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Financial Management

Principles and Practice

Fourth Edition

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FINANCIAL MANAGEMENT: PRINCIPLES AND PRACTICE, 4th Edition

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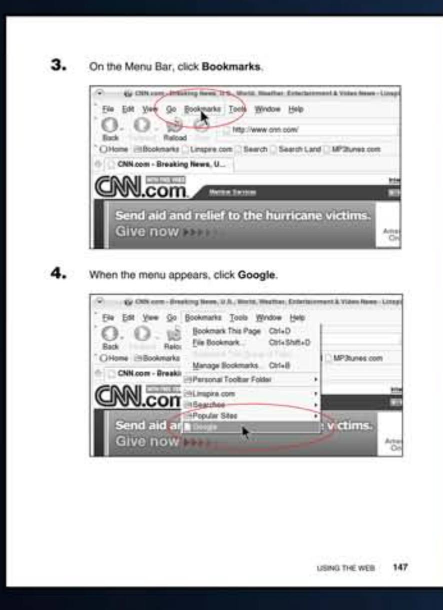

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Preface

The Challenge

Finance scares some students. There is the fear of numbers that some students have and the mistaken belief that the introductory finance course requires high-level mathematics. Also, some students mistakenly believe finance is an area in which they will not need competency. Finance concepts often seem far removed from daily life. In spite of this, almost every major in a college of business, and many majors in other colleges, require the "Principles of Finance" course. As a result, many of the students who find themselves sitting in finance class on the first day of the semester do not want to be there.

We do not believe that this needs to be the case. Finance is important, dynamic, interesting, and fun. The challenge we take head-on in *Financial Management: Principles and Practice* is to convince students of this. In order to learn, students must want to learn. If they can see the usefulness of what is presented to them, they will work hard and they will learn.

Our many years of teaching experience has taught us that the introductory financial management course can be one that students enjoy and that they see as having added considerable value to their educational experiences. Finance is, after all, central to any business entity. More CEOs have come up through the finance ranks than any other discipline. Students need to know that the principles and practices of financial management apply to any business unit—from the very large multinational corporation to the very smallest proprietorship, including the family. Financial ratios tell a story; they are not numbers to be calculated as an end unto itself. Risk is important and can be managed. Time value of money has meaning and is understood as the central tool of valuation. Funds have a cost and different sources of funds have different costs. Financial performance and condition can be assessed. Amortized loan payments, rates of return on investment, future value of investment programs, and present value of payments to be received from bonds and stocks can be calculated. The opportunities and special challenges of international operations can be understood.

Our Approach

We believe that students should walk out of the room after taking the final exam for a finance course believing that they have learned something useful. They should see a direct benefit to themselves personally, rather than just the belief that some set of necessary job skills has been mastered, although the latter will be true if the material is mastered.

In *Financial Management: Principles and Practice*, we start with the student in mind and then package the finance material so that the students (1) want to learn and (2) learn the necessary material. We do this because finance is not medicine, and it cannot be administered as such. Instead, we believe students must be engaged in such a way that they develop the desire to learn. There are those who approach the task of teaching finance with the philosophy, "Here is the finance knowledge you need. Learn it!" These are not the people we had in mind when we wrote this book.

In the fourth edition we have further integrated the text with the Internet and with multimedia material. We did this to facilitate the learning experience, not to have bells and whistles we could point to. There are Interactive Modules that directly tie material in the text to visually rich interactive material on the Web. These are not just links.

Two key characteristics of *Financial Management: Principles and Practice,* fourth edition, are currency and relevance. One of the authors of the text is an academic with over twenty years of teaching experience and the other until recently was a full-time financial practitioner. This combination of backgrounds results in a text that presents the latest in financial theory while retaining a strong "real-world" connection. No other textbook on the market enjoys this balance of academic and practitioner perspectives. This book was very successful in its first three editions with Prentice Hall as its publisher. We are very happy to be part of the exciting new business model of Freeload Press for the fourth edition. Textbooks have become too expensive for students. The sponsor and advertising business model of Freeload Press blazes the trail to the future where affordable quality textbooks are made available to students and professors.

Distinctive Focus

Although there are many other introductory financial management books on the market, none contains the unique style and content of *Financial Management: Principles and Practice,* fourth edition. Many texts focus mostly on accounting with little presentation of the economic theory that underlies the financial techniques presented. Others assume that the students remember all that was learned in the accounting course that is usually a prerequisite for this course. Still others claim to take a "valuation approach" but present their topics in a straight accounting framework. In this book we are serious about focusing on what creates value. We are consistent in this approach throughout the book, addressing issues such as what creates value, what destroys it, how value is measured, and how value and risk are related. In so doing we maximize the value of the finance course to the student.

Organization of the Text

The book is organized into six major parts as follows:

Part I. The World of Finance contains chapters on the structure and goals of firm, the role of financial managers, and an examination of the financial environment.

Part II. Essential Concepts in Finance presents chapters on accounting statements and their interpretation, forecasting, risk and return, the time value of money, and security valuation.

Part III. Capital Budgeting and Business Valuation contains chapters on measuring a firm's cost of capital, capital budgeting decision methods, incremental cash flow estimation, and business valuation.

Part IV. Long-Term Financing Decisions contains chapters on capital structure basics, corporate bonds, preferred stock, leasing, common stock, and dividend policy.

Part V. Short-Term Financial Management Decisions includes chapters on working capital policy, cash and marketable securities, accounts receivable and inventory, and short-term financing.

Part VI. Finance in a Global Economy is where international finance topics are covered, in addition to those international topics that are woven throughout the book.

Special Features in the Text

Downloads of Interactive Material

After downloading, students can move seamlessly between the text and these Interactive Modules. This process enables learning that is simply not possible from a printed page alone.

Real-World Examples

Each chapter in *Financial Management: Principles and Practice* begins with a real-world example that illustrates the concept to be addressed in that chapter. This serves to give the student a reason to learn this material and to show its practical application. Learning objectives are clear.

Calculator Solutions

Financial calculator solutions to all general time value of money and specific security valuation problems are included. This material is presented in such a way that professors' differing preferences as to the use of financial calculators can be accommodated.

Summaries

The summary for each chapter specifically describes how the learning objectives have been achieved and it also provides a bridge to the next chapter.

Key Terms

Each chapter has bolded key terms that are defined in the chapter and in the glossary. There are self-test questions and problems at the end of chapters, along with their solutions, so that students can check their grasp of the material presented.

Practice Questions and Problems

Study questions and an abundant number of end-of-chapter problems are included in the appropriate chapters.

Computer Spreadsheet Supported Problems

A number of end-of-chapter problems are marked with the special computer problem logo shown here. This indicates that a downloadable Excel spreadsheet template is available at *www.freeloadpress.com*.

Communication Skills

Suggested assignments to build students' written and oral communication skills are included in each chapter.

Color

Color is used for pedagogic effect, not just for looks.

