Part 1 Introduction to Managerial Finance

Chapters in This Part

Part 1 of *Principles of Managerial Finance* discusses the role that financial managers play in businesses and the financial market environment in which firms operate. We argue that the goal of managers should be to maximize the value of the firm and by doing so maximize the wealth of its owners. Financial managers act on behalf of the firm's owners by making operating and investment decisions whose benefits exceed their costs. These decisions create wealth for shareholders. Maximizing shareholder wealth is important because firms operate in a highly competitive financial market environment that offers shareholders many alternatives for investing their funds. To raise the financial resources necessary to fund the firm's ongoing operations and future investment opportunities, managers have to deliver value to the firm's investors. Without smart financial managers and access to financial markets, firms are unlikely to survive, let alone achieve the long-term goal of maximizing the value of the firm.

1 The Role of Managerial Finance

Learning Goals

LG 1 Define *finance* and the managerial finance function.

LG 2 Describe the legal forms of business organization.

LG 3 Describe the goal of the firm, and explain why maximizing the value of the firm is an appropriate goal for a business.

LG 4 Describe how the managerial finance function is related to economics and accounting.

LG 5 Identify the primary activities of the financial manager.

LG 6 Describe the nature of the principal–agent relationship between the owners and managers of a corporation, and explain how various corporate governance mechanisms attempt to manage agency problems.

Why This Chapter Matters to You

In your *professional* life

ACCOUNTING You need to understand the relationships between the accounting and finance functions within the firm, how decision makers rely on the financial statements you prepare, why maximizing a firm's value is not the same as maximizing its profits, and the ethical duty you have when reporting financial results to investors and other stakeholders.

INFORMATION SYSTEMS You need to understand why financial information is important to managers in all functional areas, the documentation that firms must produce to comply with various regulations, and how manipulating information for personal gain can get managers into serious trouble.

MANAGEMENT You need to understand the various legal forms of a business organization, how to communicate the goal of the firm to employees and other stakeholders, the advantages and disadvantages of the agency relationship between a firm's managers and its owners, and how compensation systems can align or misalign the interests of managers and investors.

MARKETING You need to understand why increasing a firm's revenues or market share is not always a good thing, how financial managers evaluate aspects of customer relations such as cash and credit management policies, and why a firm's brands are an important part of its value to investors.

OPERATIONS You need to understand the financial benefits of increasing a firm's production efficiency, why maximizing profit by cutting costs may not increase the firm's value, and how managers act on behalf of investors when operating a corporation.

In your *personal* life

Many of the principles of managerial finance also apply to your personal life. Learning a few simple financial principles can help you manage your own money more effectively.

Facebook

Not Much to "Like" about IPO

For its first 8 years, Facebook, Inc., operated as a privately held corporation. The company had relatively few shareholders and had no obligation to report its financial results to the public or to regulators such as the Securities and Exchange Commission (SEC), which allowed co-founder Mark Zuckerberg to focus his energy on building Facebook's rapidly growing business. Just 6 years after its awal;lahirnya inception in Zuckerberg's Harvard dorm room, Facebook's user base surpassed the 500 million mark, and pressure mounted on Zuckerberg to "take the company public" via an intial public offering (IPO) of common stock. Such a move would allow Facebook's early investors to cash out and would make dozens of Facebook's employees rich, none more so than Zuckerberg himself.

On May 18, 2012, Facebook launched its IPO by selling 421 million shares at a price of $38 per share. Almost immediately the price of Facebook stock rose as high as $45 per share, but there were signs of trouble. Technical problems on the Nasdaq stock exchange caused millions of orders for Facebook shares to be wrongly placed. Even worse, during the first month after Facebook's IPO, its share price fell to $30. Investors filed dozens of lawsuits, alleging that they were harmed not only by Nasdaq's trading glitches, but also by the selective release of unfavorable financial information by Facebook's investment bankers and its senior managers.

