Part 1
Introduction to Managerial Finance

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Integrative Case 1: Merit Enterprise Corp.

Chapter 1
The Role of Managerial Finance

◼ Instructor’s Resources

Overview

This chapter introduces the students to the field of finance and explores career opportunities in both financial services and managerial finance. The three basic legal forms of business organization (sole proprietorship, partnership, and corporation) and their strengths and weaknesses are described. The managerial finance function is defined and differentiated from economics and accounting. A discussion of the financial manager’s goals—maximizing shareholder wealth and preserving stakeholder wealth—and the role of ethics in meeting these goals is presented. The chapter then summarizes the three key activities of the financial manager: financial analysis and planning, making investment decisions, and making financing decisions. The chapter includes discussion of the agency problem—the conflict that exists between managers and owners in a large corporation.

This chapter, and all that follow, emphasizes how the chapter content plays a vital role in the student’s professional and personal life. Each chapter includes an early discussion of the relevance of the topic to majors in accounting, information systems, management, marketing, and operations. Throughout each chapter are detailed examples of how the chapter’s topic relates to the student's financial life. These pedagogic tools should motivate students to grasp quickly an understanding of the chapter content and employ it in both their professional and personal lives.

◼ Suggested Answer to *Opener-in-Review* Question

**Facebook sold shares to investors at $38 each in its IPO. One year later, its stock price was hovering around $26. What was the percentage drop in Facebook shares in its first year as a public company? Just after the IPO, Facebook’s CEO, Mark Zuckerberg, owned 443 million shares. What was the total value of his Facebook stock immediately after the IPO and one year later? How much wealth did Zuckerberg personally lose over the year?**

Percentage drop in Facebook shares in its first year as a public company

 = ($38 − $26) / $38 × 100 = 31.58%

Total value of Mark Zuckerberg’s Facebook stock immediately after the IPO

 = $38 × 443 million = $16,834 million

Total value of Mark Zuckerberg’s Facebook stock one year after the IPO

 = $26 × 443 million = $11,518 million

Total personal loss of Mark Zuckerberg over the year

 = $16,834 million − $11,518 million

 = $5,316 million

◼ Answers to Review Questions

 1. *Finance* is the art and science of managing money. Finance affects all individuals, businesses, and governments in the process of the transfer of money through institutions, markets, and instruments. At the personal level, finance is concerned with an individual’s decisions regarding the spending and investing of income. Businesses also have to determine how to raise money from investors, how to invest money in an attempt to earn a profit, and how to reinvest profits in the business or distribute them back to investors.

 2. *Financial services* is the area of finance concerned with the design and delivery of advice and financial products to individuals, businesses, and governments. It involves a variety of interesting career opportunities within the areas of banking, personal financial planning, investments, real estate, and insurance. Managerial finance is concerned with the duties of the financial manager working in a business. *Managerial finance* encompasses the functions of budgeting, financial forecasting, credit administration, investment analysis, and funds procurement for a firm. Managerial finance is the management of the firm’s funds within the firm. This field offers many career opportunities, including financial analyst, capital budgeting analyst, and cash manager. (*Note:* Other answers are possible.)

 3. Sole proprietorships are the most common form of business organization, while corporations are responsible for the majority of business revenues. The majority of sole proprietorships operate in the wholesale, retail, service, and construction industries. Although corporations engage in all types of businesses, manufacturing firms account for the largest portion of corporate business receipts and net profits.

 4. Stockholders are the owners of a corporation, whose ownership, or equity*,* takes the form of common stock or, less frequently, preferred stock. They elect the board of directors, which has the ultimate authority to guide corporate affairs and set general policy. The board is usually composed of key corporate personnel and outside directors. The president or chief executive officer (CEO) reports to the board. He or she is responsible for day-to-day operations and carrying out the policies established by the board. The owners of the corporation do not have a direct relationship with management but give their input through the election of board members and voting on major charter issues. The owners of the firm are compensated through the receipt of dividends paid by the firm or by realizing capital gains through increases in the price of their common stock shares.

