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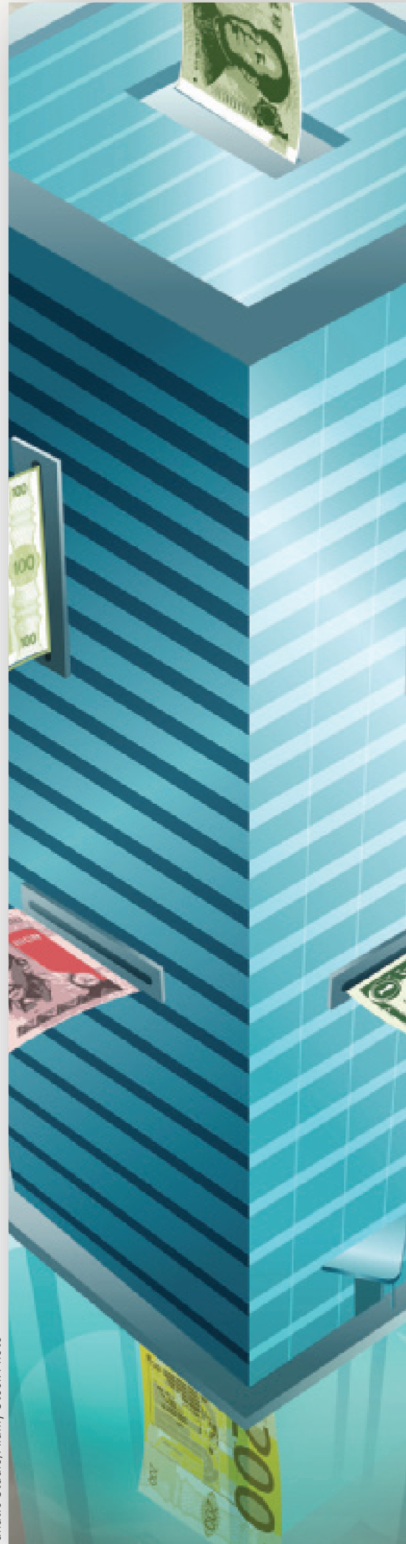

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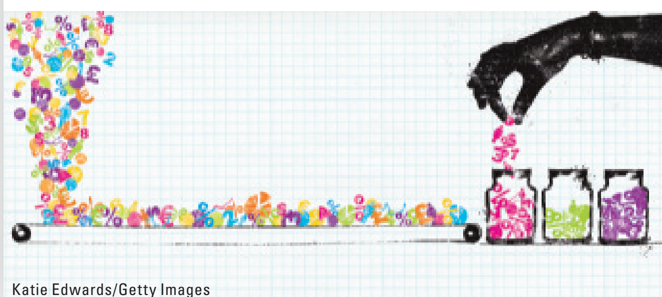