Once firms "go public" by selling shares to the public, they face a host of new pressures that private companies do not, so why do they go public at all? Often it is to provide an exit strategy for private investors, gain access to investment capital, establish a market price for the firm's shares, gain public exposure, or all those reasons. Going public helps firms grow, but that and other benefits of public ownership must be weighed against the costs of doing so. A public firm's managers work for and are responsible to the firm's investors, and government regulations require firms to provide investors with frequent reports disclosing material information about the firm's performance. The regulatory demands placed on managers of public firms can sometimes distract managers from important aspects of running their businesses. This chapter will highlight the trade-offs faced by financial managers as they make decisions intended to maximize the value of their firms.

LG 1 LG 2

1.1 Finance and Business

The field of finance is broad and dynamic. Finance influences everything that firms do, from hiring personnel to building factories to launching new advertising campaigns. Because there are important financial dimensions to almost any aspect of business, there are many financially oriented career opportunities for those who understand the principles of finance described in this textbook. Even if you do not see yourself pursuing a career in finance, you'll find that an understanding of a few key ideas in finance will help make you a smarter consumer and a wiser investor with your own money.

WHAT IS FINANCE?

finance
The science and art of managing money.

Finance can be defined as the science and art of managing money. At the personal level, finance is concerned with individuals' decisions about how much of their earnings they spend, how much they save, and how they invest their savings. In a business context, finance involves the same types of decisions: how firms raise money from investors, how firms invest money in an attempt to earn a profit, and how they decide whether to reinvest profits in the business or distribute them back to investors. The keys to good financial decisions are much the same for businesses and individuals, which is why most students will benefit from an understanding of finance regardless of the career path they plan to follow. Learning the techniques of good financial analysis will not only help you make better financial decisions as a consumer, but it will also help you understand the financial consequences of the important business decisions you will face no matter what career path you follow.

CAREER OPPORTUNITIES IN FINANCE

Careers in finance typically fall into one of two broad categories: (1) financial services and (2) managerial finance. Workers in both areas rely on a common analytical "tool kit," but the types of problems to which that tool kit is applied vary a great deal from one career path to the other.

Financial Services

financial services
The area of finance concerned with the design and delivery of advice and financial products to individuals, businesses, and governments.

Financial services is the area of finance concerned with the design and delivery of advice and financial products to individuals, businesses, and governments. It involves a variety of interesting career opportunities within the areas of banking, personal financial planning, investments, real estate, and insurance.

Managerial Finance

managerial finance
Concerns the duties of the *financial manager* in a business.

financial manager
Actively manages the financial affairs of all types of businesses, whether private or public, large or small, profit seeking or not for profit.

Managerial finance is concerned with the duties of the *financial manager* working in a business. **Financial managers** administer the financial affairs of all types of businesses: private and public, large and small, profit seeking and not for profit. They perform such varied tasks as developing a financial plan or budget, extending credit to customers, evaluating proposed large expenditures, and raising money to fund the firm's operations. In recent years, a number of factors have increased the importance and complexity of the financial manager's duties. These factors include the recent global financial crisis and subsequent responses by regulators, increased competition, and technological change. For example, globalization has led U.S. corporations to increase their transactions in other countries, and foreign corporations have done likewise in the United States. These changes increase demand for financial experts who can manage cash flows in different currencies and protect against the risks that arise from international transactions. These changes increase the finance function's complexity, but they also create opportunities for a more rewarding career. The increasing complexity of the financial manager's duties has increased the popularity of a variety of professional certification programs outlined in the *Focus on Practice* box below. Financial managers today actively develop and implement corporate strategies aimed at helping the firm grow and improve its competitive position. As a result, many corporate presidents and chief executive officers (CEOs) rose to the top of their organizations by first demonstrating excellence in the finance function.

LEGAL FORMS OF BUSINESS ORGANIZATION

One of the most important decisions all businesses confront is how to choose a legal form of organization. This decision has very important financial implications because how a business is organized legally influences the risks that the

focus on PRACTICE

Professional Certifications in Finance

in practice To be successful in finance and just about any other field, you need to continue your education beyond your undergraduate degree. For some people, it means getting a masters in business administration (MBA), but there are many other ways to advance your education and enhance your credentials without getting a graduate degree. In finance, a variety of professional certification programs are widely recognized in the field.