 5.The most popular form of limited liability organizations other than corporations are:

• Limited partnerships—A partnership with at least one general partner with unlimited liability and one or more limited partners who have limited liability. In return for the limited liability, the limited partners are prohibited from active management of the partnership.

• S corporation—If certain requirements are met, the S corporation can be taxed as a partnership but receive most of the benefits of the corporate form of organization.

• Limited liability company (LLC)—This form of organization is like an S corporation in that it is taxed as a partnership but primarily functions like a corporation. The LLC differs from the S corporation in that it is allowed to own other corporations and be owned by other corporations, partnerships, and non-U.S. residents.

• Limited liability partnership (LLP)—A partnership form authorized by many states that gives the partners limited liability from the acts of other partners, but not from personal individual acts of malpractice. The LLP is taxed as a partnership. This form is most frequently used by legal and accounting professionals.

 These firms generally do not have large numbers of owners. Most typically they have fewer than
100 owners.

 6. Virtually every function within a firm is in some way connected with the receipt or disbursement of cash. The cash relationship may be associated with the generation of sales through the marketing department, the incurring of raw material costs through purchasing, or the earnings of production workers. Because finance deals primarily with management of cash for operation of the firm, every person within the firm needs to be knowledgeable of finance to work effectively with employees of the financial departments.

 Individuals plan, monitor, and assess the financial aspects of their activities over a given period through the consideration of cash inflows and outflows.

 7. The *goal of a firm*, and therefore of all managers, is to maximize shareholder wealth. This goal is measured by share price; an increasing price per share of common stock relative to the stock market as a whole indicates achievement of this goal.

8. Profit maximization is not consistent with wealth maximization due to: (1) the timing, (2) earnings that do not represent cash flows available to stockholders, and (3) a failure to consider risk.

 9. *Risk* is the chance that actual outcomes may differ from expected outcomes. Financial managers must consider both risk and return because of their inverse effect on the share price of the firm. Increased risk may decrease the share price, while increased return is likely to increase the share price.

10. In recent years, the magnitude and severity of “white collar crime” has increased dramatically, with a corresponding emphasis on prosecution by government authorities. As a result, the actions of all corporations and their executives have been subjected to closer scrutiny. The increased scrutiny of this type of crime has resulted in many firms establishing corporate ethics guidelines and policies to cover employee actions in dealing with all corporate constituents. The adoption of high ethical standards by a corporation strengthens its competitive position by reducing the potential for litigation, maintaining a positive corporate image, and building shareholder confidence. The result is enhancement of long-term value and a positive effect on share price.

11. The treasurer or the chief financial manager typically manages a firm’s cash, investing surplus funds when available and securing outside financing when needed. The treasurer also oversees a firm’s pension plans and manages critical risks related to movements in foreign currency values, interest rates, and commodity prices. The treasurer in a mature firm must make decisions with respect to handling financial planning, acquisition of fixed assets, obtaining funds to finance fixed assets, managing working capital needs, managing the pension fund, managing foreign exchange, and distribution of corporate earnings to owners.

12. Finance is often considered a form of applied economics. Firms operate within the economy and must be aware of the economic principles, changes in economic activity, and economic policy. Principles developed in economic theory are applied to specific areas in finance. The primary economic principle used in managerial finance is *marginal cost–benefit analysis*, the principle that financial decisions should be made and actions taken only when the added benefits exceed the added costs. Nearly, all financial decisions ultimately come down to an assessment of their marginal benefits and marginal costs.

13. Accountants operate on an accrual basis, recognizing revenues at the point of sale and expenses when incurred. The financial manager focuses on the actual inflows and outflows of cash, recognizing revenues when actually received and expenses when actually paid.

 Accountants primarily collect and present financial data; financial managers devote attention primarily to decision making through analysis of financial data.

14. The two key activities of the financial manager as related to a firm’s balance sheet are

a. Making investment decisions: Determining both the most efficient level and the best mix of assets; and

b. Making financing decisions: Establishing and maintaining the proper mix of short- and long-term financing and raising needed financing in the most economical fashion.