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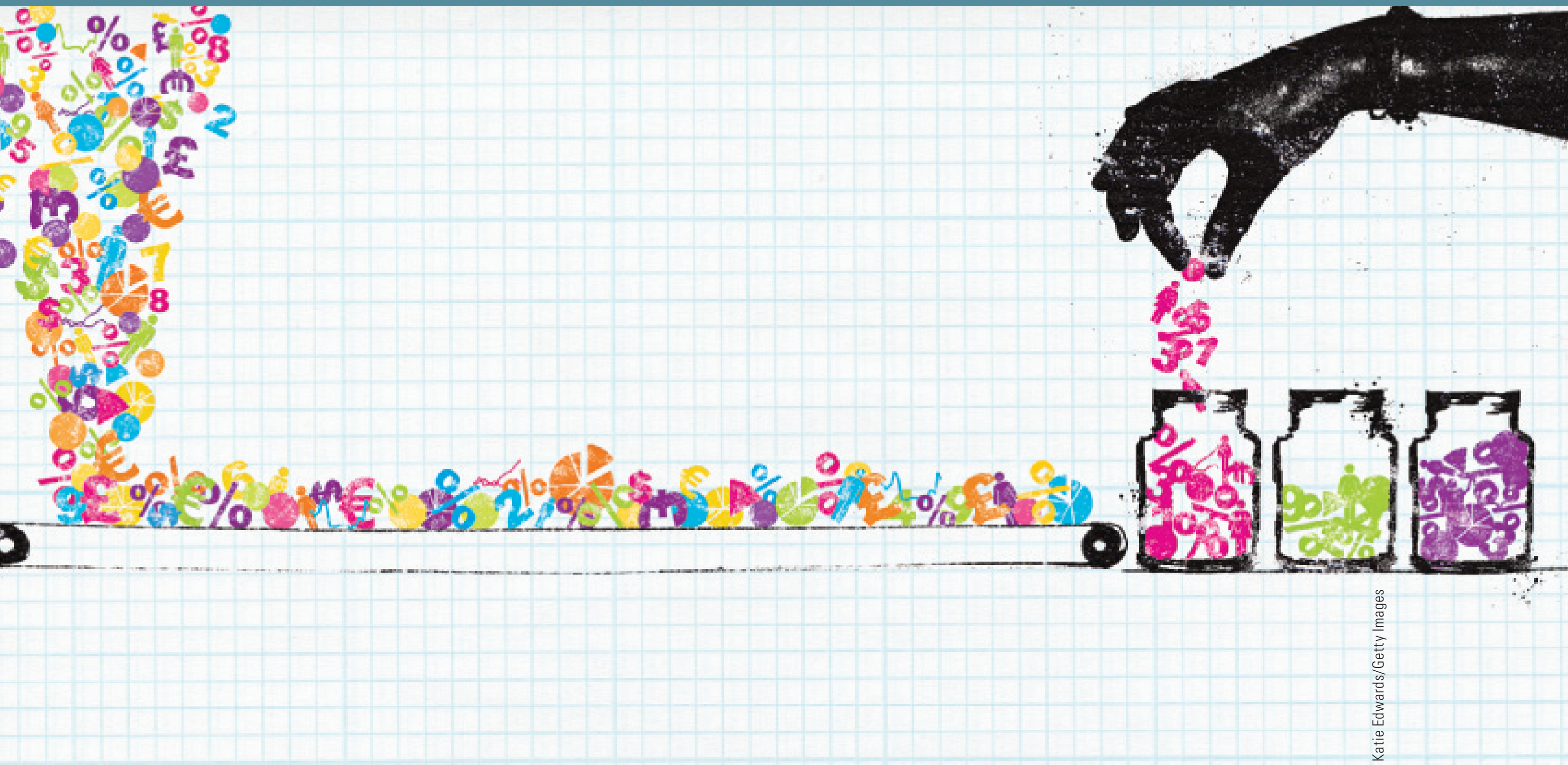
PART 1

1 An Overview of Managerial Finance



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LEARNING OUTCOMES

After studying this chapter, you will be able to . . .

1-1 Explain what finance entails and why everyone should have an understanding of basic financial concepts.

1-2 Identify different forms of business organization as well as the advantages and disadvantages of each.

1-3 Identify major goals that firms pursue and what a firm's primary goal should be.

1-4 Explain the roles ethics and good governance play in successful businesses.

1-5 Describe how foreign firms differ from U.S. firms, and identify factors that affect financial decisions in multinational firms.

After you finish this chapter, go to **PAGE 18** for **STUDY TOOLS**

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In this chapter, we introduce finance by providing you with (1) a description of the discipline and (2) an indication of the goals companies should attain, as well as the conduct that is acceptable when pursuing these goals. As you will discover, a corporation acts in the best interests of its owners (stockholders) when decisions are made that increase the firm's value, which in turn increase the value of its stock.

1-1 WHAT IS FINANCE?

In simple terms, finance is concerned with decisions about money. Financial decisions deal with how money is raised and used by businesses, governments, and individuals. To make sound financial decisions, you must understand three general, yet reasonable, concepts. Everything else equal, (1) more value is preferred to less; (2) the sooner cash is received, the more valuable it is; and (3) less risky assets are more valuable than (preferred to) riskier assets. These concepts are discussed in detail later in the book. At this point, we can state that firms that make decisions with these concepts in mind are able to provide better products to customers at lower prices, pay higher salaries to employees, and still provide greater returns to investors. In general, then, sound financial management contributes to the well-being of both individuals and the general population.

