CHAPTER 1

An Overview of Managerial Finance

A Managerial Perspective

When you invest in the common stock of a company, what do you hope (expect) to gain? Rational investors would answer this question with a single word—wealth. As you will discover in this chapter, a corporation acts in the best interests of its stockholders when decisions are made that increase the value of the firm, which translates into an increase in the value of the company's stock.

The managers of large corporations generally are encouraged to "act in the best interests" of the firms' stockholders through executive compensation packages that reward "appropriate behavior"—that is, actions that increase firms' values. When managers act in their own best interests and stockholders believe that value is not being maximized, these executives often are ousted from their very lucrative positions. Sounds like a good plan, doesn't it?

Although it seems like a good idea to reward managers who run firms with the best interests of the stockholders (owners) in mind, in recent years stockholders have complained that executive compensation plans in many large corporations provide excessive rewards to executives who are interested only in increasing their own wealth positions. Consider, for example, that the CEO of Pfizer was paid \$79 million during the period 2001–2005 and the CEOs of Home Depot and Verizon Communications were paid \$27 million and \$50 million, respectively, during the period from 2004–2005, even though at the same time these same firms produced negative returns for stockholders.[1] According to Paul Hodgson, senior research associate at The Corporate Library, this is evidence "that the link between long-term value growth and long-term incentive awards is broken at too many companies—if it was ever forged properly in the first place."[2]

In recent years, investors have said, "Enough is enough." Stockholders are now demanding, and more boards of directors are imposing, tougher rules with regard to compensation packages, making it more difficult for executives to earn excessive salaries. In 2006, for example, the shareholders of Pfizer, Merrill Lynch, Morgan Stanley, General Electric, Citigroup, and Raytheon, among others, became much more active in expressing their feelings about "excessive" executive pay plans.[3]

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[1] Alan Murray, "CEOs of the World, Unite? When Executive Pay Can Be Truly Excessive," *The Wall Street Journal,* April 26, 2006, A2.

[2] "Pay for Failure," The Corporate Library, http://thecorporatelibrary.blogspot.com/. The Corporate Library provides articles and information about corporate governance and executive compensation. Additional reports about CEO compensation can be found by searching http://money.cnn.com/ using the key words "CEO pay."

[3] "Getting Active," *The Wall Street Journal Online,* May 4, 2006.

A compensation plan that has received a great deal of attention recently is the policy of offering "golden parachute" packages that provide executives with excessive payments when they are dismissed from their firms. In the past, a *golden parachute,* which gets its name from the fact that a significant severance pay permits an executive to easily "land on his or her financial feet" after dismissal from the company, often had to be honored no matter the reason for dismissal; one exception would be if a criminal offense was committed by the executive. More companies are now limiting the amount of the severance pay that executives can earn. In addition, large corporations, including ImClone Systems, NCR Corporation, and Walt Disney Company, are revising their policies so that it is easier to fire executives without having to pay excessive severance pay. More boards of directors are redefining what it means to be fired for "just cause" to include a wider range of actions or nonactions for which executives can be dismissed without severance pay. Firms now are including poor firm performance as a justifiable reason for dismissing executives without severance. It seems that stockholders are "speaking their minds," and the boards of directors of many companies are listening.[4]

As you read this chapter, think about the issues raised here: As a stockholder in a company, what goal(s) would you like to see pursued? To what extent should top managers let their own personal goals influence the decisions they make concerning how the firm is run? What factors should management consider when trying to "boost" the value of the firm's stock?

Chapter *Essentials* —The Questions

After reading this chapter, you should be able to answer the following questions:

- What is finance, and why should everyone understand basic financial concepts?
- What are the different forms of business organization? What are the advantages and disadvantages of each?
- What goal(s) should firms pursue? Do firms always pursue appropriate goals?
- What is the role of ethics in successful businesses?
- How do foreign firms differ from U.S. firms?

"Why should I study finance?" You probably are asking yourself this question right now. To answer this question, we need to answer another question: What is finance?

WHAT IS FINANCE?

In simple terms, finance is concerned with decisions about money, or more appropriately, cash flows. Finance decisions deal with how money is raised and used by businesses, governments, and individuals. To make rational 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.

In this book, we will show that a firm that practices sound financial management can provide better products to its customers at lower prices, pay higher salaries to its employees, and still provide greater returns to investors who put up the funds needed to form and operate the business. Because the economy—both national and worldwide—consists of customers, employees, and investors, sound financial management contributes to the well-being of both individuals and the general population.

Although the emphasis in this book is 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

[4]Joann Lublin, "Just Cause: Some Firms Cut Golden Parachute," *The Wall Street Journal,* March 13, 2006, B3, and "Getting Active," *The Wall Street Journal Online,* May 4, 2006.

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 that time value of money techniques that firms use to make business decisions can be used to answer this and other questions that relate to personal finances. In fact, in each chapter, we will show how the general business finance concepts that are presented apply to decisions about personal financial management.

Self-Test Question
What are some common personal finance decisions that individuals face?

General Areas of Finance

The study of finance consists of four interrelated areas: (1) *financial markets and institutions,* (2) *investments,* (3) *financial services,* and (4) *managerial finance*. Although our concern in this book is primarily with managerial finance, because these four areas are interrelated, an individual who works in any one area should have a good understanding of the other areas as well.

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 to rise and fall, regulations to which financial institutions are subject, and the various types of financial instruments, such as mortgages, auto loans, and certificates of deposit, that financial institutions offer.

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 (1) determining the values, risks, and returns associated with such financial assets as stocks and bonds and (2) determining the optimal mix of securities that should be held in a portfolio of investments.

Financial Services

Financial services refers to functions provided by organizations that operate in the finance industry. In general, financial services organizations deal with the management of money. People who work in these organizations, which include banks, insurance companies, brokerage firms, and other 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 related activities. The financial services industry is one of the largest in the world.

Managerial (Business) Finance

Managerial finance deals with decisions that all firms make concerning their cash flows. As a consequence, managerial finance is important in all types of businesses, whether they are public or private, deal with financial services, or manufacture products. The types of duties encountered in managerial finance range from making decisions about plant expansions to choosing what types of securities to issue 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 much cash to keep on hand, whether to acquire other firms (merger analysis), and how much of the firm's earnings to reinvest in the business and how much to pay out as dividends.

If you pursue a career in finance, you will need some knowledge of each of the areas of finance, regardless of which area you might enter. For example, a banker lending to a business must have a good understanding of managerial finance to judge how well the borrowing company is operated. The same holds true for a securities analyst. Even stockbrokers must understand general financial principles if they are to give intelligent advice to their customers. At the same time, corporate financial managers need to know what their bankers are thinking about and how investors are likely to judge their corporations' performances and thus determine their stock prices.

Self-Test Question
What are the four major areas of finance?

The Importance of Finance in Nonfinance Areas

Believe it or not, everyone is exposed to finance concepts almost every day. For example, when you borrow to buy a car or 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 plan. 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 more informed financial decisions.

Let's consider how finance relates to some of the nonfinance areas in a business.

Management

Costs & budgets.

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 any needed funds are available. For these reasons, managers must have at least a general understanding of financial management concepts to make informed decisions in their areas.

Marketing

If you have taken a basic marketing course, probably one of the first things you learned was 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 consultation 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 for 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.

Accounting

In many firms (especially small ones), it is difficult to distinguish between the finance function and the accounting function. Often, accountants make finance decisions, and vice versa, because the two disciplines are closely related. In fact, you might recognize some of the material in this book from accounting courses that you have already taken. As you will discover, financial managers rely heavily on accounting information because making decisions about the future requires information 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 other outsiders who are interested in the firm's operations.

Information Systems

Businesses thrive by effectively collecting and using information, which must be reliable and available when needed for making decisions. 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 information management will affect the profitability of the firm.