Changes in the Fourth Edition

- The few errors in the third edition have been corrected.
- The financial statements used in Chapters 4 and 5 have been simplified to make financial analysis clearer.
- References and examples were updated throughout.
- The PowerPoint® slides accompanying the text were enhanced and updated.
- The Testbank has been redone with new questions written by the authors.
- A multi-level quality control program was implemented for the text and supplements. The program is designed to eliminate any and all errors.

Features Retained from the Third Edition

- The book is still written in the student-friendly style that was extremely popular in the first and second editions. The concise, easy-to-understand presentation loved by student users is maintained.
- The book provides the level of rigor professors demand. When professors get past the friendly style, they find all the rigor and all the mainstream topics they expect in a book of this type. For example, if you are not already a *Financial Management: Principles and Practice* user, does your book:
    - Cover real options?
    - Cover EVA, MVA, and EBITDA?
    - Use a value-added (NPV) approach to the inventory and accounts receivable investment coverage rather than the outmoded return on investment ratio approach?
    - Have supplements that were not "farmed out" to subcontractors but that instead have the authors' hands-on participation?
- Attempts to expand the book, and to make it longer, have been resisted. The topics that professors actually teach are here. Those that are most likely to be taught in the second course in financial management are left out. Students don't have to buy more than what they need.

The Learning Package

Financial Management: Principles and Practice is one component of a complete learning package carefully put together by the Freeload Press team. This package includes a computerized test bank, a study guide/workbook, an instructor's manual, PowerPoint slides, and downloadable Excel® spreadsheets.

For the Student

- ***Downloadable Material***—Companion downloadable material is available at *www.freeloadpress.com*. There are Excel spreadsheet files containing templates that facilitate solving computer icon designated end-of-chapter problems and interactive modules.
- ***Lecture Notes***—PowerPoint files may be downloaded from *www.freeloadpress.com* and used as lecture notes so that students can focus on what their professor is saying without having to simultaneously take copious notes. These have been carefully updated and enhanced.

For the Professor

- ***Instructor's Manual***—This provides the professor with chapter outlines and suggestions for alternative ways to present the material. Key points are identified and a variety of types of assistance for class preparation are presented.
- ***Solutions Manual***—Detailed solutions, not just final answers, are presented for each end-of-chapter question and problem. These have all been personally checked by the authors, in addition to two other levels of checking, for accuracy.
- ***Test Item File***—Available on CD, multiple-choice, short-answer, and essay questions reflect all the material in the chapter. The program allows for complete customization of an exam according to chapters covered, type of problem, and level of difficulty.
- ***PowerPoint Slides***—Animated slides covering all main topic areas in the text are available to assist the professor during class. These have been expanded, triple-checked for accuracy, and have special features added since the previous edition PowerPoint slides were prepared.
- ***Author Access***—Both authors are accessible to respond to individual questions that may come up. Tim Gallagher may be reached at tim@gallagher.com and Joe Andrew at josephandem@aol.com.

In Conclusion

We believe that students will understand the very important finance concepts, and master necessary problem-solving skills, when they complete the course in which this text is used. "Students first" is our philosophy and this belief shows up throughout the text. Professors who have more enthusiastic students and who grasp the important content, both conceptual and problem solving, will find their classroom experiences more rewarding too. If we have helped to make this happen, we have succeeded in achieving our vision for *Financial Management: Principles and Practice,* fourth edition.

Acknowledgements

The authors gratefully acknowledge the contributions of the many people who contributed to this endeavor. Without their expertise and talent, this book and the supplemental materials would not have been possible.

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For this fourth edition we are particularly indebted to our editor, Ed Laube, of Freeload Press. Ed and his partner Tom Doran had the courage to start a company that redefines textbook publishing. We are excited to be a part of it. This is the future of college textbook publishing. The old model doesn't work anymore and these people and the others who have created Freeload Press are doing something about it. We'd also like to thank Victoria Putman and Daphne Loecke for their excellent work on the production side of this project.

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About the Authors

Timothy J. Gallagher (Tim) is professor of finance and chair of the Department of Finance and Real Estate at Colorado State University. Tim received his Ph.D. in finance from the University of Illinois at Urbana–Champaign.

Tim has taught undergraduate and graduate finance courses, including courses in financial management, markets and institutions, and investments, for 24 years. He has taught traditional and nontraditional students at all levels, including executive MBAs, and in all types of classroom settings—large lecture, small seminar, and distance learning.

Tim has published in journals such as *The Journal of Money and Banking, The Journal of Portfolio Management, Financial Management,* and *The Financial Review,* among others.

Joseph D. Andrew (Joe) until September 2003 was a financial analyst with BIA Financial Network, Inc., a financial consulting firm specializing in the analysis and appraisal of broadcasting, cable, and telecommunications companies and preparation of bank presentations for communications clients. As a senior telecom analyst with BIA, Joe performed asset and stock appraisals, business plan analyses, industry studies, and litigation support functions for communications companies primarily in the local, long-distance, wireless, specialized mobile radio, and Internet industries. He also participated in specialized strategic research projects and impact studies covering various aspects of the communications industry.

Prior to joining BIA, Joe served as chief financial officer for X-Change Software, Inc., a startup software development firm in Oakton, Virginia. As CFO he was responsible for corporate investment analysis, cash flow planning, forecasting and analysis, receivables and payables management, and supervision of bookkeeping and accounting functions.

In addition to managing corporate finances, Joe teaches graduate courses for Webster University of St. Louis, Missouri. His published works include this book and *Effective Writing: A Handbook for Finance People* with Dr. Claire May of the Art Institute of Atlanta and Dr. Gordon May of the University of Georgia.

Joe's past experience includes teaching assignments for National-Louis University in McLean, Virginia, the University of Southern Colorado in Colorado Springs, and McMurry College in Abilene, Texas. He also served 23 years as a missile maintenance specialist in the U.S. Air Force, retiring at the rank of chief master sergeant in 1982.

Tim and Joe's partnership in this book's creation represents a unique opportunity for readers to experience the best of both worlds—Tim's development of theory and logic of financial principles and Joe's real-world financial orientation. Their combined experience with students ensures that readers will learn theory and practice in an innovative, up-to-date, accurate manner.

Campfire queen Cycling champion Sentimental geologist*

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The World of Finance

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We begin our study of financial management with a look at what the field of finance is all about and the environment in which financial managers operate. Chapter 1 introduces you to finance, explains what financial managers do, states the objective of financial management, and describes the four basic forms of business commonly encountered in the U.S. Chapter 2 introduces you to the financial environment in which the firm operates. The financial system is explained, along with the various financial markets and the securities that are bought and sold there. The importance of financial markets to the firm is emphasized. Chapter 2 finishes with a discussion of interest rates, which represent the price of credit in the financial markets. Chapter 3 continues with descriptions of the various types of financial institutions through which buyers, sellers, borrowers, and lenders gain access to the financial markets. These three chapters set the stage for your study of the principles and practice of managing an individual company's finances.

CHAPTERS

1 Finance and the Firm

2 Financial Markets and Interest Rates

3 Financial Institutions

1 Finance and the Firm

"The race is not always to the swift, nor the battle to the strong, but that is the way to bet."

