foreign exchange manager	Manages specific foreign operations and the firm's exposure to fluctuations in exchange rates.

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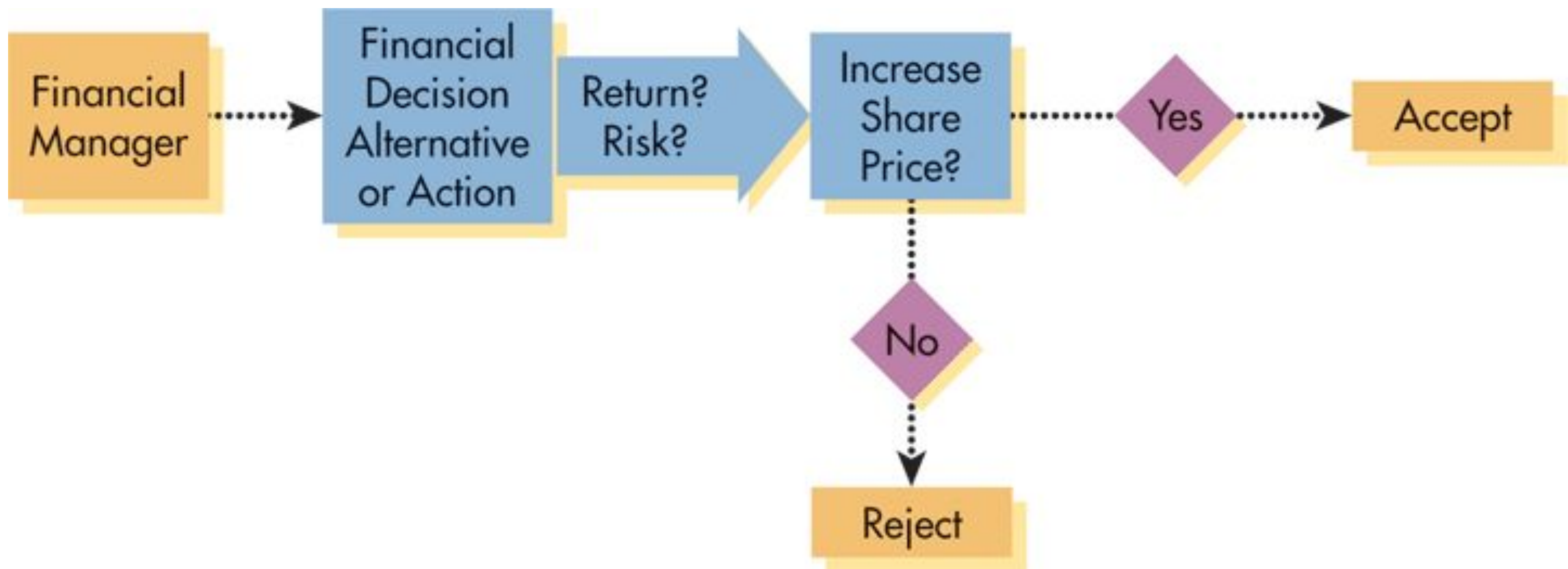
Goal of the Firm: Maximize Shareholder Wealth

- Decision rule for managers: only take actions that are expected to increase the share price.

Figure 1.2 Share Price Maximization Financial decisions and share price



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Goal of the Firm: Maximize Profit?

Which Investment is Preferred?

	Earnings per share (EPS)			
Investment	Year 1	Year 2	Year 3	Total for years 1, 2, and 3
Rotor	$1.40	$1.00	$0.40	$2.80
Valve	0.60	1.00	1.40	3.00

- Profit maximization may not lead to the highest possible share price for at least three reasons:

1. Timing is important—the receipt of funds sooner rather than later is preferred
2. Profits do not necessarily result in cash flows available to stockholders
3. Profit maximization fails to account for risk

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Goal of the Firm: What About Stakeholders?

- **Stakeholders** are groups such as employees, customers, suppliers, creditors, owners, and others who have a direct economic link to the firm.
- A firm with a *stakeholder focus* consciously avoids actions that would prove detrimental to stakeholders. The goal is not to maximize stakeholder well-being but to preserve it.
- Such a view is considered to be "socially responsible."