 Investment decisions generally refer to the items that appear on the left-hand side of the balance sheet (current and fixed assets). Financing decisions deal with the items that appear on the right-hand side of the balance sheet (current liabilities, long-term debt, and stockholders’ equity).

15. *Corporate governance* refers to a system of organizational control that is used to define and establish lines of responsibility and accountability among major participants in a corporation. These participants include the shareholders, board of directors, officers and managers of the corporations, and other stakeholders. A company’s organizational chart is an example of a broad arrangement of corporate governance. More detailed responsibilities would be established within each branch of the organizational chart.

The Sarbanes-Oxley Act of 2002 is directed toward reducing the apparent conflicts of interest that exist in many corporate structures. The act has many provisions, but the major thrust of the act is to reduce the number of situations in which a conflict of interest can arise and to hold management more accountable for the financial and operating information they communicate to the public.

16. Agency problems arise when managers deviate from the goal of maximization of shareholder wealth by placing their personal goals ahead of the goals of shareholders. These problems in turn give rise to agency costs. Agency costs are costs borne by shareholders due to the presence or avoidance of agency problems, and in either case represent a loss of shareholder wealth. For example, shareholders incur agency costs when managers fail to make the best investment decision or when managers have to be monitored to ensure that the best investment decision is made, because either situation is likely to result in a lower stock price.

 The agency problem and the associated agency costs can be reduced by a properly constructed and followed corporate governance structure. The structure of the governance system should be designed to institute a system of checks and balances to reduce the ability and incentives of management to deviate from the goal of shareholder wealth maximization.

17. *Structuring expenditures* are currently the most popular way to deal with the agency problem—and also the most powerful and expensive. Compensation plans can be either incentive or performance plans. *Incentive plans* tie management performance to share price. Managers may receive stock options giving them the right to purchase stock at a set price. This provides the incentive to take actions that maximize stock. This form of compensation plan is not favorable because of market behavior, which has a significant effect on share price and is not under management’s control. As a result, *performance plans* are more popular today. With these, compensation is based on performance measures, such as earnings per share (EPS), EPS growth, or other return ratios. Managers may receive *performance shares* and/or *cash bonuses* when stated performance goals are reached.

 In practice, recent studies have been unable to document any significant correlation between CEO compensation and share price.

18. Market forces—for example, shareholder activism from large institutional investors—can reduce or avoid the agency problem because these groups can use their voting power to elect new directors who support their objectives and will act to replace poorly performing managers. In this way, these groups place pressure on management to take actions that maximize shareholder wealth.

 The threat of hostile takeovers also acts as a deterrent to the agency problem. *Hostile takeovers* occur when a company or group not supported by existing management attempts to acquire the firm. Because the acquirer looks for companies that are poorly managed and undervalued, this threat motivates managers to act in the best interests of the firm’s owners.

 Institutional investors are a powerful source of shareholder involvement in the monitoring of managers to reduce the agency problem. Institutions hold large quantities of shares in many of the corporations in their portfolio. Managers of these institutions should be active in the monitoring of management and vote their shares for the benefit of the shareholders. The power of institutional investors far exceeds the voting power of individual investors.

◼ Suggested Answer to *Focus on Practice* Box: Professional Certifications in Finance

**Why do employers value having employees with professional certifications?**

Studying to pass certification exams allows employees to continue their education beyond their undergraduate degree. The study will be focused on one area of finance, which is likely to be that needed to perform their job well. Furthermore, it will allow the employer to advertise the additional training of the employees and, thereby, attract additional business.

◼ Suggested Answer to *Focus on Ethics* Box: Critics See EthicalDilemmasinGoogleGlass

**Is the goal of maximization of shareholder wealth necessarily ethical or unethical?**

It is not the goal that makes maximization of shareholder wealth ethical or unethical; it is actions of financial managers in pursuit of this goal.