Although the emphasis in this book is on business finance, you will discover that the same concepts that firms apply when making sound business decisions can be used to make informed decisions relating to personal finances. For example, consider the decision you might have to make if you won a state lottery worth $105 million. Which *would* you choose: a lump-sum payment of $54 million today or a payment of $3.5 million each year for the next 30 years? Which *should* you choose? In Chapter 4, we will show the time value of money techniques that firms use to make finance-related business decisions. These same techniques can be used to answer this and other questions that relate to personal finances.

1-1a General Areas of Finance

The study of finance consists of four interrelated areas:

1. ***Financial markets and institutions***—Financial institutions, which include banks, insurance companies, savings and loans, and credit unions, are an integral part of the general financial services marketplace. The success of these organizations requires an understanding of factors that cause interest rates and other returns in the financial markets to rise and fall, regulations that affect such institutions, and various types of financial instruments, such as mortgages, automobile loans, and certificates of deposit, that financial institutions offer.
2. ***Investments***—This area of finance focuses on the decisions made by businesses and individuals as they choose securities for their investment portfolios. The major functions in the investments area are (a) determining the values, risks, and returns associated with such financial assets as stocks and bonds and (b) determining the optimal mix of securities that should be held in a portfolio of investments, such as a retirement fund.
3. ***Financial services***—Financial services refer to functions provided by organizations that deal with the management of money. Persons who work in these organizations, which include banks, insurance companies, brokerage firms, and similar companies, provide services that help individuals and companies determine how to invest money to achieve such goals as home purchase, retirement, financial stability and sustainability, budgeting, and so forth.
4. ***Managerial (business) finance***—Managerial finance deals with decisions that all firms make concerning their cash flows, including both inflows and outflows. As a consequence, managerial finance is important in all types of businesses, whether they are public or private, and whether they deal with financial services or the manufacture of products. The duties encountered in managerial finance range from making decisions about plant expansions to choosing what types of securities should be issued to finance such expansions. Financial managers also have the responsibility for deciding the credit terms under which customers can buy, how much inventory the firm should carry, how

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much cash to keep on hand, whether to acquire other firms (merger analysis), and how much of each year's earnings should be paid out as dividends versus how much should be reinvested in the firm.

Although our concern in this book is primarily with managerial finance, because all areas of finance are interrelated, an individual who works in any one area should have a good understanding of the other areas as well. For example, a banker lending to a business must have a basic understanding of managerial finance to judge how well the borrowing company is operated, which provides an indication of its ability to repay a loan. The same holds true for a securities analyst, who must understand how a firm's current financial position can affect its future prospects and thus its stock price. At the same time, corporate financial managers need to know what their bankers are thinking and how investors are likely to judge their corporations' performances when establishing their stock prices.

1-1b The Importance of Finance in Non-Finance Areas

Everyone is exposed to finance concepts almost every day. For example, when you borrow to buy a car or a house, finance concepts are used to determine the monthly payments you are required to make. When you retire, finance concepts are used to determine the amount of the monthly payments you receive from your retirement funds. Further, if you want to start your own business, an understanding of finance concepts is essential for survival. Thus, even if you do not intend to pursue a career in a finance-related profession, it is important that you have some basic understanding of finance concepts. Similarly, if you pursue a career in finance, it is important that you have an understanding of other areas in the business, including marketing, accounting, production, and so forth, to make well-informed financial decisions.

Let's consider how finance relates to some of the non-finance areas that students often study in a business college.

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1. ***Management***—When we think of "management," we often think of personnel decisions and employee relations, strategic planning, and the general operations of the firm. Strategic planning, which is one of the most important activities of management, cannot be accomplished without considering how such plans impact the overall financial well-being of the firm. Such personnel decisions as setting salaries, hiring new staff, and paying bonuses must be coordinated with financial decisions to ensure that needed funds are available. For these reasons, senior managers must have at least a general understanding of financial management concepts to make informed decisions in their areas.