—Rudyard Kipling

Finance Grabs the Business Headlines

Headlines from the front pages of some recent newspapers.

- Bush Moves to Ease Oil Prices (*New York Times*, Apr 25, 2006)
- Developer Accepts World Trade Center Deal (*New York Times*, Apr 25, 2006)
- Xcel hikes good business for Denver (*Denver Post*, Apr 30, 2006)
- Home Insurers Leaving High-Risk Markets (*Washington Post*, Apr 30, 2006)
- Verizon Earnings fall 7.1% (*USA Today*, May 2, 2006)

What do all these stories have in common? They deal with finance. Companies cutting costs, companies reporting profits or losses, governments concerned about interest rates—this is just a sampling of business stories involving finance that appear every day in the press. Finance is at the heart of business management. No business firm—or government, for that matter—can exist for long without following at least the basic principles of financial management.

This book is designed to introduce you to basic financial management principles and skills. Some of these concepts and skills are surprisingly straightforward; others are quite challenging. All, however, will help you in the business world, no matter what career you choose.

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Chapter Overview

In this chapter we introduce financial management basics that provide a foundation for the rest of the course. First, we describe the field of finance and examine the role of financial management within a business organization. Then we investigate the financial goal of a business firm and the legal and ethical challenges financial managers face. We end with a description of the four forms of business in the U.S. economy: sole proprietorship, partnership, corporation, and limited liability company.

Learning Objectives

After reading this chapter, you should be able to:

1. Describe the field of finance.
2. Discuss the duties of financial managers.
3. Identify the basic goal of a business firm.
4. List factors that affect the value of a firm.
5. Discuss the legal and ethical challenges financial managers face.
6. Identify the different forms of business organization.

The Field of Finance

In business, financial guidelines determine how money is raised and spent. Although raising and spending money may sound simple, financial decisions affect every aspect of a business—from how many people a manager can hire, to what products a company can produce, to what investments a company can make.

For example, on June 6, 2006, Google announced the release of a Web-based spreadsheet program that allows users to collaborate online. This announcement follows the acquisition of Writely. This move was seen by some as an attack on Microsoft's turf. The Google spreadsheet program would be accessed through a user's Web browser. Multiple users will be able to access the spreadsheet at the same time.[1]

[1] Source: Kevin J. Delaney, "Google Advances Software Challenge With Spreadsheet," *The Wall Street Journal* (June 6, 2006): B2.

Table 1-1 Careers in the Field of Finance

Career Area	Function
Financial management	Manage the finances of a business firm. Analyze, forecast, and plan a firm's finances; assess risk; evaluate and select investments; decide where and when to find money sources, and how much money to raise; and determine how much money to return to investors in the business
Financial markets and institutions	Handle the flow of money in financial markets and institutions, and focus on the impact of interest rates on the flow of that money
Investments	Locate, select, and manage money-producing assets for individuals and groups

Money continually flows through businesses. It may flow in from banks, from the government, from the sale of stock, and so on; and it may flow out for a variety of reasons—to invest in bonds, to buy new equipment, or to hire top-notch employees. Businesses must pay constant attention to ensure that the right amount of money is available at the right time for the right use.

In large firms it may take a whole team of financial experts to track the firm's cash flows and to develop financial strategies. For instance, when Chase Manhattan acquired J.P. Morgan in 2000, teams of financial analysts worked on every detail of the $36 billion decision to determine how many shares of Chase each stockholder of J.P. Morgan would receive.[2]

Finance Career Paths

Finance has three main career paths: financial management, financial markets and institutions, and investments. Financial management, the focus of this text, involves managing the finances of a business. Financial managers—people who manage a business firm's finances—perform a number of tasks. They analyze and forecast a firm's finances, assess risk, evaluate investment opportunities, decide when and where to find money sources and how much money to raise, and decide how much money to return to the firm's investors.

Bankers, stockbrokers, and others who work in financial markets and institutions focus on the flow of money through financial institutions and the markets in which financial assets are exchanged. They track the impact of interest rates on the flow of that money. People who work in the field of investments locate, select, and manage income-producing assets. For instance, security analysts and mutual fund managers both operate in the investment field.

Table 1-1 summarizes the three main finance career paths.

Financial Management

Financial management is essentially a combination of accounting and economics. First, financial managers use accounting information—balance sheets, income statements, and statements of cash flows—to analyze, plan, and allocate financial resources for business

[2] "Chase Manhattan, J.P. Morgan complete Hldg-Co-Merger," DowJones Newswire, June 2, 2001.

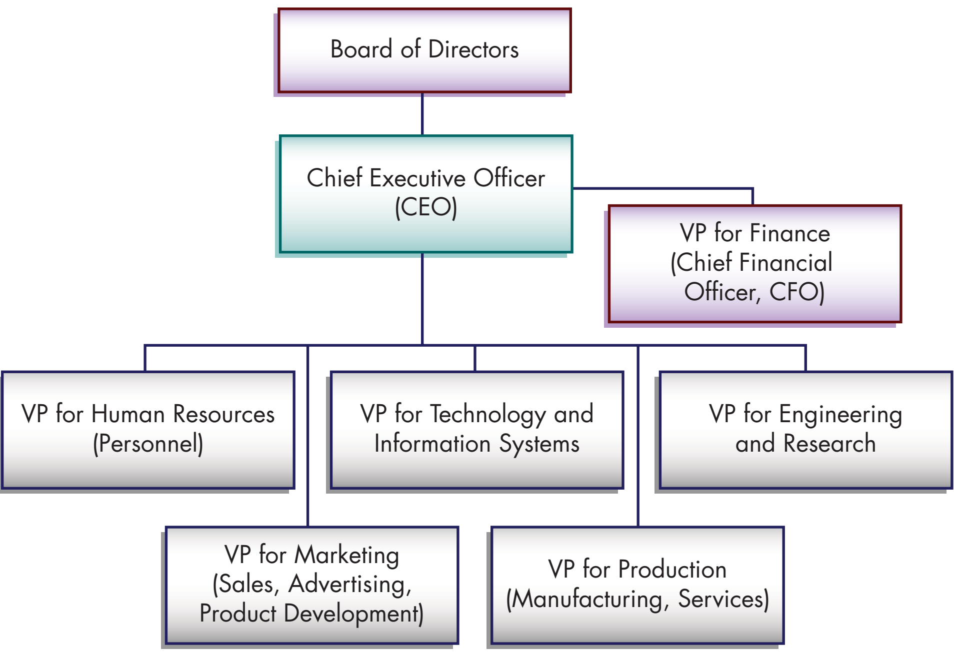

Figure 1-1
The Organization of a Typical Corporation

Figure 1-1 shows how finance fits into a typical business organization. The vice president for finance, or chief financial officer, operates with the vice presidents of the other business teams.

firms. Second, financial managers use economic principles to guide them in making financial decisions that are in the best interest of the firm. In other words, finance is an applied area of economics that relies on accounting for input.