Chartered Financial Analyst (CFA): Offered by the CFA Institute, the CFA program is a graduate-level course of study focused primarily on the investments side of finance. To earn the CFA Charter, students must pass a series of three exams, usually over a 3-year period, and have 48 months of professional experience. Although this program appeals primarily to those who work in the investments field, the skills developed in the CFA program are useful in a variety of corporate finance jobs as well.

Certified Treasury Professional (CTP): The CTP program requires students to pass a single exam that is focused on the knowledge and skills needed for those working in a corporate treasury department. The program emphasizes topics such as liquidity and working capital management, payment transfer systems, capital structure, managing relationships with financial service providers, and monitoring and controlling financial risks.

Certified Financial Planner (CFP): To obtain CFP status, students must pass a 10-hour exam covering a wide range of topics related to personal financial planning. The CFP program also requires 3 years of full-time relevant experience. The program focuses primarily on skills relevant for advising individuals in developing their personal financial plans.

American Academy of Financial Management (AAFM): The AAFM administers a host of certification programs for financial professionals in a wide range of fields. Their certifications include the Chartered Portfolio Manager, Chartered Asset Manager, Certified Risk Analyst, Certified Cost Accountant, and Certified Credit Analyst as well as many other programs. See the AAFM website for complete details on all the AAFM educational programs.

Professional Certifications in Accounting: Most professionals in the field of managerial finance need to know a great deal about accounting to succeed in their jobs. Professional certifications in accounting include the Certified Public Accountant (CPA), Certified Management Accountant (CMA), and Certified Internal Auditor (CIA) as well as many other programs.

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

firm's owners must bear, how the firm can raise money, and how the firm's profits will be taxed. The three most common legal forms of business organization are the *sole proprietorship*, the *partnership*, and the *corporation*. More businesses are organized as sole proprietorships than any other legal form, but the largest businesses are almost always organized as corporations. Even so, each type of organization has its advantages and disadvantages.

Sole Proprietorships

Kepemilikan perseorangan

sole proprietorship
A business owned by one person and operated for his or her own profit.

A **sole proprietorship** is a business owned by one person who operates it for his or her own profit. About 61 percent of all businesses are sole proprietorships. The typical sole proprietorship is small, such as a bike shop, personal trainer, or plumber. The majority of sole proprietorships operate in the wholesale, retail, service, and construction industries.

Typically, the owner (proprietor), along with a few employees, operates the proprietorship. The proprietor raises capital from personal resources or by borrowing, and he or she is responsible for all business decisions. As a result, this form of organization appeals to entrepreneurs who enjoy working independently.

unlimited liability
The condition of a sole proprietorship (or general partnership), giving creditors the right to make claims against the owner's personal assets to recover debts owed by the business.

A major drawback to the sole proprietorship is **unlimited liability,** which means that liabilities of the business are the entrepreneur's responsibility and that creditors can make claims against the entrepreneur's personal assets if the business fails to pay its debts. The key strengths and weaknesses of sole proprietorships are summarized in Table 1.1.

Partnerships

partnership
A business owned by two or more people and operated for profit.

A **partnership** consists of two or more owners doing business together for profit. Partnerships account for about 8 percent of all businesses, and they are typically larger than sole proprietorships. Partnerships are common in the finance, insurance, and real estate industries. Public accounting and law partnerships often have large numbers of partners.

articles of partnership
The written contract used to formally establish a business partnership.

Most partnerships are established by a written contract known as **articles of partnership.** In a *general* (or *regular*) *partnership,* all partners have unlimited liability, and each partner is legally liable for *all* of the debts of the partnership. Table 1.1 summarizes the strengths and weaknesses of partnerships.

Matter of fact

BizStats.com Total Receipts by Type of U.S. Firm

Although there are vastly more sole proprietorships than there are partnerships and corporations combined, they generate the lowest level of receipts. In total, sole proprietorships generated more than $1.3 trillion in receipts, but this number hardly compares to the more than $50 trillion in receipts generated by corporations.