Economics

Finance and economics are so similar that some universities and colleges offer courses related to these areas in the same department or functional area. 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 small 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—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 a personal capacity, when you will make finance-related decisions. It is therefore important that you have some understanding of general finance concepts. *There are financial implications in virtually all business decisions, and nonfinancial 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, Figure 1-1 presents a fairly typical picture of the role of finance and its relationship with other areas within a firm. The chief financial officer (CFO), who often has the title of vice president of finance, 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.

Self-Test Questions

Why do people in areas outside financial management need to know something about managerial finance?

Identify the two subordinates who report to the firm's chief financial officer and indicate the primary responsibilities of each.

Alternative Forms of Business Organization

There are three main forms of business organization: (1) proprietorships, (2) partnerships, and (3) corporations. In terms of numbers, approximately 72 percent of businesses are operated as proprietorships, 8 percent are partnerships, and the remaining 20 percent are corporations. Based on the dollar value of sales, however, almost 85 percent of all business is conducted by corporations, while the remaining 15 percent is generated by both proprietorships (4 percent) and partnerships (11 percent).[5] 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.

Proprietorship

proprietorship
An unincorporated business owned by one individual.

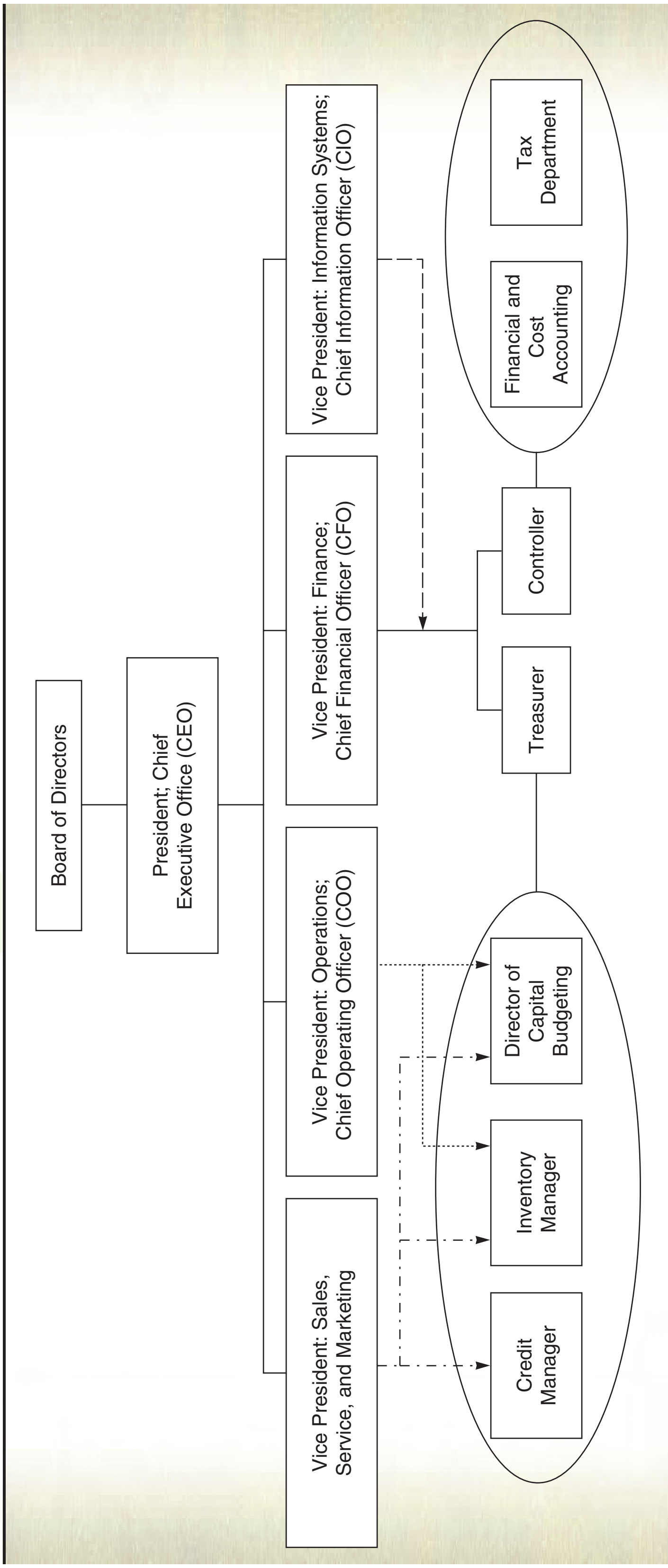
A **proprietorship** is an unincorporated business owned by one individual. Starting a proprietorship is fairly easy—just begin business operations. In many cases, however, even the smallest business must be licensed by the municipality (city, county, or state) in which it operates.

The proprietorship has three important advantages:

1. It is easily and inexpensively formed.
2. It is subject to few government regulations. Large firms that potentially threaten competition are much more heavily regulated than small "mom-and-pop" businesses.
3. It is taxed like an individual, not a corporation; thus, earnings are taxed only once.

[5]The statistics provided in this section are based on business tax filings reported by the Internal Revenue Service (IRS) in 2006. Additional statistics can be found on the IRS website at http://www.irs.ustreas.gov/tax_stats.

FIGURE 1-1 Role of Finance in a Typical Business Organization



The proprietorship also has four important limitations:

1. The proprietor has *unlimited personal liability* for business debts. 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.
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, technically 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.
4. It is difficult for a proprietorship to obtain large sums of capital because the firm's financial strength generally is based on the financial strength of the sole owner.

For the reasons mentioned here, 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 greater; nearly 90 percent have assets valued at $100,000 or less. However, most large businesses start out as proprietorships and then convert to corporations when their growth causes the disadvantages of being a proprietorship—namely, unlimited personal liability—to outweigh the advantages.

Partnership

partnership
An unincorporated business owned by two or more people.

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 for a proprietorship:

1. Formation is easy and relatively inexpensive.
2. It is subject to few government regulations.
3. It is taxed like an individual, not a corporation.

The disadvantages are also similar to those associated with proprietorships:

1. Owners have unlimited personal liability.
2. The life of the organization is limited.
3. Transferring ownership is difficult.
4. Raising large amounts of capital is difficult.

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 a direct party to such activities.

The first three disadvantages—unlimited liability, impermanence of the organization, and difficulty of transferring ownership—lead to the fourth, the difficulty partnerships have in attracting substantial amounts of funds. This is not a major problem for a slow-growing business. But if a business's products really catch on and it needs to raise large amounts of funds to capitalize on its opportunities, the difficulty in attracting funds becomes a real drawback. For this reason, growth companies such as Microsoft Corporation and Dell Inc. generally begin life as proprietorships or partnerships, but at some point they find it necessary to convert to corporations.

Corporation

A **corporation** is a legal entity created by a state. It is separate and distinct from its owners and managers. This separateness gives the corporation four major advantages:

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.

1. 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*.
2. Ownership interests can be divided into shares of stock, which in turn can be *transferred far more easily* than can proprietorship or partnership interests.
3. 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 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.[6]
4. The first three factors—unlimited life, easy transferability of ownership interest, and limited liability—make it much easier for corporations than for proprietorships or partnerships to raise money in the financial markets.

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, as well as subsequent filings of required state and federal reports, 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, 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 specifies how the corporation will be governed must be drawn up by the founder.
2. Corporate earnings are subject to double taxation—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.[7]

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.

Hybrid Business Forms—LLP, LLC, and S Corporation

Alternative business forms that include some of the advantages, as well as 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

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

[6]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 businesses.

[7]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 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. Taxes will be discussed briefly later in this book.

and partnerships with some characteristics of corporations. In this section, we provide a brief description of three popular *hybrid business forms* that exist today.

Limited Liability Partnership (LLP)

limited liability partnership (LLP)
A partnership wherein one (or more) partner is designated the *general partner(s)* with unlimited personal financial liability and the other partners are limited partners whose liability is limited to amounts they invest in the firm.