**What responsibility, if any, does Google have to protect the privacy of those who interact with other people wearing Glass?**

Google has a responsibility to ensure that its products and users of its product protect the privacy of those who interact with the users of Google’s products. Google Glass poses an ethical challenge as users could seemingly videotape or photograph others without their knowledge. It is Google’s responsibility to ensure that its devices cannot be used to captures images of people inconspicuously. For example, in some countries like Germany, it is legally prohibited to photograph a person in certain circumstances without the consent of the concerned person. Google glass raise an ethical and legal concern as it allows for shooting pictures secretly in violations of law.

◼ Answers to Warm-Up Exercises

E1-1. Comparison of advantages and disadvantages of a partnership versus incorporation.

Answer: Partnerships as each partner is taxed on his/her personal tax return.

Strengths:

• Can raise more funds than sole proprietorships

• Borrowing power enhanced by more owners

• More available brain power and managerial skill

• Income included and taxed on partner’s personal tax return

Weaknesses:

• Owners have unlimited liability and may have to cover debts of other partners

• Partnership is dissolved when a partner dies

• Difficult to liquidate or transfer partnership

E1-2 Timings of cash flows

Answer: Based on the information provided, the choice is not obvious. Even though the second project is expected to provide the larger overall increase in earnings and, therefore, is the more profitable project, the goal of the firm is to maximize value so timing, cash flow, and risk have to be considered to determine which project is superior. Although it is often the case that profit maximization leads to value maximization, it is definitely not always the case.

E1-3. Cash flow vs. accrued profits

Answer: It is not unusual for a firm to be profitable yet experience a cash crunch. The most common cause is when expenses have a shorter due date than expected revenue. In such cases, the firm must arrange short-term financing to meet its debt obligations before the revenue arrives. If the forthcoming cash crunch is not a new situation for this firm, management should probably consider going ahead with the year-end party if it is important for employee morale and the future success of the firm, as long as adequate short-term funding can be arranged. On the other hand, if the firm has not experienced such a cash crunch before, there may be larger problems looming ahead, and it would be unseemly to spend cash on a party that would be better spent meeting the debt obligations of the firm.

E1-4. Sunk costs

Answer: Marginal cost-benefit analysis ignores sunk costs, so the $2.5 million dollars is irrelevant to the current decision that must be made. At this point there are two questions that must be answered. First, will the $10,000 additional investment generate a *PV* of expected revenue that will exceed the $10,000 investment? In other words, will the project generate a positive net *present value*? If it does, the project must be considered further to see if it is the best use of capital. If the firm has a need to ration capital, the project must then be compared to other projects competing for the limited capital to see if it is viable. The fact that the project’s technology has been surpassed by new technology does not immediately disqualify the project because new technology does not ensure a positive cost-benefit result. In this case, a small $10,000 investment might avoid a heavy expenditure in new technology. Depending upon the industry, however, failure to keep up with competitors can be devastating. The key may well lie in the description “the project has little chance to be viable,” which indicates that approving the $10,000 is likely to be throwing good money after bad.

E1-5. Agency costs

Answer: Agency costs are the costs borne by stockholders to maintain a governance structure that ensures against dishonest acts of management and gives managers the financial incentive to maximize share price. One example of agency costs is stock options, which are used to provide an incentive for managers to work diligently for the benefit of the firm. Tips are similar to stock options in that they are offered as rewards for good service much as stock options are used to reward managers, presumably based on their good performance—which subsequently leads to a higher stock price. The Donut Shop, Inc., example does not represent a clear case of agency costs because it is the management itself that has instituted the “No tips” policy and the employees have responded with reduced performance. By banning tips, the management has created a situation where an agency cost may be necessary to provide an incentive for employees to resume their former level of performance.

 One solution that may work for Donut Shop, Inc., is to institute a profit-sharing plan that reaches down to the employee level where the slowdown and inefficiency are occurring. A profit-sharing plan is designed to motivate the employees and could alleviate the aggravation caused by the no-tip policy but must be clearly identified as the replacement to tipping in order to be effective. A profit-sharing plan is usually viewed by the employees as a reward for good performance but does not have the immediacy of the positive effect that an employee gets from a tip.

 It is unclear from the case whether the new no-tip policy is a company-wide policy or simply the actions of a few branch managers. However, the real solution here is to recognize that the no-tip policy has created an unnecessary backlash that can be alleviated by reversing management’s position without incurring the additional costs of revising the current employee benefit plan and paying out a portion of corporate profits.