BizStats.com Total Receipts by Type of U.S. Firm

	Sole proprietorships	Partnerships	Corporations
Number of firms (millions)	23.1	3.1	7.7
Percentage of all firms	61%	8%	20%
Total receipts ($ billions)	1,324	4,244	50,757
Percentage of all receipts	2%	7%	80%

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

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

Corporations

corporation
An entity created by law.

stockholders
The owners of a corporation, whose ownership, or *equity*, takes the form of common stock or, less frequently, preferred stock.

limited liability
A legal provision that limits stockholders' liability for a corporation's debt to the amount they initially invested in the firm by purchasing stock.

common stock
The purest and most basic form of corporate ownership.

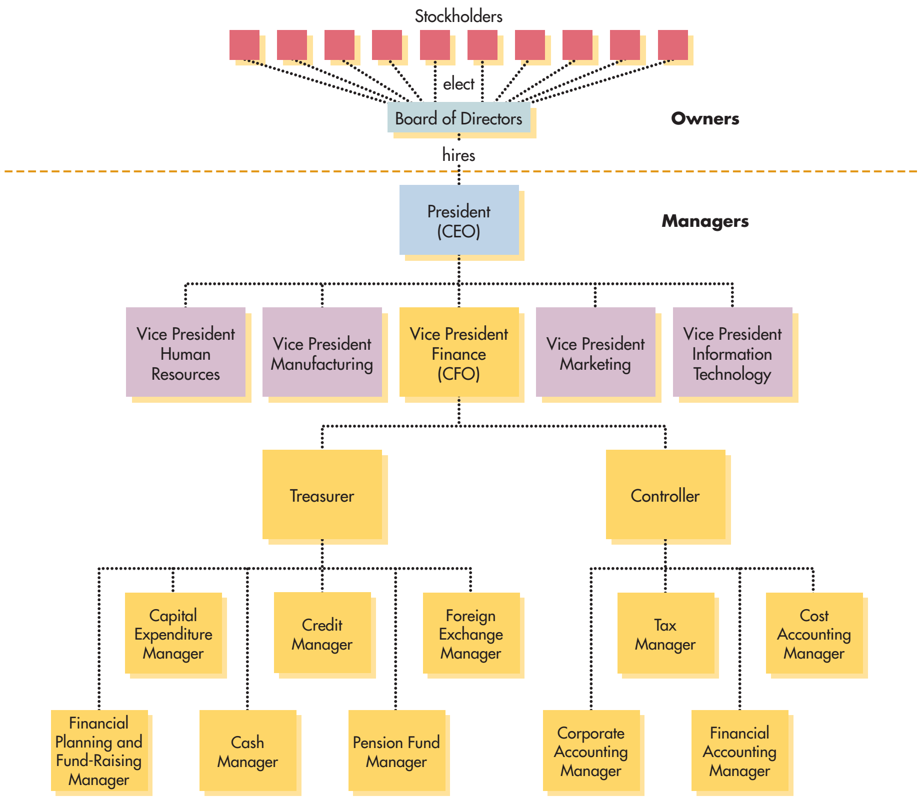
dividends
Periodic distributions of cash to the stockholders of a firm.

A **corporation** is an entity created by law. A corporation has the legal powers of an individual in that it can sue and be sued, make and be party to contracts, and acquire property in its own name. Although only about 20 percent of all U.S. businesses are incorporated, the largest businesses nearly always are; corporations account for roughly 80 percent of total business revenues. Although corporations engage in all types of businesses, manufacturing firms account for the largest portion of corporate business receipts and net profits. Table 1.1 lists the key strengths and weaknesses of corporations.

The owners of a corporation are its **stockholders**, whose ownership, or *equity,* takes the form of common stock or, less frequently, preferred stock. Unlike the owners of sole proprietorships or partnerships, stockholders of a corporation enjoy **limited liability**, meaning that they are not personally liable for the firm's debts. Their losses are limited to the amount they invested in the firm when they purchased shares of stock. In Chapter 7, you will learn more about common stock, but for now it is enough to say that **common stock** is the purest and most basic form of corporate ownership. Stockholders expect to earn a return by receiving **dividends**—periodic distributions of cash—or by realizing gains through increases in share price. Because the money to pay dividends generally comes from the profits that a firm earns, stockholders are sometimes referred to as *residual claimants,* meaning that stockholders are paid last, after employees,

FIGURE 1.1

Corporate Organization
The general organization of a corporation and the finance function (which is shown in yellow)



board of directors
Group elected by the firm's stockholders and typically responsible for approving strategic goals and plans, setting general policy, guiding corporate affairs, and approving major expenditures.

president or chief executive officer (CEO)
Corporate official responsible for managing the firm's day-to-day operations and carrying out the policies established by the board of directors.