In the earlier discussion of a partnership, we described the form of business that generally is referred to as a *general partnership*, where each partner is personally liable for 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),** wherein one (or more) partner is designated the *general partner(s)* and the others are *limited partners.* The general partner(s) remains fully personally liable for all business debts, whereas the limited partners are liable only for the amounts they have invested in the business. Only the general partners can participate in the management of the business. If a limited partner becomes involved in the day-to-day management of the firm, then he or she no longer has the protection of limited personal liability. The LLP form of business allows people to invest in partnerships without exposure to the personal financial liability that general partners face.

Limited Liability Company (LLC)

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

A **limited liability company (LLC)** is a legal entity that is separate and distinct from its owners and managers. An LLC offers the limited personal liability associated with a corporation, but the company's income is taxed like a partnership in that it passes through to the owners (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. Like a corporation, paperwork (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.[8]

S Corporation

S corporation
A corporation with no more than 75 stockholders that elects to be taxed the same as proprietorships and partnerships so that business income is taxed only once.

A domestic corporation that has no more than 75 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 is that an LLC can have more than 75 stockholders and more than one type of stock.

For the following reasons, 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. Other things held constant, *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 attract funds more easily than can unincorporated businesses to take advantage of growth opportunities.
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 a proprietorship or partnership,

[8] Some states designate the types of businesses that can be LLCs. For example, often law firms and accounting firms can be formed as LLCs.

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.

Self-Test Questions

What are the key differences among proprietorships, partnerships, and corporations?

Explain why the value of any business (other than a small firm) will be maximized if it is organized as a corporation.

What Goal(s) Should Businesses Pursue?

Depending on the form of business, the primary goal of a firm might differ somewhat. 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 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, then 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 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.*

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.

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, new products, and new jobs. Finally, stock price maximization necessitates efficient and courteous service, adequate stocks of merchandise, and well-located business establishments. These factors all are necessary to maintain a customer base that is required for producing sales and thus profits. Therefore, most actions that help a firm increase the price of its stock also are beneficial to society at large. This is why profit-motivated, free-enterprise economies have been so much more successful than socialistic and communistic economic systems. Because managerial finance plays a crucial role in the operation of successful firms, and because successful firms are necessary for a healthy, productive economy, it is easy to see why finance is important from a social standpoint.[9]

Self-Test Questions

What should be management's primary goal?

How does the goal of stock price maximization benefit society at large?

Managerial Actions to Maximize Shareholder Wealth

How do we measure value, and what types of actions can management take to maximize value? Although we will discuss valuation in much greater detail later in the book, we introduce the concept of value here to give you an indication of how management can affect the price of a company's stock. First, the value of any investment, such as a stock, is based on the amount of cash flows the asset is expected to generate during its life. Second, investors prefer to receive a particular cash flow sooner rather than later. And, third, investors generally are risk averse, which means that they are willing to pay more for investments with more certain future cash flows than investments with less certain, or riskier, cash flows, everything else equal. For these reasons, we know that managers can increase the value of a firm by making decisions that increase the firm's expected future cash flows, generate the expected cash flows sooner, increase the certainty of the expected cash flows, or produce any combination of these actions.

capital structure decisions
Decisions about how much and what types of debt and equity should be used to finance the firm.

capital budgeting decisions
Decisions as to what types of assets should be purchased to help generate future cash flows.

dividend policy decisions
Decisions concerning how much of current earnings to pay out as dividends rather than retain for reinvestment in the firm.

The financial manager makes decisions about the expected cash flows of the firm, which include decisions about how much and what types of debt and equity should be used to finance the firm **(capital structure decisions),** what types of assets should be purchased to help generate expected cash flows **(capital budgeting decisions),** and what to do with net cash flows generated by the firm—reinvest in the firm or pay dividends **(dividend policy decisions).** Each of these topics will be addressed in detail later in the book. But at this point, it should be clear that the decisions financial managers make can significantly affect the firm's value because they affect the amount, timing, and riskiness of the cash flows the firm produces.

Although managerial actions affect the value of a firm's stock, external factors also influence stock prices. Included among these factors are legal constraints, the general level of economic activity, tax laws, and conditions in the financial markets. Working within the set of external constraints, management makes a set of long-run strategic policy decisions that chart a future course for the firm. These policy decisions, along with the general level of economic activity and government regulations and rules (for instance, tax payments), influence the firm's expected

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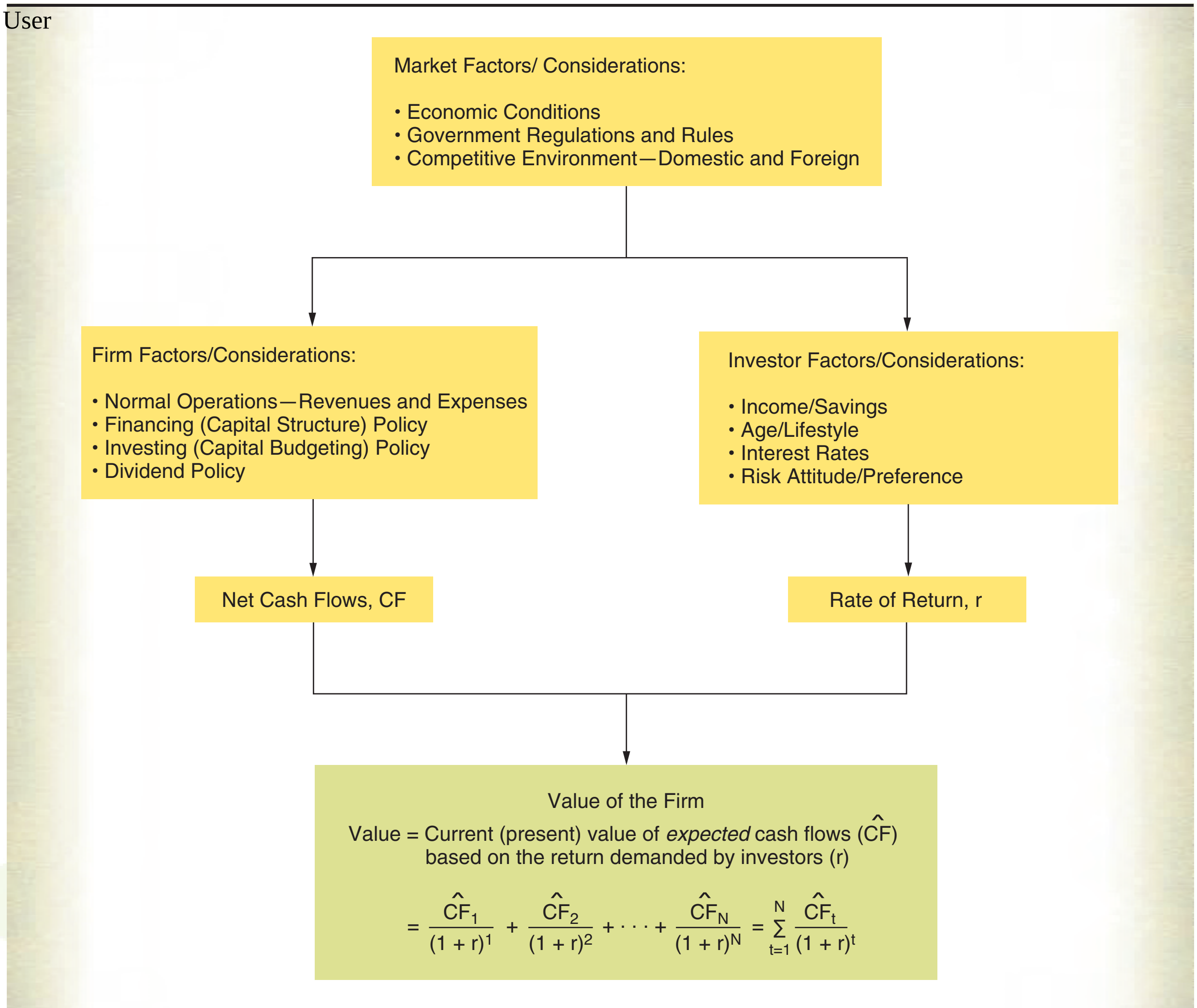
[9]People sometimes argue that firms, in their efforts to raise profits and stock prices, increase product prices and gouge the public. In a reasonably competitive economy, which we have, prices are constrained by competition and consumer resistance. If a firm raises its prices beyond reasonable levels, it will simply lose its market share. Even giant firms like General Motors lose business to the Japanese and Germans, as well as to Ford and Chrysler, if they set prices above levels necessary to cover production costs and earn a "normal" profit. Of course, firms want to earn more, and they constantly try to cut costs or develop new products and thereby to earn above-normal profits. Note, though, that if they are indeed successful and do earn above-normal profits, those very profits will attract competition that will eventually drive prices down, so again the main long-term beneficiary is the consumer.