Because finance looks closely at the question of what adds value to a business, financial managers are central to most businesses. Let's take a look at what financial managers do.

The Role of the Financial Manager

Financial managers measure the firm's performance, determine what the financial consequences will be if the firm maintains its present course or changes it, and recommend how the firm should use its assets. Financial managers also locate external financing sources and recommend the most beneficial mix of financing sources while focusing on the financial expectations and risk tolerances of the firm's owners.

All financial managers must be able to communicate, analyze, and make decisions based on information from many sources. To do this, they need to be able to analyze financial statements, forecast and plan, and determine the effect of size, risk, and timing of cash flows. We'll cover all of these skills in this text.

Finance in the Organization of the Firm Financial managers work closely with other types of managers. For instance, they rely on accountants for raw financial data and on marketing managers for information about products and sales. Financial managers coordinate with technology experts to determine how to communicate financial information to others in the firm. Management experts in the area of supply chain work are also part of this team. Financial managers provide advice and recommendations to top management.

Figure 1-1 shows how finance fits into a typical business firm's organization.

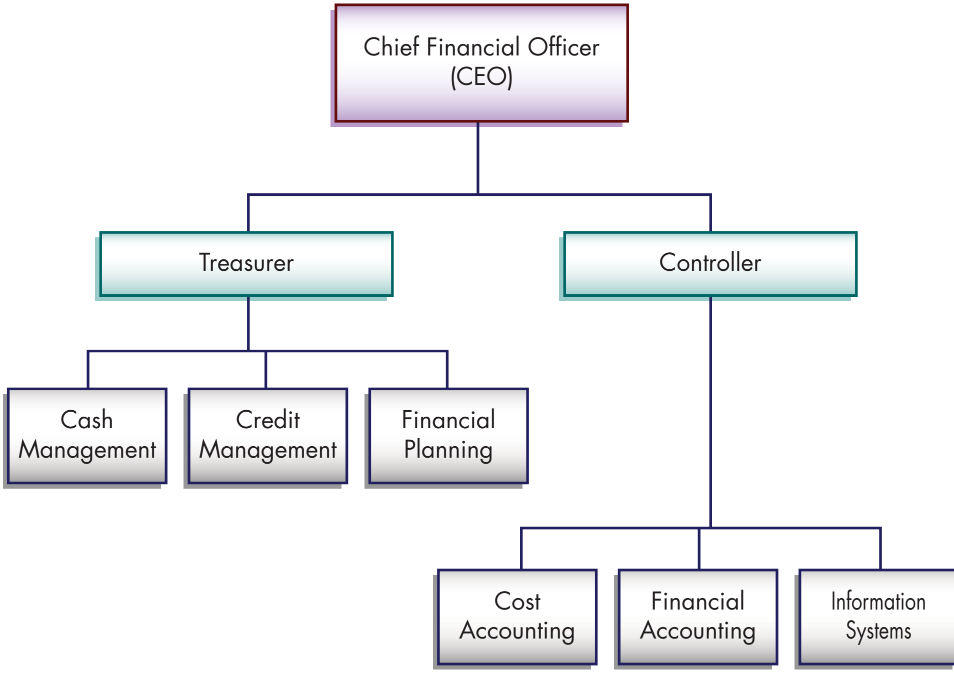

Figure 1-2 An Example of How to Organize a Finance Team

This chart shows how to organize a finance team in a medium-to-large business. Most teams include both a finance function (on the left) and an accounting function (on the right). The chief financial officer usually reports to the CEO, as shown in Figure 1-1.

The Organization of the Finance Team In most medium-to-large businesses, a chief financial officer (CFO) supervises a team of employees who manage the financial activities of the firm. One common way to organize a finance team in a medium-to-large business is shown in Figure 1-2.

In Figure 1-2 we see that the **chief financial officer** (CFO) directs and coordinates the financial activities of the firm. The CFO supervises a treasurer and a controller. The **treasurer** generally is responsible for cash management, credit management, and financial planning activities, whereas the **controller** is responsible for cost accounting, financial accounting, and information system activities. The treasurer and the controller of a large corporation are both likely to have a group of junior financial managers reporting to them.

At a small firm, one or two people may perform all the duties of the treasurer and controller. In very small firms, one person may perform all functions, including finance.

The Basic Financial Goal of the Firm

The financial manager's basic job is to make decisions that add value to the firm. When asked what the basic goal of a firm is, many people will answer, "to make a lot of money" or "to maximize profits." Although no one would argue that profits aren't important, the single-minded pursuit of profits is not necessarily good for the firm and its owners. We will explain why this is so in the sections that follow. For now, let's say that a better way to express the primary financial goal of a business firm is to "maximize the wealth of the firm's owners." This is an extremely important, even crucial, point, so we will say it again: *The primary financial goal of the business firm is to maximize the wealth of the firm's owners.*

Everything the financial manager does—indeed, all the actions of everyone in the firm—should be directed toward this goal, subject to legal and ethical considerations that we will discuss in this chapter and throughout the book.

Now, what do we mean by wealth? **Wealth** refers to value. If a group of people owns a business firm, the contribution that firm makes to that group's wealth is determined by the market value of that firm.

This is a very important point: We have defined wealth in terms of *value*. The concept of value, then, is of fundamental importance in finance. Financial managers and researchers spend a lot of time measuring value and figuring out what causes it to increase or decrease.

In Search of Value

We have said that the basic goal of the business firm is to maximize the wealth of the firm's owners—that is, to maximize the value of the firm. The next question, then, is how to measure the value of the firm.

The value of a firm is determined by whatever people are willing to pay for it. The more valuable people think a firm is, the more they will pay to own it. Then the existing owners can sell it to investors for more than the amount of their investment, thereby increasing current owner wealth. The financial manager's job is to make decisions that will cause people to think more favorably about the firm and, in turn, to be willing to pay more to purchase the business.

For companies that sell stock to the general public, stock price can indicate the value of a business because *stockholders*—people who purchase corporate shares of stock—become part owners of the corporation. (We will discuss stock in greater detail in Chapter 2.) People will pay a higher price for stock—that is, part ownership of a business—if they believe the company will perform well in the future. For instance, Yahoo, a developer of Internet access software, originally sold its stock for $1.38 (adjusted for dividends and stock splits) per share. (A share is one unit of ownership.) Because of the potential of its Internet services, it was worth more than $118 per share in January 2000. This wasn't too bad for a company that had losses for most of its early history. Investors were betting on a bright future for Yahoo.

For businesses that sell stock publicly, then, the financial manager's basic role is to help make the firm's stock more valuable. Although some businesses do not sell stock to the general public, we will focus on stock price as a measure of the value of the firm. Keep in mind, however, that investing in one share (one unit) of stock means the investor only owns one small piece of a firm. Many firms sell hundreds of thousands or millions of shares of stock, so the total value of the firm is the equivalent of the sum of all the stock shares' values.[3]

Next, let's look closely at three factors that affect the value of a firm's stock price: cash flow, timing, and risk.