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The Role of Business Ethics

- **Business ethics** are the standards of conduct or moral judgment that apply to persons engaged in commerce.
- Violations of these standards in finance involve a variety of actions: “creative accounting,” earnings management, misleading financial forecasts, insider trading, fraud, excessive executive compensation, options backdating, bribery, and kickbacks.
- Negative publicity often leads to negative impacts on a firm

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The Role of Business Ethics: Considering Ethics

- Robert A. Cooke, a noted ethicist, suggests that the following questions be used to assess the ethical viability of a proposed action:
  - Is the action arbitrary or capricious? Does the action unfairly single out an individual or group?
  - Does the action affect the morals, or legal rights of any individual or group?
  - Does the action conform to accepted moral standards?
  - Are there alternative courses of action that are less likely to cause actual or potential harm?

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The Role of Business Ethics: Ethics and Share Price

- Ethics programs seek to:
  - reduce litigation and judgment costs
  - maintain a positive corporate image
  - build shareholder confidence
  - gain the loyalty and respect of all stakeholders
- The expected result of such programs is to positively affect the firm’s share price.

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Managerial Finance Function

- The size and importance of the managerial finance function depends on the size of the firm.
- In small firms, the finance function is generally performed by the accounting department.
- As a firm grows, the finance function typically evolves into a separate department linked directly to the company president or CEO through the chief financial officer (CFO) (see Figure 1.1).

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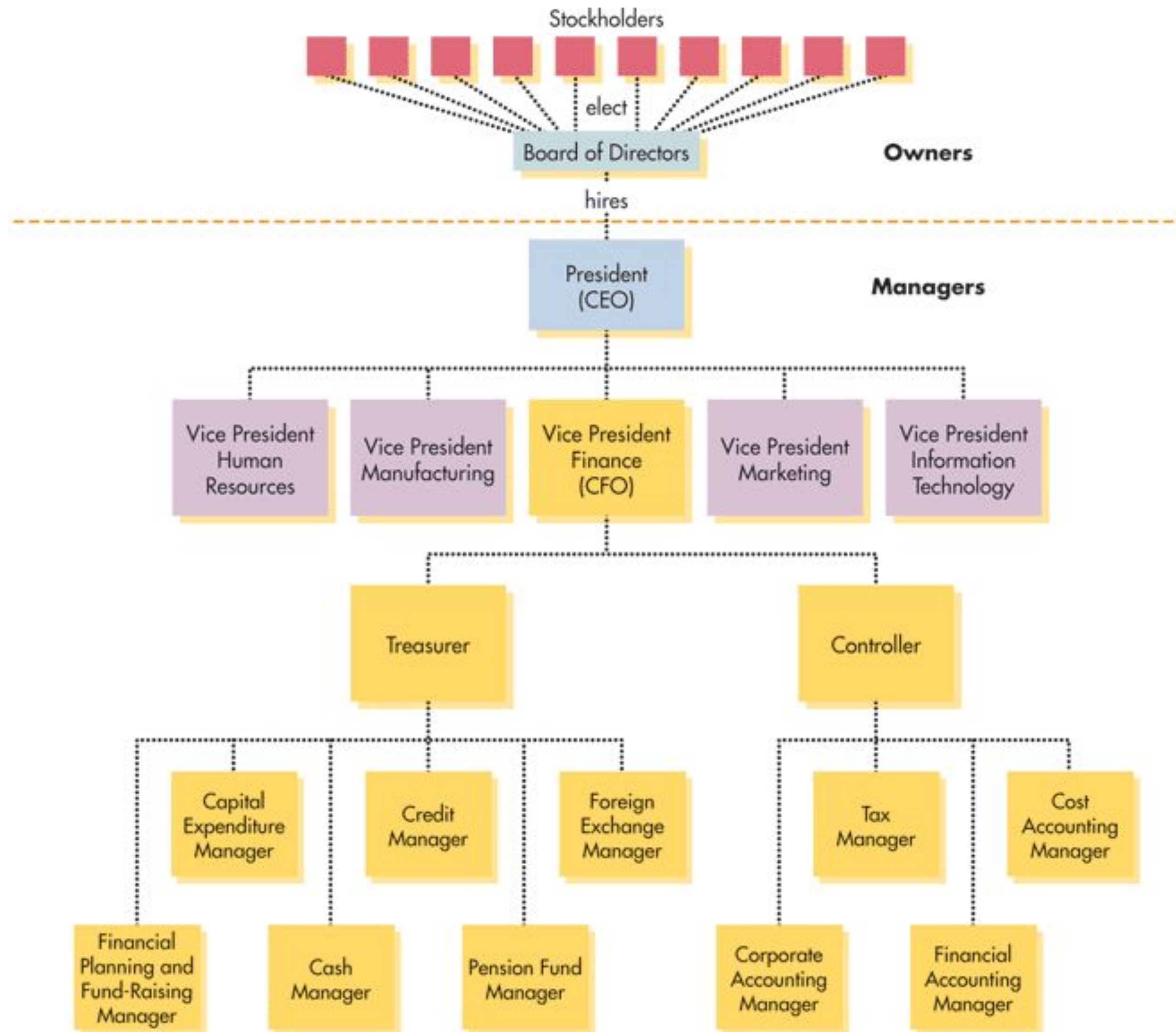
Figure 1.1 Corporate Organization