FIGURE 1-2 Value of the Firm



cash flows, the timing of these cash flows and their eventual transfer to stockholders in the form of dividends, and the degree of risk inherent in the expected cash flows.

Figure 1-2 diagrams the general relationships involved in the valuation process. As you can see, and we will discuss in much greater detail throughout the book, a firm's value is ultimately a function of the cash flows it is expected to generate in the future and the rate of return at which investors are willing to provide funds to the firm for the purposes of financing operations and growth. Many factors, including conditions in the economy and financial markets, the competitive environment, and the general operations of the firm, affect the determination of the expected cash flows and the rate people demand when investing their funds. As we progress through the book, we will discuss these and other factors that affect a firm's value. For now, however, it is important to know that when we refer to **value,** we mean the worth of the expected future cash flows stated in current dollars—that is, the present, or current, value of the future cash flows associated with an asset.

value
The present, or current, value of the cash flows an asset is expected to generate in the future.

Self-Test Questions

Identify some decisions made by financial managers that affect the firm's value.

Identify some factors beyond a firm's control that influence its stock price.

Should Earnings Per Share (EPS) Be Maximized?

profit maximization Maximization of the firm's net income.

earnings per share (EPS) Net income divided by the number of shares of common stock outstanding.

Will **profit maximization** also result in stock price maximization? In answering this question, we introduce the concept of **earnings per share (EPS),** which equals net income (NI) divided by the number of outstanding shares of common stock (Shares)—that is, NI/Shares. Many investors use EPS to gauge the value of a stock. A primary reason EPS receives so much attention is the belief that net income, and thus EPS, can be used as a barometer for measuring the firm's potential for generating future cash flows. Although current earnings and cash flows are generally highly correlated, as we mentioned earlier, a firm's value is determined by the cash flows it is expected to generate in the future as well as the risk associated with these expected cash flows. Thus, financial managers who attempt to maximize earnings might not maximize value because earnings maximization is a shortsighted goal. Most managers who focus solely on earnings generally do not consider the impact that maximizing earnings in the current period has on either future earnings (timing) or the firm's future risk position.

First, think about the *timing of the earnings.* Suppose Xerox has a project that will cause earnings per share to rise by $0.20 per year for five years, or $1 in total, whereas another project would have no effect on earnings for four years but would increase EPS by $1.25 in the fifth year. Which project is better—in other words, is $0.20 per year for five years better or worse than $1.25 in Year 5? The answer depends on which project contributes the most to the value of the firm, which in turn depends on the time value of money to investors. Thus, timing is an important reason to concentrate on wealth as measured by the price of the stock rather than on earnings alone.

Second, consider *risk.* Suppose one project is expected to increase EPS by $1, while another is expected to increase earnings by $1.20 per share. The first project is not very risky. If it is undertaken, earnings will almost certainly rise by approximately $1 per share. However, the other project is quite risky. Although our best guess is that earnings will rise by $1.20 per share, we must recognize the possibility that there might be no increase whatsoever, or the firm might even suffer a loss. Depending on how averse stockholders are to risk, the first project might be preferable to the second.

In many instances, firms have taken actions that increased earnings per share, yet the stock price decreased because investors believed that either the higher earnings would not be sustained in the future or the riskiness of the firm would be increased substantially. Of course, the opposite effect has been observed as well. We see, then, that the firm's stock price, and thus its value, is dependent on (1) the cash flows the firm is expected to provide in the future, (2) when these cash flows are expected to occur, and (3) the risk associated with these cash flows. As we proceed through the book, you will discover that, everything else equal, the firm's value increases if the cash flows the firm is expected to provide increase, they are received sooner, their risk is lowered, or some combination of these actions occurs. Every significant corporate decision should be analyzed in terms of its effect on the firm's value, and hence the price of its stock.

Self-Test Questions

Will profit maximization always result in stock price maximization?

Identify three factors that affect the value of the firm, and explain the effects of each.

Managers' Roles as Agents of Stockholders

Because they generally are not involved in the day-to-day operations, stockholders of large corporations "permit" (empower) the managers to make decisions as to how the firms are run. Of course, the stockholders want the managers to make decisions that are consistent with the goal of wealth maximization. However, managers' interests can potentially conflict with stockholders' interests.

An *agency relationship* exists when one or more individuals, who are called the *principals,* hire another person, the *agent,* to perform a service and delegate decision-making authority to that agent. An **agency problem** arises when the agent makes decisions that are not in the best interests of the principals.

agency problem
A potential conflict of interest between outside shareholders (owners) and managers who make decisions about how to operate the firm.

If a firm is a proprietorship managed by the owner, the owner-manager will presumably operate the business in a fashion that will improve his or her own welfare, with welfare measured in the form of increased personal wealth, more leisure, or perquisites.[10] However, if the owner-manager incorporates and sells some of the firm's stock to outsiders, a potential conflict of interest immediately arises. For example, the owner-manager might now decide not to work as hard to maximize shareholder wealth because less of the firm's wealth will go to him or her or might decide to take a higher salary or enjoy more perquisites because part of those costs will fall on the outside stockholders. This potential conflict between two parties—the principals (outside shareholders) and the agents (managers)—is an agency problem.

The potential for agency problems is greatest in large corporations with widely dispersed ownership—for example, IBM and General Motors—because individual stockholders own very small proportions of the companies and managers have little, if any, of their own wealth tied up in these companies. For this reason, managers might be more concerned about pursuing their own agendas, such as increased job security, higher salary, or more power, than maximizing shareholder wealth.

What can be done to ensure that management treats outside stockholders fairly at the same time the goal of wealth maximization is pursued? Several mechanisms are used to motivate managers to act in the shareholders' best interests. These include the following:

1. **Managerial compensation (incentives).** A common method used to motivate managers to operate in a manner consistent with stock price maximization is to tie managers' compensation to the company's performance. Such compensation packages should be developed so that managers are rewarded on the basis of the firm's performance over a long period of time, not on the performance in any particular year. For example, Dell uses performance targets based on growth in sales and profit margins relative to industry measures and such nonfinancial factors as customer satisfaction and product leadership. If the company achieves a targeted average growth in earnings per share, managers earn 100 percent of a specified reward. If the performance is above the target, higher rewards can

[10]Perquisites are executive fringe benefits, such as luxurious offices, use of corporate planes and yachts, personal assistants, and general use of business assets for personal purposes.

be earned, whereas managers receive lower rewards when performance is below the target. Often the reward that managers receive is the stock of the company. If managers own stock in the company, they are motivated to make decisions that will increase the firm's value and thus the value of the stock they own.

All incentive compensation plans are designed to accomplish two things: (a) provide inducements to executives to act on those factors under their control in a manner that will contribute to stock price maximization and (b) attract and retain top-level executives. Well-designed plans can accomplish both goals.

2. **Shareholder intervention.** More than 25 percent of the individuals in the United States invest *directly* in stocks. Along with such institutional stockholders as pension funds and mutual funds, individual stockholders are "flexing their muscles" to ensure that firms pursue goals that are in the best interests of shareholders rather than managers (where conflicts might arise). Many institutional investors, especially pension funds such as TIAA-CREF and Laborers International Union of North America, routinely monitor top corporations to ensure that managers pursue the goal of wealth maximization. When it is determined that action is needed to "realign" management decisions with the interests of investors, these institutional investors exercise their influence by suggesting possible remedies to management or by sponsoring proposals that must be voted on by stockholders at the annual meeting. Stockholder-sponsored proposals are not binding, but the results of the votes are surely noticed by corporate management.