The Importance of Cash Flow In business, cash is what pays the bills. It is also what the firm receives in exchange for its products and services. Cash is, therefore, of ultimate importance, and the expectation that the firm will generate cash in the future is one of the factors that gives the firm its value.

[3] To be sure, investors' dreams took a big hit when Internet stocks crashed big-time in 2001-2002. The price of Yahoo's stock fell to $4.50 (adjusted) in September, 2002. However, by April 2006 it had climbed back to $33.00. This illustrates that the stock market can be a risky place to invest your money! (More about this in Chapter 7.)

We use the term *cash flow* to describe cash moving through a business. Financial managers concentrate on increasing cash *in*flows—cash that flows into a business—and decreasing cash *out*flows—cash that flows away from a business. Cash outflows will be approved if they result in cash inflows of sufficient magnitude and if those inflows have acceptable timing and risk associated with them.

It is important to realize that sales are not the same as cash inflows. Businesses often sell goods and services on credit, so no cash changes hands at the time of the sale. If the cash from the sale is never collected, the sale cannot add any value to the firm. Owners care about actual cash collections from sales—that is, cash inflows.

Likewise, businesses may buy goods and services to keep firms running but may make the purchases on credit, so no cash changes hands at that time. However, bills always come due sooner or later, so owners care about cash expenditures for purchases—cash outflows. For any business firm (assuming other factors remain constant), the higher the expected cash inflows and the lower the expected cash outflows, the higher the firm's stock price will be.

The Effect of Timing on Cash Flows The timing of cash flows also affects a firm's value. To illustrate, consider this: Would you rather receive $100 cash today and $0 one year from now, or would you rather receive $0 cash today and $100 one year from now? The two alternatives follow:

	Today	One Year from Today
Alternative A	+$100	$ 0
Alternative B	$ 0	+$100

Take Note:
The point about cash received sooner being better than cash received later works in reverse too. It is better to pay out cash later rather than sooner (all other factors being equal, of course).

Both alternatives promise the same total amount of cash, but most people would choose Alternative A, because they realize they could invest the $100 received today and earn interest on it during the year. By doing so they would end up with more money than $100 at the end of the year. For this reason we say that—all other factors being equal—cash received sooner is better than cash received later.

Owners and potential investors look at when firms can expect to receive cash and when they can expect to pay out cash. All other factors being equal, the sooner a company expects to receive cash and the later it expects to pay out cash, the more valuable the firm and the higher its stock price will be.

The Influence of Risk We have seen that the size of a firm's expected cash inflows and outflows and the timing of those cash flows influence the value of the firm and its stock price. Now let us consider how risk affects the firm's value and its stock price.

Risk affects value because the less certain owners and investors are about a firm's expected cash inflows, the lower they will value the company. The more certain owners and investors are about a firm's expected cash inflows, the higher they will value the company. In short, companies whose expected future cash flows are doubtful will have lower values than companies whose expected future cash flows are virtually certain.

Table 1-2 Accomplishing the Primary Financial Goal of the Firm

The Goal: Maximize the wealth of the firm's owners

Measure of the Goal: Value of the firm
(measured by the price of the stock on the open market for corporations)

Factor	Effect on Stock Price
Size of expected future cash flows	Larger future cash inflows raise the stock price. Larger future cash outflows lower the stock price. Smaller future cash inflows lower the stock price. Smaller future cash outflows raise the stock price.
Timing of future cash flows	Cash inflows expected sooner result in a higher stock price. Cash inflows expected later result in a lower stock price. *(The opposite effect occurs for future cash outflows.)*
Riskiness of future cash flows	When the degree of risk associated with future cash flows goes down, the stock price goes up. When the degree of risk associated with future cash flows goes up, the stock price goes down.

What isn't nearly as clear as the way risk affects value is *how much* it affects it. For example, if one company's cash inflows are twice as risky as another company's cash inflows, is its stock worth half as much? We can't say. In fact, we have a tough time quantifying just how risky the companies are in the first place.

We will examine the issue of risk in some detail in Chapter 7. For now, it is sufficient to remember that risk affects the stock price—as risk increases, the stock price goes down; and conversely, as risk decreases, the stock price goes up.

Table 1-2 summarizes the influences of cash flow size, timing, and risk on stock prices.

Take Note:
If the company is organized in the form of a corporation then the company's value is determined by the value of the corporation's common stock and the focus of the company's managers is on maximizing the value of that stock.

Profits versus Company Value Earlier in the chapter, we said that the single-minded pursuit of profits is not necessarily good for the firm's owners. Indeed, the firm's owners view company value, not profit, as the appropriate measure of wealth. Company value depends on future cash flows, their timing, and their riskiness. Profit calculations do not consider these three factors. Profit, as defined in accounting, is simply the difference between sales revenue and expenses. If all we were interested in were profits, we could simply start using high-pressure sales techniques, cut all expenses to the bone, and then point proudly to the resulting increase in profits. For the moment, anyway. In all probability, managers practicing such techniques would find their firm out of business later, when the quality of the firm's products, services, and workforce dropped, eventually leading to declining sales and market share.

It is true that more profits are generally better than less profits. But when the pursuit of short-term profits adversely affects the size of future cash flows, their timing, or their riskiness, then these profit maximization efforts are detrimental to the firm. Concentrating on company value, not profits, is a better measure of financial success.

Legal and Ethical Challenges in Financial Management

Several legal and ethical challenges influence financial managers as they pursue the goal of wealth maximization for the firm's owners. Examples of legal considerations include environmental statutes mandating pollution control equipment, workplace safety standards that must be met, civil rights laws that must be obeyed, and intellectual property laws that regulate the use of others' ideas.

Ethical concerns include fair treatment of employees, customers, the community, and society as a whole. Indeed, many businesses have written ethics codes that articulate the ethical values of the business organization.

Three legal and ethical influences of special note include the agency problem, the interests of non-owner stakeholders, and the interests of society as a whole. We will turn to these issues next.

Agency Issues

The financial manager, and the other managers of a business firm, are agents for the owners of the firm. An **agent** is a person who has the implied or actual authority to act on behalf of another. The owners whom the agents represent are the principals. For example, the board of directors and senior management of IBM are agents for the IBM stockholders, the **principals**. Agents have a legal and ethical responsibility to make decisions that further the interests of the principals.

The interests of the principals are supposed to be paramount when agents make decisions, but this is often easier said than done. For example, the managing director of a corporation might like the convenience of a private jet on call 24 hours a day, but do the common stockholder owners of the corporation receive enough value to justify the cost of a jet? It looks like the interests of the managing director (the agent) and the interests of the common stockholder owners (the principals) of the corporation are in conflict in this case.

The Agency Problem When the interests of the agents and principals conflict, an **agency problem** results. In our jet example, an agency problem occurs if the managing director buys the jet, even though he knows the benefits to the stockholders do not justify the cost.