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Managerial Finance Function: Relationship to Economics

- The field of finance is closely related to economics.
- Financial managers must understand the economic framework and be alert to the consequences of varying levels of economic activity and changes in economic policy.
- They must also be able to use economic theories as guidelines for efficient business operation.
- **marginal cost–benefit analysis**

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Managerial Finance Function: Relationship to Economics (cont.)

- **Marginal cost–benefit analysis** is the economic principle that states that financial decisions should be made and actions taken only when the added benefits exceed the added costs
- Marginal cost-benefit analysis can be illustrated using the following simple example.

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Managerial Finance Function: Relationship to Economics (cont.)

Nord Department Stores is applying marginal-cost benefit analysis to decide whether to replace a computer:

Benefits with new computer	$10,000
Less: Benefits with old computer	3,000
(1) Marginal (added) benefits	$ 7,000
Cost of new computer	$ 8,000
Less: Proceeds from sale of old computer	2,000
(2) Marginal (added) costs	$ 6,000
Net benefit [(1) − (2)]	$ 1,000

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Managerial Finance Function: Relationship to Accounting

- The firm's finance and accounting activities are closely-related and generally overlap.
- In small firms accountants often carry out the finance function, and in large firms financial analysts often help compile accounting information.
- One major difference in perspective and emphasis between finance and accounting is that accountants generally use the accrual method while in finance, the focus is on cash flows.

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Managerial Finance Function: Relationship to Accounting (cont.)

- Whether a firm earns a profit or experiences a loss, *it must have a sufficient flow of cash to meet its obligations as they come due.*
- The significance of this difference can be illustrated using the following simple example.

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Managerial Finance Function: Relationship to Accounting (cont.)

The Nassau Corporation experienced the following activity last year:

Sales: $100,000 (1 yacht sold, 100% still uncollected)

Costs: $80,000 (all paid in full under supplier terms)

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Managerial Finance Function: Relationship to Accounting (cont.)

Now contrast the differences in performance under the accounting method (accrual basis) versus the financial view (cash basis):

Accounting view
(accrual basis)

Nassau Corporation
income statement
for the year ended 12/31

Sales revenue	$100,000
Less: Costs	80,000
Net profit	$ 20,000

Financial view
(cash basis)

Nassau Corporation
cash flow statement
for the year ended 12/31

Cash inflow	$ 0
Less: Cash outflow	80,000
Net cash flow	($80,000)

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Managerial Finance Function: Relationship to Accounting (cont.)

Finance and accounting also differ with respect to decision-making:

- Accountants devote most of their attention to the *collection and presentation of financial data.*
- Financial managers evaluate the accounting statements, develop additional data, and *make decisions* on the basis of their assessment of the associated returns and risks.

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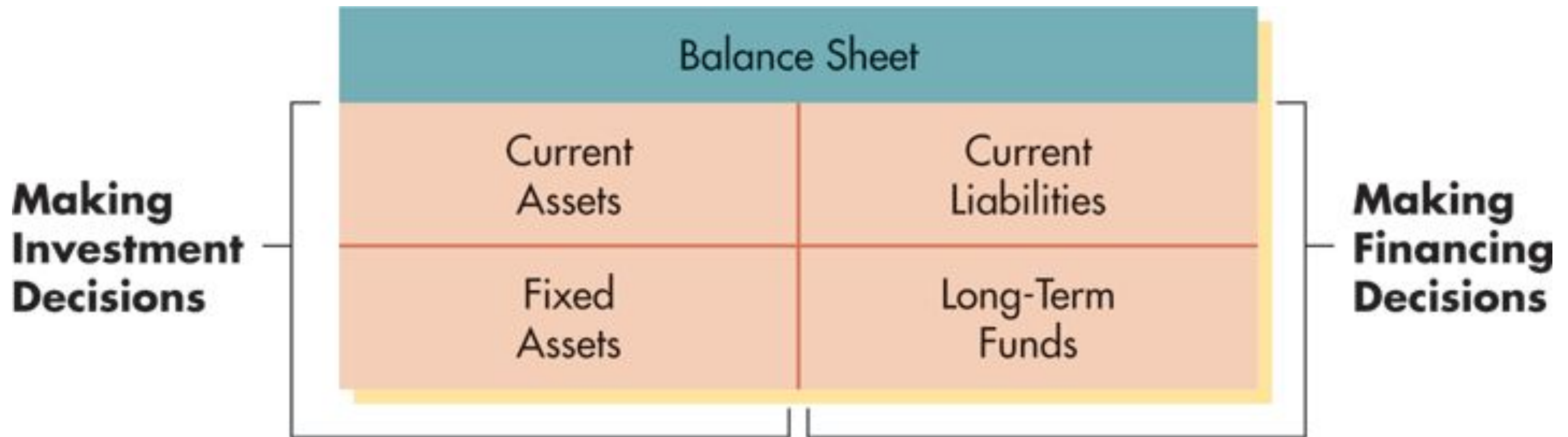
Figure 1.3
Financial Activities