2. ***Marketing***—If you have taken a basic marketing course, you learned that the *four Ps of marketing*—product, price, place, and promotion—determine the success of products that are manufactured and sold by companies. Clearly, the price that should be charged for a product and the amount of advertising a firm can afford for the product must be determined in conjunction with financial managers because the firm will lose money if the price of the product is too low or too much is spent on advertising. Coordination of the finance function and the marketing function is critical to the success of a company, especially a small, newly formed firm because it is necessary to ensure that sufficient cash is generated to survive. For these reasons, people in marketing must understand how marketing decisions affect and are affected by such issues as funds availability, inventory levels, and excess plant capacity.

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3. ***Accounting***—In many firms (especially small ones), it is difficult to distinguish between the finance function and the accounting function. Because the two disciplines are closely related, often accountants are involved in finance decisions and financial managers are involved in accounting decisions. As our discussions will show, financial managers rely heavily on accounting information because making decisions about the future requires information that accountants provide about the past. As a consequence, accountants must understand how financial managers use accounting information in planning and decision making so that it can be provided in an accurate and timely fashion. Similarly, accountants must understand how accounting data are viewed (used) by investors, creditors, and others who are interested in the firm's operations.
4. ***Information systems***—To make sound decisions, financial managers rely on accurate information that is available when needed. The process by which the delivery of such information is planned, developed, and implemented is costly, but so are the problems caused by a lack of good information. Without appropriate information, decisions relating to finance, management, marketing, and accounting could prove disastrous. Different types of information require different information systems, so information system specialists work with financial managers to determine what information is needed, how it should be stored, how it should be delivered, and how managing information affects the profitability of the firm.
5. ***Economics***—Finance and economics are so similar that some universities offer courses related to these two subjects in the same functional area (department). Many tools used to make financial decisions evolved from theories or models developed by economists. Perhaps the most noticeable difference between finance and economics is that financial managers evaluate information and make decisions about cash flows associated with a particular firm or a group of firms, whereas economists analyze information and forecast changes in activities associated with entire industries and the economy as a whole. It is important that financial managers understand economics and that economists understand finance because economic activity and policy impact financial decisions, and vice versa.

Finance will be a part of your life no matter what career you choose. There will be a number of times during your life, both in business and in your personal finances, that you will make finance-related decisions. Therefore, it is vitally important that you have some understanding of general finance concepts. *There are financial implications in virtually all business decisions, and non-financial executives must know enough finance to incorporate these implications into their own specialized analyses.* For this reason, every student of business, regardless of his or her major, should be concerned with finance.

Finance in the Organizational Structure of the Firm. Although organizational structures vary from company to company, the chief financial officer (CFO), who often has the title of vice president of finance, generally reports to the president. The financial vice president's key subordinates are the treasurer and the controller. In most firms, the *treasurer* has direct responsibility for managing the firm's cash and marketable securities, planning how the firm is financed and when funds are raised, managing risk, and overseeing the corporate pension fund. The treasurer also supervises the credit manager, the inventory manager, and the director of capital budgeting, who analyzes decisions related to investments in fixed assets. The *controller* is responsible for the activities of the accounting and tax departments.

1-2 ALTERNATIVE FORMS OF BUSINESS ORGANIZATION

There are three major forms of business organization in the United States: (1) proprietorships, (2) partnerships, and (3) corporations. In terms of numbers, 70–75 percent of businesses are operated as proprietorships, 9–12 percent are partnerships, and the remaining 15–20 percent are corporations. Based on the dollar value of sales, however, approximately 82 percent of all business is conducted by corporations, while the remaining 18 percent is generated by proprietorships (3–4 percent) and partnerships (14–15 percent).[1] Because most business is conducted by corporations, we will focus on that form in this book. However, it is important to understand the differences among the three major forms of business, as well as the popular "hybrid" forms of business that have evolved from these major forms.

[1]The statistics provided in this section are based on business tax filings reported by the Internal Revenue Service (IRS), which can be found on the IRS website at http://www.irs.ustreas.gov/taxstats/.

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1-2a Proprietorship

A **proprietorship** is an unincorporated business owned by one individual. Starting a proprietorship is generally as easy as just beginning business operations.