Another example of an agency problem occurs when managers must decide whether to undertake a project with a high potential payoff but high risk. Even if the project is more likely than not to be successful, managers may not want to take a risk that owners would be willing to take. Why? An unsuccessful project may result in such significant financial loss that the managers who approved the project lose their jobs—and all the income from their paychecks. The stockholder owners, however, may have a much smaller risk because their investment in company stock represents only a small fraction of their financial investment portfolio. Because the risk is so much larger to the manager as compared to the stockholder, a promising but somewhat risky project may be rejected even though it is likely to benefit the firm's owners.

The agency problem can be lessened by tying the managers' compensation to the performance of the company and its stock price. This tie brings the interests of the managers and those of the firm's owners closer together. That is why companies often make shares of stock a part of the compensation package offered to managers, especially top executives. If managers are also stockholders, then the agency problem should be reduced.

Agency Costs Sometimes firms spend time and money to monitor and reduce agency problems. These outlays of time and money are **agency costs**. One common example of an agency cost is an accounting audit of a corporation's financial statements. If a business is owned and operated by the same person, the owner does not need an audit—she can trust herself to report her finances accurately. Most companies of any size, however, have agency costs because managers, not owners, report the finances. Owners audit the company financial statements to see whether the agents have acted in the owners' interests by reporting finances accurately.

The Interests of Other Groups

Stockholders and managers are not the only groups that have a stake in a business firm. There are also non-manager workers, creditors, suppliers, customers, and members of the community where the business is located. These groups are also **stakeholders**—people who have a "stake" in the business. Although the primary financial goal of the firm is to maximize the wealth of the owners, the interests of these other stakeholders can influence business decisions.

For example, in the spring of 2006 rising gasoline prices and record oil company profits prompted consumers across the country to demand that the government to take some sort of action to bring them down. Politicians joined in, many accusing the big oil companies such as Exxon Mobil and Chevron of price gouging. In response, President Bush, in a speech on April 25, 2006, called for rolling back government assistance and tax breaks for oil companies, waivers to clean air requirements to ease fuel bottlenecks, developing alternative sources of energy like ethanol, and temporarily halting deposits into the Strategic Petroleum Reserve.[4] He also ordered an investigation into possible cheating, price gouging, or illegal manipulation in the marketplace.

The Interests of Society as a Whole

Sometimes the interests of a business firm's owners are not the same as the interests of society. For instance, the cost of properly disposing of toxic waste can be so high that companies may be tempted to simply dump their waste in nearby rivers. In so doing, the companies can keep costs low and profits high, and drive their stock prices higher (if they are not caught). However, many people suffer from the polluted environment. This is why we have environmental and other similar laws—so that society's best interests take precedence over the interests of individual company owners.

When businesses take a long-term view, the interests of the owners and society often (but not always) coincide. When companies encourage recycling, sponsor programs for disadvantaged young people, run media campaigns promoting the responsible use of alcohol, and contribute money to worthwhile civic causes, the goodwill generated as a result of these activities causes long-term increases in the firm's sales and cash flows, which can translate into additional wealth for the firm's owners.

Although the traditional primary economic goal of the firm is to maximize shareholder wealth, the unbridled pursuit of value is too simplistic a view of this goal. Firms often take into account ethical factors, the interests of other stakeholders, and the long-term interests of society.[5]

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[4] The Strategic Petroleum Reserve (SPR) is a huge supply of crude oil that is stored in underground salt caverns along the Gulf of Mexico coastline. Its purpose is to ensure the availability of oil in the event of an emergency. As of this writing the SPR has been used for emergency purposes twice. Once during Operation Desert Storm in 1991 and once after Hurricane Katrina in 2005. (Source: U.S. Department of Energy website, *www.fe.doe.gov*)

[5] Not everyone agrees with this approach. Milton Friedman, Nobel laureate in economics, claims that any action taken by a manager that is not legally mandated and that reduces the value available to the owners, is theft.

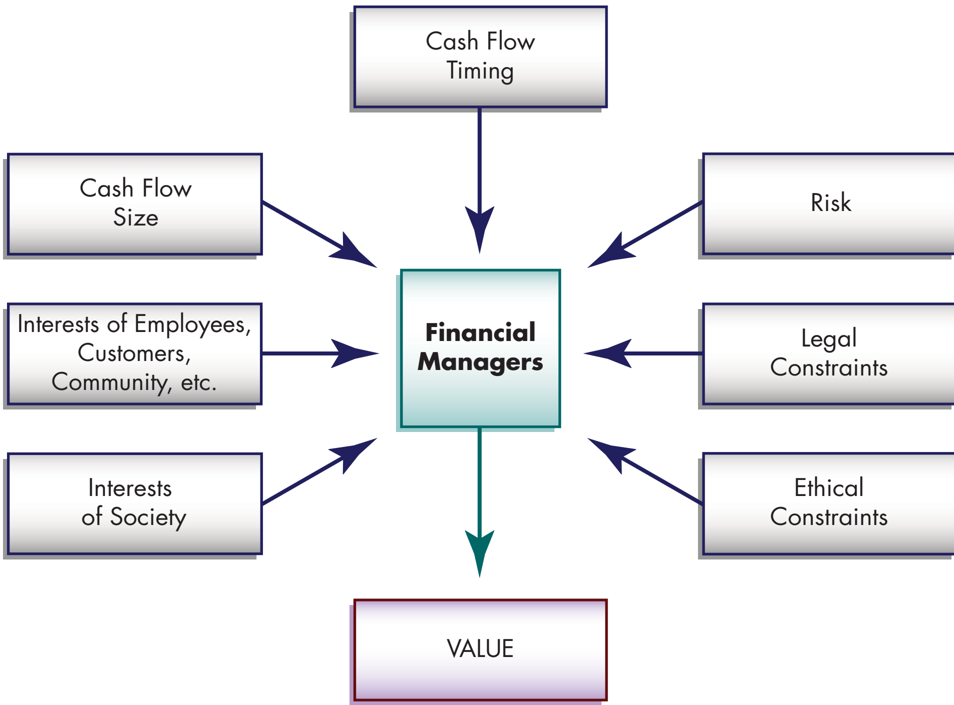

Figure 1-3 Influences on Financial Managers

Figure 1-3 summarizes the various influences that financial managers may consider in their pursuit of value.

Forms of Business Organization

Businesses can be organized in a variety of ways. The four most common types of organization are proprietorships, partnerships, corporations, and limited liability companies (LLCs). The distinguishing characteristics give each form its own advantages and disadvantages.

The Proprietorship

The simplest way to organize a business is to form a **proprietorship**, a business owned by one person. An individual raises some money, finds a location from which to operate, and starts selling a product or service. The profits or losses generated are reported on a form called Schedule C of the individual's Form 1040 income tax return. The sole proprietor is responsible for any tax liability generated by the business, and the tax rates are those that apply to an individual.

The sole proprietor has *unlimited liability* for matters relating to the business. This means that the sole proprietor is responsible for all the obligations of the business, even if those obligations exceed the amount the proprietor has invested in the business. If a customer is injured on the company premises and sues for $1 million, the sole proprietor must pay that amount if the court awards it to the plaintiff customer. This is true even if the total amount invested by the sole proprietor in the business is only $10,000.