   In situations where large blocks of the stock are owned by a relatively few large institutions, such as pension funds and mutual funds, and they have enough clout to influence a firm's operations, these institutional owners often have enough voting power to overthrow management teams that do not act in the best interests of stockholders. Examples of major corporations whose managements have been ousted in recent years include Coca-Cola, General Motors, IBM, Lucent Technologies, United Airlines, and Xerox.

hostile takeover
The acquisition of a company over the opposition of its management.

3. **Threat of takeover. Hostile takeovers,** instances in which management does not want the firm to be taken over, are most likely to occur when a firm's stock is undervalued relative to its potential, which often is caused by poor management. In a hostile takeover, the managers of the acquired firm generally are fired, and those who do stay on typically lose the power they had prior to the acquisition. Thus, managers have a strong incentive to take actions that maximize stock prices. In the words of one company president, "If you want to keep control, don't let your company's stock sell at a bargain price."

Wealth maximization is a long-term goal, not a short-term goal. For this reason, when executives are rewarded for maximizing the price of the firm's stock, the reward should be based on the long-run performance of the stock. Because the goal of wealth maximization is achieved over time, management must be able to convey to stockholders that their best interests are being pursued. As you proceed through the book, you will discover that many factors affect the value of a stock, which makes it difficult to determine precisely when management is acting in the stockholders' best interests. However, a firm's management team will find it difficult to "fool" investors, both in general and for a long period—stockholders can generally differentiate when a firm makes a major decision that is value increasing, and vice versa.

Self-Test Questions

What is an agency relationship?

Give some examples of potential problems between stockholders and managers.

List some factors that motivate managers to act in the best interests of stockholders.

Business Ethics

The word *ethics* can be defined as "standards of conduct or moral behavior." **Business ethics** can be thought of as a company's attitude and conduct toward its employees, customers, community, and stockholders. High standards of ethical behavior demand that a firm treat each party with which it deals in a fair and honest manner. A firm's commitment to business ethics can be measured by the tendency of the firm and its employees to adhere to laws and regulations relating to such factors as product safety and quality, fair employment practices, fair marketing and selling practices, the use of confidential information for personal gain, community involvement, bribery, and illegal payments to foreign governments to obtain business.

business ethics A company's attitude and conduct toward its stakeholders—employees, customers, stockholders, and so forth; ethical behavior requires fair and honest treatment of all parties.

Although most firms have policies that espouse ethical business conduct, there are many instances of large corporations that have engaged in unethical behavior. For example, companies such as Arthur Andersen, Enron, and WorldCom MCI have fallen or been changed significantly as the result of unethical, and sometimes illegal, practices. In some cases, employees (generally top management) have been sentenced to prison for illegal actions that resulted from unethical behavior. In recent years, the number of high-profile instances in which unethical behavior has resulted in substantial gains to executives at the expense of stockholders' positions has increased to the point where public outcry resulted in legislation aimed at arresting the apparent tide of unethical behavior in the corporate world. As a result of the large number of recent scandals disclosed by major corporations, Congress passed the Sarbanes-Oxley Act of 2002. A major reason for the legislation was that accounting scandals caused the public to be skeptical of accounting and financial information reported by large U.S. corporations. Simply put, the public no longer trusted what managers said. Investors felt that executives were pursuing interests that too often resulted in large gains for themselves and large losses for stockholders.

The 11 "titles" in the Sarbanes-Oxley Act of 2002 establish standards for accountability and responsibility of reporting financial information for major corporations. The act provides that a corporation must (1) have a committee that consists of outside directors to oversee the firm's audits, (2) hire an external auditing firm that will render an unbiased (independent) opinion concerning the firm's financial statements, and (3) provide additional information about the procedures used to construct and report financial statements. In addition, the firm's CEO and CFO must certify financial reports submitted to the Securities and Exchange Commission. The act also stiffens the criminal penalties that can be imposed for producing fraudulent financial information and provides regulatory bodies with greater authority to enact prosecution for such actions.

Despite the recent decline in investor trust of financial reporting by corporations, the executives of most major firms in the United States believe their firms should, and do, try to maintain high ethical standards in all of their business dealings. Further, most executives believe that there is a positive correlation between ethics and long-run profitability because ethical behavior (1) prevents fines and legal expenses, (2) builds public trust, (3) attracts business from customers who appreciate and support ethical policies, (4) attracts and keeps employees of the highest caliber, and (5) supports the economic viability of the communities where these firms operate.

Today most firms have in place strong codes of ethical behavior, and they conduct training programs designed to ensure that all employees understand the correct behavior in different business situations. It is imperative that top management—the company's chairman, president, and vice presidents—be openly committed to ethical behavior and that they communicate this commitment through their own personal actions as well as through company policies, directives, and punishment/reward systems. Clearly, investors expect nothing less.

Self-Test Questions

How would you define *business ethics?*

Is "being ethical" good for profits and firm value in the long run? In the short run?

Corporate Governance

corporate governance The "set of rules" that a firm follows when conducting business; these rules identify who is accountable for major financial decisions.

stakeholders Those who are associated with a business; stakeholders include mangers, employees, customers, suppliers, creditors, stockholders, and other parties with an interest in the firm.

The term *corporate governance* has become a regular part of business vocabulary in recent years. As a result of the scandals uncovered at Arthur Andersen, Enron, WorldCom MCI, and many other companies, stockholders, managers, and Congress have become quite concerned with how firms are operated. **Corporate governance** deals with the "set of rules" that a firm follows when conducting business. Together these rules provide the "road map" that managers follow to pursue the various goals of the firm, including maximizing its stock price. It is important for a firm to clearly specify its corporate governance structure so that individuals and entities that have an interest in the well-being of the business understand how their interests will be pursued. A good corporate governance structure should provide those who have a relationship with a firm—that is, the **stakeholders**—with an understanding as to how executives run the business and who is accountable for important decisions. As a result of the Sarbanes-Oxley Act of 2002 and increased stockholder pressure, firms are revising their corporate governance policies so that all stakeholders—managers, stockholders, creditors, customers, suppliers, and employees—better understand their rights and responsibilities.[11] And, from our previous discussions, it should be clear that maximizing shareholder wealth requires the fair treatment of all stakeholders.

Studies show that firms that follow good corporate governance generate higher returns to stockholders. Good corporate governance includes a board of directors with members that are independent of the company's management. An independent board generally serves as a "checks and balances" system that monitors important management decisions, including executive compensation. It has also been shown that firms that develop governance structures that make it easier to identify and correct accounting problems and potentially unethical or fraudulent practices perform better than firms that have poor governance policies (internal controls).[12]

[11]Broadly speaking, the term *stakeholders* should include the environment in which we live and do business. It should be apparent that a firm cannot survive—that is, remain sustainable—unless it fairly treats both human stakeholders and environmental stakeholders. A firm that destroys either the trust of its employees, customers, and shareholders or the environment in which it operates, destroys itself.

[12]See, for example, Reshma Kapadia, "Stocks Reward Firms' Good Behavior," *The Wall Street Journal Online*, March 18, 2006, and David Reilly, "Checks on Internal Controls Pay Off," *The Wall Street Journal*, May 8, 2006, C3.

Self-Test Question
Why is it important for a firm to have a good corporate governance policy?

Forms of Businesses in Other Countries

U.S. corporations can best be described as "open" companies because they are publicly traded organizations that, for the most part, are independent of each other and of the government. As we described earlier, such companies offer limited liability to owners who usually do not participate in the day-to-day operations and who can easily transfer ownership by trading stock in the financial markets. While most developed countries with free economies have business organizations that are similar to U.S. corporations, some differences exist relating to ownership structure and management of operations. Although a comprehensive discussion is beyond the scope of this book, this section provides some examples of differences between U.S. companies and non-U.S. companies.