The proprietorship has three important advantages:

1. It is easily and inexpensively formed. Not much "red tape" is involved when starting a proprietorship; generally, only licenses required by the state and the municipality in which the business operates are needed.
2. It is subject to few government regulations. Large firms that potentially threaten competition are much more heavily regulated than small so-called mom-and-pop businesses, such as proprietorships.
3. It is taxed like an individual, not like a corporation; thus, earnings are taxed only once. The double taxation of dividends is discussed later in the chapter.

The proprietorship also has four important limitations:

1. The proprietor has unlimited personal liability for business debts because any debts of the business are considered obligations of the sole owner. With unlimited personal liability, the proprietor (owner) can potentially lose all of his or her personal assets, even those assets not invested in the business. Thus, losses can far exceed the money that he or she has invested in the company. An explanation of this concept is given later in this chapter.
2. A proprietorship's life is limited to the time the individual who created it owns the business. When a new owner takes over the business, legally the firm becomes a new proprietorship (even if the name of the business does not change).
3. Transferring ownership is somewhat difficult. Disposing of the business is similar to selling a house in that the proprietor must seek out and negotiate with a potential buyer, which generally takes weeks or months to complete.
4. It is difficult for a proprietorship to obtain large sums of capital because the firm's financial strength generally is based solely on the financial strength of the only owner. A proprietorship's funds are derived from the owner's sources of credit, which include his or her credit cards, access to bank loans, loans from relatives and friends, and so forth. Unlike corporations, proprietorships cannot raise funds by issuing stocks and bonds to investors.

proprietorship An unincorporated business owned by one individual.

partnership An unincorporated business owned by two or more persons.

For these reasons, individual proprietorships are confined primarily to small business operations. In fact, only about 1 percent of all proprietorships have assets that are valued at $1 million or more; nearly 90 percent have assets valued at $100,000 or less. However, most businesses start out as proprietorships and then convert to corporations when their growth causes the disadvantages of being a proprietorship—namely, unlimited personal liability and the inability to raise large sums of money—to outweigh the advantages.

1-2b Partnership

A **partnership** is the same as a proprietorship, except that it has two or more owners. Partnerships can operate under different degrees of formality, ranging from informal, oral understandings to formal agreements filed with the secretary of the state in which the partnership does business. Most legal experts recommend that partnership agreements be put in writing.

The advantages of a partnership are the same as those of a proprietorship, except that most partnerships have more sources available for raising funds because there are more owners, with more relatives, more friends, and more opportunities to raise funds through credit. Even though they generally have greater capabilities than proprietorships to raise funds to support growth, partnerships still have difficulty in attracting substantial amounts of funds. This is not a major problem for a slow growing partnership. However, if a business's products really catch on and it needs to raise large amounts of funds to capitalize on its opportunities, the difficulty of attracting funds becomes a real drawback. For this reason, growth companies, such as Google Inc. and Amazon.com Inc., generally begin life as proprietorships or partnerships but at some point find it necessary to convert to corporations.

Under partnership law, each partner is liable for the debts of the business. Therefore, if any partner is unable to meet his or her pro rata claim in the event the partnership goes bankrupt, the remaining partners must make good on the unsatisfied claims, drawing on their personal assets if necessary. Thus, the business-related activities of any of the firm's partners can bring ruin to the other partners, even though those partners are not direct parties to such activities.

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1-2c Corporation

A **corporation** is a legal entity created by a state, which means that a corporation has the legal authority to act like a person when conducting business. It is separate and distinct from its owners and managers. This separateness gives the corporation four major advantages:

1. A corporation offers its owners *limited liability*. To illustrate the concept of limited liability, suppose you invested $10,000 to become a partner in a business formed as a partnership that subsequently went bankrupt, owing creditors $1 million. Because the owners are liable for the debts of a partnership, as a partner you would be assessed for a share of the company's debt; you could even be held liable for the entire $1 million if your partners could not pay their shares. This is the danger of *unlimited liability*. On the other hand, if you invested $10,000 in the stock of a corporation that then went bankrupt, your potential loss on the investment would be limited to your $10,000 investment.[2]

2. Ownership interests can be divided into shares of stock, which can be *transferred far more easily* than can proprietorship or partnership interests. Shares of stock can be bought and sold in minutes, whereas interests in proprietorships and partnerships generally cannot.