Although unlimited liability is a major disadvantage of a proprietorship, liability insurance is often available to reduce the risk of losing business and non-business assets. However, the risk always remains that the business will be unsuccessful and that the losses incurred will exceed the amount of the proprietor's money invested. The other assets owned by the proprietor will then be at risk.

The Partnership

Two or more people may join together to form a business as a **partnership**. This can be done on an informal basis without a written partnership agreement, or a contract can spell out the rights and responsibilities of each partner. This written contract is called the *articles of partnership* and is strongly recommended to lessen the likelihood of disputes between partners.

The articles of partnership contract generally spells out how much money each partner will contribute, what the ownership share of each partner will be, how profits and losses will be allocated among partners, who will perform what work for the business, and other matters of concern to the partners. The percent of ownership for each partner does not have to be the same as the percent each partner invests in the partnership.

Each partner in a partnership is usually liable for the activities of the partnership as a whole.[6] This is an important point. Even if there are 100 partners, each one is technically responsible for all the debts of the partnership.[7] If 99 partners declare personal bankruptcy, the hundredth partner still is responsible for all the partnership's debts.

Special Kinds of Partnerships Some partnerships contain two different classes of partners, general partners and limited partners. These are called **limited partnerships**, or **LPs**. In a limited partnership, the general partners usually participate actively in the management of the business, whereas limited partners usually do not. Limited partners usually contribute capital and share in the profits but take no part in running the business. As a result, general partners usually contract for a more favorable allocation of ownership, profits, and losses compared with limited partners. General partners have unlimited liability for the partnership's activities. Limited partners are only liable for the amount they invest in the partnership. If you are a limited partner who invests $5,000 in the business, then $5,000 is the most you can lose. For this reason, every partnership must have at least one general partner (a partnership could have all general partners, but it could not have all limited partners).

In some states, attorneys and accountants organize their businesses into what is called a **limited liability partnership**, or **LLP**. This is simply a general partnership that is allowed to operate like a corporation, with limited liability features much like those of a corporation (more about limited liability in the next section).

A partner's profits and losses are reported on Schedule K-1. The dollar figure from Schedule K-1 is entered on the appropriate line of each partner's individual 1040 income tax return. The partners pay any taxes owed. The partnership itself is not taxed because the income merely passes through the partnership to the partners, where it is taxed.

[6] But see the discussion that follows on general and limited partners.

[7] In legal terms this concept is called "joint and several liability."

The Corporation

The third major form of business organization is the **corporation**. Unlike proprietorships and partnerships, corporations are legal entities separate from their owners. To form a corporation, the owners specify the governing rules for the running of the business in a contract known as the *articles of incorporation*. They submit the articles to the government of the state in which the corporation is formed, and the state issues a charter that creates the separate legal entity.

Corporations are taxed as separate legal entities. That is, corporations must pay their own income tax just as if they were individuals.[8] This is where the often-discussed "double taxation" of corporate profits comes into play. First, a corporation pays income tax on the profit it earns. Then the corporation may distribute to the owners the profits that are left after paying taxes. These distributions, called dividends, count as income for the owners and are taxed on the individual owners' income tax returns. Thus, the IRS collects taxes twice on the same income.

Double taxation of dividends is bad news for the owners of corporations, but there is good news as well. Stockholders, the corporation's owners, have limited liability for the corporation's activities. They cannot lose more than the amount they paid to buy the stock. This makes the corporate form of organization very attractive for owners who desire to shelter their personal assets from creditors of the business.

Corporations have other benefits too. For example, because they exist separately from their owners, they can "live" beyond the death of their original owners. Another benefit of the corporate form of business is that corporations generally have a professional management team and board of directors, elected by the owners. It is the board's job to look out for the interests of the owners (the stockholders). Stockholders, especially in the case of large corporations, usually do not take an active role in the management of the business, so it is the board of directors' job to represent them.

Special Kinds of Corporations "Regular" corporations are often referred to as **C corporations**, as they are defined in the United States tax code.[9] Another classification in the code is called the **S corporation** (after subchapter S in the code). S corporations do not pay income tax themselves; instead, they pass their income through to the owners, who report it on their individual tax returns. S corporations are generally very small; in fact, this form of business ownership was created to relieve small businesses from some of the rules that large Subchapter C corporations must follow. S corporations can have no more than 75 shareholders, and the shareholders must be individuals (rather than organizations such as other corporations). The stockholders of S corporations also have limited liability.

Professional corporations, or **PCs**, are special corporations for businesses that provide "professional services," such as medical, legal, accounting, or architectural services. Only members of the profession may be shareholders in the corporation. As with any other corporation, shareholders share limited liability for the corporation's debts. Note, however, that PC status does not protect the firm from malpractice claims.

[8] Corporations file their income tax returns using Form 1041.

[9] The complete reference is Title 26—Internal Revenue Code, Subtitle A—Income Taxes, Chapter 1, Normal Taxes and Surtaxes, Subchapter S—Tax treatment of S corporations and their shareholders. Oddly enough, C corporations are defined in Subchapter S.

Table 1-3 Characteristics of Business Ownership Forms

	Proprietorship	Partnership	Corporation	LLC
Ease of formation	Very easy	Relatively easy	More difficult	Relatively easy
Owners' liability	Unlimited	Unlimited for general partners	Limited	Limited
Life of firm	Dies with owner, unless heirs continue operating or sell the business	Surviving partners must deal with the deceased partner's heirs	Can live beyond owners' lifetimes	Dies with owner, heirs may continue operating the business
Separate legal entity?	No	No	Yes	Yes
Degree of control by owners	Complete	May be limited for individual partner	May be very limited for individual stockholder	Depends on the number of owners

Limited Liability Companies (LLCs)

Limited liability companies, or **LLCs**, are hybrids between partnerships and corporations. LLCs pass their profits and losses through to their owners, without taxation of the LLC itself, as partnerships do. They also provide limited liability for their owners, like corporations. S corporations and limited partnerships share these characteristics, but unlike S corporations, LLCs are actually non-corporate entities. The owners of LLCs are called members and they can be individuals or organizations (corporations, other LLCs, trusts, pension plans, and so on). LLCs can also have more than 75 owners. LLCs are popular because they provide the "best of both worlds" between partnerships and corporations. That is, they avoid the double taxation C corporations face while shielding the owners from personal liability.

Table 1-3 summarizes the advantages and disadvantages of the various forms of business ownership.

Interactive Module

Go to *http://www.freeloadpress.com*, then to the Book List, then to the listing for this text. Download the Downloadable Companion Material for this book. Then go to Chapter 1 for this link. There is additional information there on the advantages and disadvantages of different forms of business organization.