Firms in most developed economies, such as corporations in the United States, offer equities with limited liability to stockholders that can be traded in domestic financial markets. However, such firms are not always called corporations. For instance, a comparable firm in England is called a *public limited company,* or PLC, while in Germany it is known as an *Aktiengesellschaft,* or AG. In Mexico, Spain, and Latin America, such a company is called a *Sociedad Anónima,* or SA. Some of these firms are publicly traded, whereas others are privately held.

Like corporations in the United States, most large companies in England and Canada are "open," and their stocks are widely dispersed among a large number of different investors. Of note, however, is that two-thirds of the traded stocks of English companies are owned by institutional investors rather than individuals. On the other hand, in much of continental Europe, stock ownership is more concentrated; major investor groups include families, banks, and other corporations. In Germany and France, for instance, corporations represent the primary group of shareholders, followed by families. Although banks do not hold a large number of shares of stock, they can greatly influence companies because many shareholders assign banks their **proxy votes** for the directors of the companies. Also, often the family unit has concentrated ownership and thus is a major influence in many large companies in developed countries such as these. The ownership structures of these firms and many other non-U.S. companies, including very large organizations, often are concentrated in the hands of a relatively few investors or investment groups. Such firms are considered "closed" because shares of stock are not publicly traded, relatively few individuals or groups own the stock, and major stockholders often are involved in the firms' daily operations.

proxy votes
Voting power that is assigned to another party, such as another stockholder or institution.

The primary reason non-U.S. firms are likely to be more closed, and thus have more concentrated ownership, than U.S. firms results from the "universal" banking relationships that exist outside the United States. Financial institutions in other countries generally are less regulated than in the United States, which means foreign banks, for instance, can provide businesses a greater variety of services, including short-term loans, long-term financing, and even stock ownership. These services are available at many locations, or branches, throughout the country. As a result, non-U.S. firms tend to have close relationships with individual banking organizations that also might take ownership positions in the companies. What this means is that banks in countries like Germany can meet the financing needs of family-owned businesses, even if they are very large. Therefore, such companies need not "go public," and thus relinquish control, to finance additional growth. Consider the fact that in both France and Germany approximately

75 percent of the gross domestic product (GDP) comes from firms not publicly traded—that is, closed businesses. The opposite is true in the United States, where large firms do not have "one-stop" financing outlets; hence, their growth generally must be financed by bringing in outside owners, which results in more widely dispersed ownership.

industrial groups
Organizations composed of companies in different industries with common ownership interests, which include firms necessary to manufacture and sell products—a network of manufacturers, suppliers, marketing organizations, distributors, retailers, and creditors.

In some parts of the world, firms belong to **industrial groups,** which are organizations composed of companies in different industries with common ownership interests and, in some instances, shared management. Firms in the industrial group are "tied" by a major lender, typically a bank, which often also has a significant ownership interest along with other firms in the group. The objective of an industrial group is to include firms that provide materials and services required to manufacture and sell products—that is, to create an organization that ties together all the functions of production and sales from start to finish. Thus, an industrial group encompasses firms involved in manufacturing, financing, marketing, and distribution of products, which includes suppliers of raw materials, production organizations, retail stores, and creditors. A portion of the stocks of firms that are members of an industrial group might be traded publicly, but the "lead" company, which is typically a major creditor, controls the management of the entire group. Industrial groups are most prominent in Asian countries. In Japan, an industrial group is called a *keiretsu,* and it is called a *chaebol* in Korea. Well-known *keiretsu* groups include Mitsubishi, Toshiba, and Toyota, while the best-known *chaebol* probably is Hyundai. The success of industrial groups in Japan and Korea has inspired the formation of similar organizations in developing countries in Latin America and Africa as well as other parts of Asia.

The differences in ownership concentration of non-U.S. firms might cause the behavior of managers, and thus the goals they pursue, to differ. For instance, often it is argued that the greater concentration of ownership of non-U.S. firms permits managers to focus more on long-term objectives, especially wealth maximization, than short-term earnings because firms have easier access to credit in times of financial difficulty. In other words, creditors who also are owners generally have greater interest in supporting short-term survival. On the other hand, it also has been argued that the ownership structures of non-U.S. firms create an environment in which it is difficult to change managers, especially if they are significant stockholders. Such entrenchment could be detrimental to firms if management is inefficient. Consider, for example, firms in Japan that generally are reluctant to fire employees because losing one's job is a disgrace in the Japanese culture. Whether the ownership structure of non-U.S. firms is an advantage or a disadvantage is debatable. But we do know that the greater concentration of ownership in non-U.S. firms permits greater monitoring and control by individuals or groups than the more dispersed ownership structures of U.S. firms.

Self-Test Questions

What is the primary difference between U.S. corporations and non-U.S. firms?

What is an industrial group?

What are some of the names given to firms in other countries?

Multinational Corporations

Large firms, both in the United States and in other countries, generally do not operate in a single country; rather, they conduct business throughout the world. In fact, the largest firms in the world truly are multinational rather than domestic operations. Managers of such multinational companies face a wide range of issues that are not present when a company operates in a single country. This section highlights the key differences between multinational and domestic corporations and the impacts these differences have on managerial finance for U.S. businesses.

The term **multinational corporation** is used to describe a firm that operates in two or more countries. Rather than merely buying resources from foreign concerns, multinational firms make direct investments in fully integrated operations, with worldwide entities controlling all phases of the production process, from extraction of raw materials, through the manufacturing process, to distribution to consumers throughout the world. Today, multinational corporate networks control a large and growing share of the world's technological, marketing, and productive resources.

multinational corporation
A firm that operates in two or more countries.

U.S. and foreign companies "go international" for the following major reasons:

1. **To seek new markets.** After a company has saturated its home market, growth opportunities often are better in foreign markets. As a result, such homegrown firms as Coca-Cola and McDonald's have aggressively expanded into overseas markets, and foreign firms such as Sony and Toshiba are major competitors in the U.S. consumer electronics market.
2. **To seek raw materials.** Many U.S. oil companies, such as ExxonMobil, have major subsidiaries around the world to ensure they have continued access to the basic resources needed to sustain their primary lines of business.
3. **To seek new technology.** No single nation holds a commanding advantage in all technologies, so companies scour the globe for leading scientific and design ideas. For example, Xerox has introduced more than 80 different office copiers in the United States that were engineered and built by its Japanese joint venture, Fuji Xerox.
4. **To seek production efficiency.** Companies in countries where production costs are high tend to shift production to low-cost countries. For example, General Motors has production and assembly plants in Mexico and Brazil, and even Japanese manufacturers have shifted some of their production to lower-cost countries in the Pacific Rim. The ability to shift production from country to country has important implications for labor costs in all countries. For example, when Xerox threatened to move its copier rebuilding work to Mexico, its union in Rochester, New York, agreed to work rule and productivity improvements that kept the operation in the United States.
5. **To avoid political and regulatory hurdles.** Many years ago, Japanese auto companies moved production to the United States to get around U.S. import quotas. Now, Honda, Nissan, and Toyota all assemble automobiles or trucks in the United States. Similarly, one of the factors that prompted U.S. pharmaceutical maker SmithKline and UK drug company Beecham to merge in 1989 was the desire to avoid licensing and regulatory delays in their largest markets. Now, GlaxoSmithKline, as the company is known, can identify itself as an inside player in both Europe and the United States.

Since the 1980s, investments in the United States by foreign corporations have increased significantly. This "reverse" investment has created concerns for U.S. government officials, who contend it could erode the doctrine of independence and self-reliance that has traditionally been a hallmark of U.S. policy. Just as U.S. corporations with extensive overseas operations are said to use their economic power to exert substantial economic and political influence over host governments around the world, it is feared that foreign corporations might gain similar influence over U.S. policy. These developments also suggest an increasing degree of mutual influence and interdependence among business enterprises and nations, to which the United States is not immune. Political and social developments that influence the world economy also influence U.S. businesses and financial markets.