3. A corporation can continue after its original owners and managers no longer have a relationship with the business; thus it is said to have *unlimited life*. The life of a corporation is based on the longevity of its stock, not the longevity of those who own the stock (the owners).

4. The first three factors—limited liability, easy transferability of ownership interest, and unlimited life—make it much easier for corporations than for proprietorships or partnerships to raise money in the financial markets. In addition, corporations can issue stocks and bonds to raise funds, whereas proprietorships and partnerships cannot.

Even though the corporate form of business offers significant advantages over proprietorships and partnerships, it does have two major disadvantages:

1. Setting up a corporation is more complex and time-consuming than for a proprietorship or a partnership. When a corporation is created, (a) a **corporate charter**, which provides general information, including the name of the corporation, types of activities it will pursue, amount of stock that initially will be issued, and so forth, must be filed with the secretary of the state in which the firm incorporates; and (b) a set of rules, called **bylaws**, that specify how the corporation will be governed must be drawn up by the founder(s). In addition, corporations must file periodic state and federal reports that are not required of other forms of businesses.

2. Because the earnings of the corporation are taxed at the corporate level and then any earnings paid out as dividends are again taxed as income to stockholders, corporate earnings are subject to *double taxation*.[3]

corporation A legal entity created by a state, separate and distinct from its owners and managers, having unlimited life, easy transferability of ownership, and limited liability.

corporate charter A document filed with the secretary of the state in which a business is incorporated that provides information about the company, including its name, address, directors, and amount of capital stock.

bylaws A set of rules drawn up by the founders of the corporation that indicates how the company is to be governed; includes procedures for electing directors, rights of stockholders, and how to change the bylaws when necessary.

[2]In the case of small corporations, the limited liability feature is often a fiction because bankers and credit managers frequently require personal guarantees from the stockholders of small, weak corporations.

[3]There was a push in Congress in 2003 to eliminate the double taxation of dividends by either treating dividends paid by corporations the same as interest—that is, making them a tax-deductible business expense—or allowing dividends to be tax exempt to stockholders. Congress passed neither; instead, the tax on dividends received by investors was reduced from the ordinary tax rate to the capital gains rate.

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1-2d Hybrid Forms of Business: LLP, LLC, and S Corporation

Alternative business forms that include some of the advantages, and avoid some of the disadvantages, of the three major forms of business have evolved over time. These alternative forms of business combine some characteristics of proprietorships and partnerships with some characteristics of corporations. In this section, we provide brief descriptions of three popular *hybrid business forms* that exist today.

Limited Liability Partnership (LLP). In the earlier discussion of a partnership, we described the form of business that is referred to as a *general partnership*, wherein each partner is personally liable for any of the debts of the business. It is possible to limit the liability faced by some of the partners by establishing a **limited liability partnership (LLP)**. The legal aspects of LLPs vary from state to state. Even so, an LLP generally is set up as one of two forms. In some states an LLP can be established that permits persons to invest in partnerships without exposure to the personal liability that general partners face. With this type of LLP, at least one partner is designated a *general partner* and the others are *limited partners*. The general partners remain fully personally liable for all business debts, whereas the limited partners are liable only for the amounts they have invested in the business. With this form of an LLP, only the general partners can participate in the management of the business; partners with limited liability are considered investors only. In other states, all partners in an LLP are fully liable for the general debts of the business, but an individual partner is not liable for the negligence, irresponsibility, or similar acts committed by any other partner (thus the limited liability). Some states require LLPs to file partnership agreements with the secretary of state, whereas other states do not.

limited liability partnership (LLP) A partnership wherein at least one partner is designated as a *general partner* with unlimited personal financial liability, and the other partners are *limited partners* whose liability is limited to amounts they invest in the firm.

limited liability company (LLC) Offers the limited personal liability associated with a corporation; however, the company's income is taxed like that of a partnership.

S corporation A corporation with no more than 100 stockholders that elects to be taxed in the same manner as proprietorships and partnerships, so that business income is only taxed once.