What's Next

In this book we will look at how firms raise and allocate funds, and how firms invest in assets that generate returns at a reasonable risk. In Part 1 of the text, we discuss the environment in which financial managers make decisions. In Chapter 2, we will examine how funds are raised in the financial marketplace. In Chapter 3, we'll explore how financial institutions and interest rates affect financial decisions.

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Summary

1. Describe the field of finance.

Finance is important to business people. Financial decisions about how to raise, spend, and allocate money can affect every aspect of a business—from personnel to products. Finance also offers career opportunities in three main areas: financial management, financial markets and institutions, and investments. Financial management focuses on managing the finances of a business.

2. Discuss the duties of financial managers.

Financial managers use accounting information and economic principles to guide their financial decisions. They measure the firm's financial condition, forecast, budget, raise funds, and determine the financial goals of the firm's owners. They also work closely with other managers to further the firm's goals.

At medium and large firms, more than one person usually handles the financial management duties. In some firms a chief financial officer (CFO) supervises the financial activities, including cash and credit management, financial planning, and accounting.

3. Identify the basic goal of a business firm.

The basic goal of the business firm is to maximize the wealth of the firm's owners by adding value; it is not to maximize profits. The value of a firm is measured by the price investors are willing to pay to own the firm. For businesses that sell stock to the general public, stock price indicates the firm's value because shares of stock are units of ownership. So the basic financial goal of such firms is to maximize the price of the firm's stock.

4. List factors that affect the value of a firm.

The value of a firm is affected by the size of future cash flows, their timing, and their riskiness.

- Cash inflows increase a firm's value, whereas cash outflows decrease it.
- The sooner cash flows are expected to be received, the greater the value. The later those cash flows are expected, the less the value.
- The less risk associated with future cash flows, the higher the value. The more risk, the lower the value.

5. Discuss the legal and ethical challenges financial managers face.

- Legal and ethical considerations include the agency problem, the interests of other stakeholders, and the interests of society as a whole.
- The agency problem exists when the interests of a firm's managers (the agents) are in conflict with those of the firm's owners (the principals).
- Other stakeholders whose interests are often considered in financial decisions include employees, customers, and members of the communities in which the firm's plants are located.
- Concerns of society as a whole—such as environmental or health problems—often influence business financial decisions.

6. Identify the four different forms of business organization.

The four most common forms of business organization are the proprietorship, the partnership, the corporation, and the limited liability company.

- Proprietorships are businesses owned by one person. The owner is exposed to unlimited liability for the firm's debts.
- Partnerships are businesses owned by two or more people, each of whom is responsible for the firm's debts. The exception is a limited partner, a partner who contracts for limited liability.
- Corporations are separate legal entities. They are owned by stockholders, who are responsible for the firm's debts only to the extent of their investment.
- Limited liability companies are hybrids between partnerships and corporations.

Self-Test

ST-1. What are the three main areas of career opportunities in finance?

ST-2. What are the primary responsibilities of a person holding the title of treasurer at a large corporation?

ST-3. Who is a "principal" in an agent–principal relationship?

ST-4. What legal and ethical factors may influence a firm's financial decisions?

ST-5. What is a Subchapter S corporation?

ST-6. What is an LLC?

Review Questions

1. How is finance related to the disciplines of accounting and economics?
2. List and describe the three career opportunities in the field of finance.
3. Describe the duties of the financial manager in a business firm.
4. What is the basic goal of a business?
5. List and explain the three financial factors that influence the value of a business.
6. Explain why striving to achieve accounting profits and maximizing stock value are not the same.
7. What is an agent? What are the responsibilities of an agent?
8. Describe how society's interests can influence financial managers.
9. Briefly define the terms *proprietorship*, *partnership*, *LLC*, and *corporation*.
10. Compare and contrast the potential liability of owners of proprietorships, partnerships (general partners), and corporations.

Build Your Communication Skills

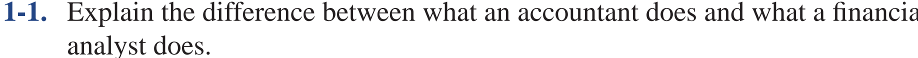
CS-1. Divide into small groups. Each small group should then divide in half. The first group should defend the idea that managers of a firm should consider only the interests of stockholders, subject to legal constraints. The other group should argue that businesses should consider the interests of other stakeholders of the firm and society at large.

CS-2. Assume you work for WealthMax Corporation in New York City. You've noticed that managers who work late charge the corporation for their dinners and transportation home. You've also noticed that almost all employees from these managers' departments take office supplies, ranging from pens to computer software, for personal use at home. You estimate the costs of this pilfering at a shocking $150,000 a year. Your boss, the chief financial officer for WealthMax, asks you to write a memo to the offending managers describing why their actions and those of their employees violate their duties and conflict with the goal of the firm. Write this memo.

Problems

The Field of Finance

1-1. Explain the difference between what an accountant does and what a financial analyst does.



The Basic Financial Goal of a Firm

1-2. Describe the basic role of a financial manager in a firm that sells stock publicly.

Factors Affecting the Value of a Firm

1-3. How would the value of a firm be affected by the following events?

a. The introduction of a new product designed to increase the firm's cash inflows is delayed by one year. The size of the expected cash flows is not affected.

b. A firm announces to the press that its cash earnings for the coming year will be 10 percent higher than previously forecast.

c. A utility company acquires a natural gas exploration company. After the acquisition, 50 percent of the new company's assets are from the original utility company and 50 percent from the new exploration company.

Legal and Ethical Challenges

1-4. According to federal law, federally chartered banks are permitted to bypass state usury and other laws that would hamper their ability to do business. This makes it possible for loan outlets in some states to offer "quickie" loans of $300 that must be paid back in two weeks with the principal plus $51, which is equivalent to an annual interest rate of over 400 percent. Banks engaged in this practice say they are merely giving people access to emergency credit. Others say the practice is unethical.* State your opinion on this issue and justify it.

* Source: "Exploiting a Loophole, Banks Skirt State Laws on High Interest Rates," by Paul Beckett, *The Wall Street Journal*, (May 25, 2001): 1.

Forms of Business Organization

1-5. Limited liability companies are said to be hybrids between partnerships and corporations. Explain why.

Answers to Self-Test

ST-1. Financial management, financial markets and institutions, and investments.

ST-2. The treasurer of a large corporation is responsible for cash management, credit management, and financial planning.

ST-3. A principal in an agent–principal relationship is the person who hires the agent to act on the principal's behalf. The principal is the person to whom the agent owes a duty.

ST-4. Legal and ethical factors influence businesses. Examples of legal constraints include environmental, safety, and civil rights laws. Examples of ethical considerations include fair treatment of workers, environmental sensitivity, and support for the community.

ST-5. A Subchapter S corporation is a small corporation that is taxed as if it were a partnership. As a result, the owners of a Subchapter S corporation avoid double taxation of corporate income paid to stockholders.

ST-6. LLCs, or limited liability companies, are hybrids between partnerships and corporations. LLCs pass their profits and losses through to their owners, as partnerships do, without taxation of the LLC itself, and they provide limited liability for their owners, as corporations do.

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