Self-Test Questions

What is a multinational corporation?

Why do companies "go international"?

Multinational versus Domestic Managerial Finance

In theory, the concepts and procedures discussed in the remaining chapters of this book are valid for both domestic and multinational operations. However, several problems uniquely associated with the international environment increase the complexity of the manager's task in a multinational corporation, and they often force the manager to change the way alternative courses of action are evaluated and compared. Six major factors distinguish managerial finance as practiced by firms operating entirely within a single country from management by firms that operate in several different countries:

exchange rates
The prices at which the currency from one country can be converted into the currency of another country.

1. **Different currency denominations.** Cash flows in various parts of a multinational corporate system often are denominated in different currencies. Hence, an analysis of **exchange rates** and the effects of fluctuating currency values must be included in all financial analyses.
2. **Economic and legal ramifications.** Each country in which the firm operates has its own unique political and economic institutions, and institutional differences among countries can cause significant problems when a firm tries to coordinate and control the worldwide operations of its subsidiaries. For example, differences in tax laws among countries can cause a particular transaction to have strikingly dissimilar after-tax consequences, depending on where it occurred. Also, differences in legal systems of host nations complicate many matters, from the simple recording of a business transaction to the role played by the judiciary in resolving conflicts. Such differences can restrict multinational corporations' flexibility to deploy resources as they wish and can even make procedures illegal in one part of the company that are required in another part. These differences also make it difficult for executives trained in one country to operate effectively in another.
3. **Language differences.** The ability to communicate is critical in all business transactions. People born and educated in the United States often are at a disadvantage because they generally are fluent only in English, whereas European and Japanese businesspeople usually are fluent in several languages, including English. As a result, it is often easier for international companies to invade U.S. markets than it is for Americans to penetrate international markets.
4. **Cultural differences.** Even within geographic regions long considered fairly homogeneous, different countries have unique cultural heritages that shape values and influence the role of business in the society. Multinational corporations find that such matters as defining the appropriate goals of the firm, attitudes toward risk taking, dealing with employees, and the ability to curtail unprofitable operations can vary dramatically from one country to the next.
5. **Role of governments.** Most traditional models in finance assume the existence of a competitive marketplace in which the terms of trade are

determined by the participants. The government, through its power to establish basic ground rules, is involved in this process, but its participation is minimal. Thus, the market provides both the primary barometer of success and the indicator of the actions that must be taken to remain competitive. This view of the process is reasonably correct for the United States and a few other major industrialized nations, but it does not accurately describe the situation in most of the world. Frequently, the terms under which companies compete, the actions that must be taken or avoided, and the terms of trade on various transactions are determined not in the marketplace but by direct negotiation between the host government and the multinational corporation. This is essentially a political process, and it must be treated as such.

6. **Political risk.** The distinguishing characteristic that differentiates a nation from a multinational corporation is that the nation exercises sovereignty over the people and property in its territory. Hence, a nation is free to place constraints on the transfer of corporate resources and even to *expropriate*—that is, take for public use—the assets of a firm without compensation. This is political risk, and it tends to be largely a given rather than a variable that can be changed by negotiation. Political risk varies from country to country, and it must be addressed explicitly in any financial analysis. Another aspect of political risk is terrorism against U.S. firms or executives abroad. For example, in the past, U.S. executives have been captured and held for ransom in several South American and Middle Eastern countries.

These six factors complicate managerial finance within multinational firms and they increase the risks these firms face. However, prospects for high profits often make it worthwhile for firms to accept these risks and to learn how to minimize or at least live with them.

Self-Test Question

Identify and briefly explain the major factors that complicate managerial finance within multinational firms.

Chapter *Essentials* —The Answers

To summarize the key concepts, let's answer the questions that were posed at the beginning of the chapter:

- **What is finance, and why should everyone understand basic financial concepts?** Finance deals with decisions about money—that is, how money is raised and used by companies and individuals. Everyone deals with financial decisions, both in business and in their personal lives. For this reason, and because *there are financial implications in nearly every business-related decision*, it is important that everyone has at least a general knowledge of financial concepts so that they can make informed decisions about their money.
- **What are the different forms of business organization? What are the advantages and disadvantages of each?** The three main forms of business organization are the *proprietorship,* the *partnership,* and the *corporation*. Although proprietorships and partnerships are easy to start, the major disadvantage to these forms of business is that the owners have unlimited personal liability for the debts of the businesses. On the other hand, a corporation is more difficult to start than the other forms of business, but owners have limited liability. Most business is conducted by corporations because this organizational form maximizes firms' values.

- **What goal(s) should firms pursue? Do firms always pursue appropriate goals?** The primary goal of management should be to maximize stockholders' wealth, which in turn means maximizing the price of the firm's stock. Further, actions that maximize stock prices also increase social welfare. The price of a firm's stock depends on the firm's projected cash flows and the timing and riskiness of these cash flows.

  There are times when managers might be tempted to act in their own best interests rather than pursue the goal of wealth maximization. The potential for such an *agency problem,* or conflict of interest, can be lessened by providing managers with incentives, or motivations, to act in the best interests of the stockholders.
- **What is the role of ethics in successful businesses?** Most firms have established strict *codes of conduct,* or guidelines, to ensure that managers "behave" ethically when dealing with stakeholders. Executives believe that there is a positive correlation between business ethics and the long-run success of their firms—that is, "ethical firms" survive, whereas "unethical firms" do not.
- **How do foreign firms differ from U.S. firms?** Non-U.S. firms generally have more concentrated ownership than U.S. firms. International operations have become increasingly important to individual firms and to the national economy. Companies go "international" to seek new markets, seek raw materials, seek new technology, seek production efficiency, and avoid trade barriers.

  The major factors that distinguish managerial finance as practiced by domestic firms from that of multinational companies include (1) different currency denominations, (2) economic and legal ramifications, (3) language differences, (4) cultural differences, (5) role of governments, and (6) political risk.

Chapter *Essentials* —Personal Finance

The basic knowledge you learn in this book will help you understand how to (1) review companies and industries to determine their prospects for future growth and ability to maintain the safety of the funds you invest, (2) determine how much risk you are willing to take with your investment position, and (3) evaluate how well your investments are performing so that you can better ensure your funds are invested "appropriately."

Following are the general concepts presented in this chapter as they relate to personal financial decisions.

Valuation

Throughout the book we will show that the concept of value is fairly easy to grasp—that is, value is based on the future cash flows an asset is expected to produce (both the amount and the timing) and the risk associated with those cash flows. If you can apply this concept, you should be able to estimate the values of investments and make informed decisions about these investments based on their current selling prices.

Investment Goals

When you invest your money in a company's stock, you hope that the value of the stock increases significantly—that is, you want the value of the stock to be maximized. Thus, you want managers to make decisions that maximize the value of the firm. When managers make decisions that are in their own best interests rather than the best interests of stockholders—that is, an agency problem exists—you will have a tendency to sell the stock of that firm and invest in firms where managers "do the right thing."

Ethics

When investing, you should behave ethically—that is, your interaction with and conduct toward other investors should be fair and honest. Also, you will tend to invest in firms that are considered ethical because firms that have good corporate governance policies have proven to be better investments than firms that have poor corporate governance policies.

Ethical Dilemma

Chances Are What They Don't Know Won't Hurt Them!

Futuristic Electronic Technologies (FET) recently released a new advanced electronic micro system to be used by financial institutions, large corporations, and governments to process and store financial data, such as taxes and automatic payroll payments. Even though FET developed the technology used in the creation of the product, FET's competitors are expected to possess similar technology soon. To beat the competition to the market, FET introduced its new micro system a little earlier than originally planned. In fact, laboratory testing had not been fully completed before the product reached the market. The tests are complete now, and the final results suggest the micro system might be flawed with respect to how some data are retrieved and processed. The tests are not conclusive, though, and even if additional testing proves a flaw does exist, according to FET, it is of minuscule importance because the problem seems to occur for only one out of 100 million retrieval and processing attempts. The financial ramifications associated with the flaw are unknown at this time.