Limited Liability Company (LLC). A **limited liability company (LLC)** is a relatively new business form that has become popular during the past couple of decades; it combines the features of a corporation and a partnership. An LLC offers the limited personal liability associated with a corporation, but the company can choose to be taxed as either a corporation or as a partnership. If an LLC is taxed like a partnership, income is said to pass through to the owners, so that it is taxed only once. The structure of the LLC is fairly flexible; owners generally can divide liability, management responsibilities, ownership shares, and control of the business any way they please. In addition, LLC owners, who are called members, can be individuals or other businesses. Unlike a partnership, an LLC can have a single owner. As with a corporation, legal paperwork, which is termed articles of organization, must be filed with the state in which the business is set up, and there are certain financial reporting requirements after the formation of an LLC. Because LLCs are created by state laws, which vary considerably from state to state, there can be substantial differences between how an LLC can be formed in one state versus another state. As this type of business organization becomes more widespread, state regulation likely will become more uniform.

S Corporation. A domestic corporation that has no more than 100 stockholders and only one type of stock outstanding can elect to file taxes as an **S corporation**. If a corporation elects the S corporation status, then its income is taxed the same as income earned by proprietorships and partnerships; that is, income passes through the company to the owners so that it is taxed only once. The major differences between an S corporation and an LLC are that an LLC can have more than 100 stockholders (members) and more than one type of stock (membership interest).

1-2e Which Form of Business Is Best?

Different forms of business serve different purposes. For the following reasons, however, the value of any business, other than a very small concern, probably will be maximized if it is organized as a corporation:

1. Limited liability reduces the risks borne by investors. All else equal, *the lower the firm's risk, the higher its market value.*
2. *A firm's current value is related to its future growth opportunities,* and corporations can more easily

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attract funds to take advantage of growth opportunities than can unincorporated businesses (only corporations can issue stocks and bonds to raise funds).

3. Corporate ownership can be transferred more easily than ownership of either a proprietorship or a partnership. Therefore, all else equal, investors would be willing to pay more for a corporation than for a proprietorship or partnership, which means that the corporate form of organization can *enhance the value* of a business.

Most firms are managed with value maximization in mind, and this, in turn, has caused most large businesses to be organized as corporations.

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1-3 WHAT GOAL(S) SHOULD BUSINESSES PURSUE?

Depending on the form of business, one firm's major goals might differ somewhat from another firm's major goals. But, in general, every business owner wants the value of his or her investment in the firm to increase. The owner of a proprietorship has direct control over his or her investment in the company because it is the proprietor who owns and runs the business. As a result, a proprietor might choose to work three days per week and play golf or fish the rest of the week as long as the business remains successful and he or she is satisfied living this type of life. On the other hand, the owners (stockholders) of a large corporation have very little control over their investments because they generally do not run the business. Because they are not involved in the day-to-day decisions, these stockholders expect that the managers who run the business do so with the best interests of the owners in mind.

Investors purchase the stock of a corporation because they expect to earn an acceptable return on the money they invest. Because we know investors want to increase their wealth positions as much as possible, all else equal, it follows that managers should behave in a manner that is consistent with enhancing the firm's value. For this reason, throughout this book we operate on the assumption that management's primary goal is **stockholder wealth maximization**, which, as we will see, translates into maximizing the value of the firm as measured by the price of its common stock. Firms do, of course, have other objectives. In particular, managers who make the actual decisions are also interested in their own personal satisfaction, in their employees' welfare, and in the good of the community and of society at large. Still, *stock price maximization is the most important goal of most corporations.*

If a firm attempts to maximize its stock price, is this good or is this bad for society? In general, it is good. Aside from such illegal actions as attempting to form monopolies, violating safety codes, and failing to meet pollution control requirements, *the same actions that maximize stock prices also benefit society.* First, note that stock price maximization requires efficient, low-cost plants that produce high-quality goods and services that are sold at the lowest possible prices. Second, stock price maximization requires the development of products that consumers want and need, so the profit motive leads to new technology, to new products, and to new jobs. Finally, stock price maximization necessitates efficient and courteous service, adequate stocks of merchandise, and well located business establishments. These factors are necessary to maintain a customer base that generates sustainable profits. Therefore, most actions that help a firm increase the price

stockholder wealth maximization The appropriate goal for management decisions; considers the risk and timing associated with expected cash flows to maximize the price of the firm's common stock.

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