◼ Solutions to Problems

P1-1. Liability comparisons

  **LG 2; Basic**

a. John will be held personally liable for the $120,000 in outstanding debt.

b. John and Peter will be held personally liable for the $120,000 in outstanding debt and since the distribution is equal, both will have to $60,000.

c. John will be held liable for the outstanding debt to the amount he invested in the firm, that is, $50,000.

P1-2. Accrual income vs. cash flow for a period

 **LG 4; Basic**

a. Sales revenue $ 500,000

 Less: Costs 400,000

 Net profit $ 100,000

b. Cash inflow $ 150,000

 Less: Cash outflow 400,000

 Net cash flow ($250,000)

c. Accountant: Firm made a profit of $100,000 on the deal and the accountant is satisfied.

 Financial manager: Firm ran out of cash and financial manager is not satisfied.

P1-3. Cash flow statement

 **LG 4; Intermediate**

a. Cash inflows = Interest paid + Salaries

 = $500 + $5,500

 = $6,000

 Cash outflows = Loan repayment + Groceries bill + Gas bill + Utility bills

 = $1,550 + $850 + $200 + $310

 = $2,910

b. Net cash flow = Total cash inflows − Total cash outflows

 = $6,000 − $2,910

 = $3,090

 Sheldon’s total cash inflow exceeds his total cash outflow by $3,090.

c. If there is a surplus of funds, Sheldon may invest the funds in some form of short-term investment.

d. If there is a shortfall of funds, Sheldon will have to either borrow or withdraw the amount required from his savings (short-term investments). Sheldon could also reduce his expenses by spending less.

P1-4. Marginal cost-benefit analysis and the goal of the firm

 **PG 3, 5; Challenge**

a. Marginal cost-benefit analysis – Economic principle that states that financial decisions should be made and actions taken only when the added benefits exceed the added costs.

b. Marginal benefit = Benefits of new system − Benefits of old system

 = $325,000 − $125,000

 = $200,000

c. Marginal cost = Cost of new system – Proceeds of sale of current system

 = $250,000 – $55,000

 = $195,000

d. Wendy will recommend that the new warehouse system should be bought as the net benefit is $5,000 ($200,000 – $195,000).

e. Yes, as the new system is expected to increase the stock price which will increase the shareholder wealth.

P1-5. Identifying agency problems, costs, and resolutions

 **LG 4; Intermediate**

The goal of management is to increase the stock price to maximize the shareholder wealth. If the management team believes that it can improve the profitability of the firm that the share price will exceed $38.60, then management should fight the hostile takeover. If the management team believes that the company B will actually pay more than $38.60 to acquire the company, then the management team should still fight the offer. However, if the current management team cannot increase the value of the firm beyond the bid price ($38.60), then the management team is not acting in the interests of the stockholders by fighting the offer. Another aspect is that the current management team often loses its job when the company is acquired by another company. Due to this reason, the management team will use this as an incentive to fight takeovers.

P1-6. Ethics Problem

 **LG 3; Intermediate**

 The current market price of the stock of the company reflects, among other things, market opinion about the quality of firm management. If the sale price is low, this indirectly reflects on the reputation of the managers, as well as potentially impacting their standing in the employment market. Alternatively, if the sale price is high, this indicates that the market believes current management is increasing firm value, and therefore doing a good job. An increase in the selling price would mean that shareholder wealth was maximized.