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Governance and Agency: Corporate Governance

- **Corporate governance** refers to the rules, processes, and laws by which companies are operated, controlled, and regulated.
- It defines the rights and responsibilities of the corporate participants such as the shareholders, board of directors, officers and managers, and other stakeholders, as well as the rules and procedures for making corporate decisions.
- The structure of corporate governance was previously described in Figure 1.1.

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Governance and Agency: Individual versus Institutional Investors

- **Individual investors** are investors who own relatively small quantities of shares so as to meet personal investment goals.
- **Institutional investors** are investment professionals, such as banks, insurance companies, mutual funds, and pension funds, that are paid to manage and hold large quantities of securities on behalf of others.
- Unlike individual investors, institutional investors often monitor and directly influence a firm's corporate governance by exerting pressure on management to perform or communicating their concerns to the firm's board.

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Governance and Agency: Government Regulation

- Government regulation generally shapes the corporate governance of all firms.
- During the recent decade, corporate governance has received increased attention due to several high-profile corporate scandals involving abuse of corporate power and, in some cases, alleged criminal activity by corporate officers.

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Governance and Agency: Government Regulation

The Sarbanes-Oxley Act of 2002:

- established an oversight board to monitor the accounting industry;
- tightened audit regulations and controls;
- toughened penalties against executives who commit corporate fraud;
- strengthened accounting disclosure requirements and ethical guidelines for corporate officers;
- established corporate board structure and membership guidelines;
- established guidelines with regard to analyst conflicts of interest;
- mandated instant disclosure of stock sales by corporate executives;
- increased securities regulation authority and budgets for auditors and investigators.

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Governance and Agency: The Agency Issue

- A **principal-agent relationship** is an arrangement in which an agent acts on the behalf of a principal. For example, shareholders of a company (principals) elect management (agents) to act on their behalf.
- **Agency problems** arise when managers place personal goals ahead of the goals of shareholders.
- **Agency costs** arise from agency problems that are borne by shareholders and represent a loss of shareholder wealth.

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The Agency Issue: Management Compensation Plans

- In addition to the roles played by corporate boards, institutional investors, and government regulations, corporate governance can be strengthened by ensuring that managers' interests are aligned with those of shareholders.
- A common approach is to structure management compensation to correspond with firm performance.

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The Agency Issue: Management Compensation Plans

- **Incentive plans** are management compensation plans that tie management compensation to share price; one example involves the granting of stock options.
- **Performance plans** tie management compensation to measures such as EPS or growth in EPS. Performance shares and/or cash bonuses are used as compensation under these plans.

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Matter of Fact—Forbes.com CEO Performance vs. Pay

Chief Executive	Company	2012 Compensation ($ millions)	2012 Stock Return (Rank)
Larry Ellison	Oracle Corp.	$96.2	−22% (99)
Richard Bracken	HCA	$38.6	+66% (10)
Robert Iger	Disney	$37.1	+75% (7)
Mark Parker	Nike	$35.2	+30% (26)
Philippe Dauman	Viacom	$33.4	+41% (16)
John Donahoe	eBay	$29.7	+68% (9)
Howard Schulz	Starbucks	$28.9	+38% (19)
Stephen Chazen	Occidental Petroleum	$28.5	−16% (97)
Paul Jacobs	Qualcomm	$20.7	+30% (25)

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The Agency Issue: The Threat of Takeover

- When a firm's internal corporate governance structure is unable to keep agency problems in check, it is likely that rival managers will try to gain control of the firm.
- The threat of takeover by another firm, which believes it can enhance the troubled firm's value by restructuring its management, operations, and financing, can provide a strong source of external corporate governance.

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