Assume you are one of FET's senior executives whose annual salary is based on the performance of the firm's common stock. You realize that if FET recalls the affected micro system, the stock price will suffer; thus, your salary for the year will be less than you expected. To complicate matters, you just purchased an expensive house based on your salary expectations for the next few years—expectations that will not be realized unless the new micro system is a success for FET. As one of the senior executives, you will help determine what course of action FET will follow with respect to the micro system. What should you do? Should you encourage FET to recall the micro system until further testing is completed? Or can you suggest another course of action?

Questions

1-1 What are the three principal forms of business organization? What are the advantages and disadvantages of each?

1-2 Would the role of the financial manager be likely to increase or decrease in importance relative to other executives if the rate of inflation increased? Explain.

1-3 What does it mean to maximize the value of a corporation?

1-4 In general terms, how is value measured? What are the three factors that determine value? How does each factor affect value?

1-5 Should stockholder wealth maximization be thought of as a long-term or a short-term goal? For example, if one action would probably increase the firm's stock price from a current level of $20 to $25 in six months and then to $30 in five years, but another action would probably keep the stock at $20 for several years but then increase it to $40 in five years, which action would be better? Can you think of some specific corporate actions that might have these general tendencies?

1-6 Drawing on your background in accounting, can you think of any accounting procedure differences that might make it difficult to compare the relative performance of different firms?

1-7 Would the management of a firm in an oligopolistic or in a competitive industry be more likely to engage in what might be called "socially conscious" practices? Explain your reasoning.

1-8 What is the difference between stock price maximization and profit maximization? Under what conditions might profit maximization not lead to stock price maximization?

1-9 If you were the president of a large publicly owned corporation, would you make decisions to maximize stockholders' welfare or your own personal interests? What are some actions stockholders can take to ensure that management's interests and those of stockholders coincided? What are some other factors that might influence management's actions?

1-10 The president of United Semiconductor Corporation made this statement in the company's annual report: "United's primary goal is to increase the value of the common stockholders' equity over time." Later on in the report, the following announcements were made:

a. The company contributed $1.5 million to the symphony orchestra in San Francisco, where it is headquartered.

b. The company is spending $500 million to open a new plant in Mexico. No revenues will be produced by the plant for four years, so earnings will be depressed during this period in comparison to earnings had the decision not been made to open the new plant.

c. The company is increasing its relative use of debt. Whereas assets were formerly financed with 35 percent debt and 65 percent equity, henceforth the financing mix will be 50-50.

d. The company uses a great deal of electricity in its manufacturing operations, and it generates most of this power itself. Plans are to use nuclear fuel rather than coal to produce electricity in the future.

e. The company has been paying out half of its earnings as dividends and retaining the other half. Henceforth, it will pay out only 30 percent as dividends.

Discuss how United's stockholders, customers, and labor force will react to each of these actions and then how each action might affect United's stock price.

1-11 What is corporate governance? Does a firm's corporate governance policy relate to whether it conducts business in an ethical manner? Explain.

1-12 Can a firm sustain its operations by maximizing stockholders' wealth at the expense of other stakeholders?

1-13 Why do U.S. corporations build manufacturing plants abroad when they could build them at home?

1-14 Compared to the ownership structure of U.S. firms, which are "open" companies, what are some advantages of the ownership structure of non-U.S. firms, many of which are "closed" companies? Can you think of any disadvantages?

1-15 Compared to purely domestic firms, what are some factors that make financial decision making more complicated for firms that operate in foreign countries?

Self-Test Problem

Solution appears in Appendix B

ST-1 Define each of the following terms: **key terms**

a. Proprietorship; partnership; corporation

b. Corporate charter; bylaws

c. Stockholder wealth maximization

d. Capital structure decisions; capital budgeting decisions; dividend policy decisions

e. Value

f. Profit maximization; earnings per share

g. Agency problem

h. Hostile takeover

i. Business ethics; corporate governance

j. Stakeholders

k. Multinational corporation

l. Industrial group; *chaebol; keiretsu*

m. Exchange rate

Problem

Integrative Problem

1-1 Marty Kimble, who "retired" many years ago after winning a huge lottery jackpot, wants to start a new company that will sell authentic sports memorabilia. He plans to name the company Pro Athlete Remembrances, or PAR for short. Marty is still in the planning stages, so he has a few questions about how PAR should be organized when he starts the business and what he should do if the company becomes very successful in the future. Marty has little knowledge of finance concepts. To answer his questions and learn more about finance in general, Mr. Kimble has hired Sunshine Business Consultants (SBC). Assume you are a new employee of SBC and your boss has asked you to answer the following questions for Mr. Kimble. **forms of business**

a. What is finance? Why is the finance function important to the success of a business?

b. Why is it important for people who work in other areas in a business to have an understanding of finance? Do you think it is more important for Marty Kimble to have a basic understanding of all the areas in a business than it is for a person who works for a large national corporation?

c. What are the alternative forms of business organization? What are the advantages and disadvantages of each?

d. What form of business organization do you recommend that Mr. Kimble use when starting PAR? Why?

e. Assume that PAR is organized as a proprietorship when it starts business. If PAR becomes extremely successful and grows substantially, would you recommend that Mr. Kimble change the business organization to either a partnership or a corporation? Explain your answer.

f. What goal should Mr. Kimble pursue when operating PAR?

g. Assume that PAR is organized as a proprietorship when it starts business and that Mr. Kimble plans to convert the business to a corporation at some point in the future. What are some potential problems that Mr. Kimble as one of the owners might face after converting to a corporation? Discuss some solutions to these potential problems.

h. Mr. Kimble would like PAR to grow so that at some point in the future the company can conduct business in other countries. Why do firms "go global"?

i. Discuss any differences and problems that Mr. Kimble should be aware of when conducting business in foreign markets.

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organizational structure

1-1 Adobe Systems Inc. [NASNM:ADBE] makes the popular Adobe Acrobat software for creating PDF-formatted files. Symantec Corporation [NASNM: SYMC] produces the popular Norton Security software for computer virus protection.

These firms are peers, operating in the same industry—the technology industry—as well as the same market sector—the software sector. Using the Thomson One database, answer the following questions:

a. According to the Overview section, who are the key executives, based on their titles, in each firm?

b. You can access the firms' websites from their Overview section. Go to their corporate websites and find the corporate executive structure. Create an organizational chart for each firm.

c. Point out the similarities and differences for these firms, which are in the same market sector and industry, with regard to their organizational structure.

d. Where does the chief financial officer fit on the organizational charts of these two firms?

multinational business

1-2 Using the Thomson One database, find a multinational firm that is based in the United States. Answer these questions:

a. What is the name and ticker symbol of the company you selected?

b. What is the industry and market sector in which the firm is classified?

c. What is the firm's major line of business?

d. In what countries does the firm operate?

e. Why, in your opinion, do overseas operations help the firm you selected to maximize shareholder wealth? Be specific in your answer.

Appendix B
Solutions to Self-Test Problems

Note: Except for Chapter 1, we do not show an answer for ST-1 problems because they are verbal rather than quantitative in nature.

Chapter 1

ST-1 Refer to the marginal glossary definitions or relevant chapter sections to check your responses.

Appendix D
Selected Equations

Chapter 1

Value = Current (present) value of *expected* cash flows $\hat{CF}$ based on the return demanded by investors (r)

$$= \frac{\hat{CF}_1}{(1+r)^1} + \frac{\hat{CF}_2}{(1+r)^2} + \cdots + \frac{\hat{CF}_N}{(1+r)^N} = \sum_{t=1}^{N} \frac{\hat{CF}_t}{(1+r)^t}$$

This page contains answers for this chapter only.

PART 2

Essential Concepts in Managerial Finance

CHAPTER 2
Analysis of Financial Statements

CHAPTER 3
The Financial Markets and the Investment Banking Process

CHAPTER 4
The Time Value of Money