◼ Case

*Case studies are available on www.myfinancelab.com.*

Assessing the Goal of Sports Products, Inc.

 a. Maximization of shareholder wealth, which means maximization of share price, should be the primary goal of the firm. Unlike profit maximization, this goal considers timing, cash flows, and risk. It also reflects the worth of the owners’ investment in the firm at any time. It is the value they can realize should they decide to sell their shares.

 b. Yes, there appears to be an agency problem. Although compensation for management is tied to profits, it is not directly linked to share price. In addition, management’s actions with regard to pollution controls suggest a profit-maximization focus, which would maximize their earnings, rather than an attempt to maximize share price.

 c. The firm’s approach to pollution control seems to be questionable ethically. While it is unclear whether their acts were intentional or accidental, it is clear that they are violating the law—an illegal act potentially leading to litigation costs—and as a result are damaging the environment, an immoral and unfair act that has potential negative consequences for society in general. Clearly, Sports Products has not only broken the law but also established poor standards of conduct and moral judgment.

 d. From the information given there appears to be a weak corporate governance system. The fact that management is able to measure and reward their performance on profits indicates that no one is watching out for the shareholders. Loren and Dale’s concerns indicate that employees apparently have an interest in the long-run success of the firm. Allowing the continuation of pollution violations is also apparently escaping the interest and control ability of others who should be monitoring the firm.

 e. Some specific recommendations for the firm include:

• Tie management, and possibly employee, compensation to share price or a performance-based measure and make sure that all involved own stock and have a stake in the firm. Being compensated partially on the basis of share price or another performance measure and owning stock in the firm will more closely link the wealth of managers and employees to the firm’s performance.

• Comply with all federal and state laws as well as accepted standards of conduct or moral judgment.

• Establish a corporate ethics policy, to be read and signed by all employees.

• Set up a corporate governance system that has as its basis the oversight and welfare of all the stakeholders in the firm.

(Other answers are, of course, possible.)

◼ Spreadsheet Exercise

The answer to Chapter 1’s Monsanto spreadsheet problem is located on the Instructor’s Resource Center
at *www.pearsonglobaleditions.com/gitman* under the Instructor’s Manual.

◼ Group Exercise

*Group exercises are available on MyFinanceLab.*

Notes for Adopters

The motivation for these group exercises is to place the learning goals of each chapter within the context of a fictitious firm while giving students a valuable set of teamwork skills. Creativity is encouraged, while the strong links of each assignment to a real-world, shadow firm should ground each group’s work in reality. Any of these assignments and their deliverables can be modified to better fit within an adopter’s course goals as they were designed with an eye toward flexibility of use. The learning through these exercises should be something students enjoy, being both applicable to the real world and less confining than traditional homework.

The first issue for adopters to address is group composition and size. Should students self-separate or be divided by their instructor? How big should the groups be? This is a semester-long assignment and students will need to get along with their fellow group members. If students choose their own groups it may, though not always, reduce the incidence of intra-group squabbles. Diversity within the groups might then be sacrificed, however. One strategy is to ask students to first pair-off. The instructor can then join the pairs into groups of four. This pairing of the pairs could be done randomly through a number-in-the-hat selection process, as could the entire group setup.

Group size does matter and these exercises were designed for a workload spread across a minimum of three students. Larger groups would lessen the homework load; however, the issue of free-riding is often more prevalent in larger groups, where slackers can hide. Management of larger groups is also more challenging for the participants. The suggested group size is between three and five students.

Group leadership is another issue. The best situation might be rotating the CEO/leader, where each group member has several opportunities to be in charge. Last, these exercises were designed to allow students freedom but with the responsibility of working somewhat independently of their instructor. In this vein, the instructions for each assignment have been written to be relatively self-explanatory.

Chapter 1

This first chapter asks students to name their fictitious firm and describe its business. As this firm is going public, students are asked to explain why it is appropriate for them to go public and also discuss different managerial roles within the corporation. The group must choose a shadow firm to follow that is publicly held, allowing them to gather a substantial amount of information about it on the Internet. This publicly traded firm should be in an industry related to their fictitious firm.

The most important counsel students could get at the outset is to spend time making these initial decisions. Later work is going to build on these choices, and careful choosing is paramount. For example, in choosing the shadow firm, students should pick a well-established firm whose information, including financials, will be easily found. This also impacts their decisions regarding their own fictitious firm. Throughout many of the subsequent chapters, students will be taking real-world information from their shadow firm and applying it to their fictitious firm; dressing their own firm with the clothes of the shadow firm. Students should feel comfortable in these clothes, so encouraging them to choose industries they’re familiar with, or interested in, is helpful.