Limited partnership (LP)
A partnership in which one or more partners have limited liability as long as at least one partner (the general partner) has unlimited liability. The limited partners are passive investors that cannot take an active role in the firm's management.

suppliers, tax authorities, and lenders receive what they are owed. If the firm does not generate enough cash to pay everyone else, there is nothing available for stockholders.

As noted in the upper portion of Figure 1.1, control of the corporation functions a little like a democracy. The stockholders (owners) vote periodically to elect members of the *board of directors* and to decide other issues such as amending the corporate charter. The **board of directors** is typically responsible for approving strategic goals and plans, setting general policy, guiding corporate affairs, and approving major expenditures. Most importantly, the board decides when to hire or fire top managers and establishes compensation packages for the most senior executives. The board consists of "inside" directors, such as key corporate executives, and "outside" or "independent" directors, such as executives from other companies, major shareholders, and national or community leaders. Outside directors for major corporations receive compensation in the form of cash, stock, and stock options. This compensation often totals $100,000 per year or more.

The **president or chief executive officer** (CEO) is responsible for managing day-to-day operations and carrying out the policies established by the board of directors. The CEO reports periodically to the firm's directors.

It is important to note the division between owners and managers in a large corporation, as shown by the dashed horizontal line in Figure 1.1. This separation and some of the issues surrounding it will be addressed in the discussion of *the agency issue* later in this chapter.

Other Limited Liability Organizations

A number of other organizational forms provide owners with limited liability. The most popular are **limited partnership** (LP), **S corporation** (S corp), **limited liability company** (LLC), and **limited liability partnership** (LLP). Each represents a specialized form or blending of the characteristics of the organizational forms described previously. What they have in common is that their owners enjoy limited liability, and they typically have fewer than 100 owners.

S corporation (S corp)
A tax-reporting entity that allows certain corporations with 100 or fewer stockholders to choose to be taxed as partnerships. Its stockholders receive the organizational benefits of a corporation and the tax advantages of a partnership.

Limited liability company (LLC)
Permitted in most states, the LLC gives its owners limited liability and taxation as a partnership. But unlike an S corp, the LLC can own more than 80% of another corporation, and corporations, partnership, or non-U.S. Residents can own LLC shares.

Limited liability partnership (LLP)
Permitted in most states, LLP partners are liable for their own acts of malpractice, but not for those of other partners. The LLP is taxed as a partnership and is frequently used by legal and accounting professionals.

WHY STUDY MANAGERIAL FINANCE?

An understanding of the concepts, techniques, and practices of managerial finance will fully acquaint you with the financial manager's activities and decisions. Because the consequences of most business decisions are measured in financial terms, the financial manager plays a key operational role. People in all areas of responsibility—accounting, information systems, management, marketing, operations, and so forth—need a general awareness of finance so that they will understand how to quantify the consequences of their actions.

OK, so you're not planning to major in finance! To improve your chance of success in your chosen business career, you still will need to understand how financial managers think. Managers in the firm, regardless of their job descriptions, usually have to provide financial justification for the resources they need to do their job. Whether you are hiring new workers, negotiating an advertising budget, or upgrading the technology used in a manufacturing process, understanding the financial aspects of your actions will help you gain the resources you need to be successful. The "Why This Chapter Matters to You" section that appears on each chapter-opening page should help you understand the importance of each chapter in both your professional and personal life.

As you study, you will learn about the career opportunities in managerial finance, which are briefly described in Table 1.2 below. Although we focus on publicly held profit-seeking firms, the principles presented are equally applicable to private and not-for-profit organizations. The decision-making principles

TABLE 1.2 Career Opportunities in Managerial Finance

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

developed can also be applied to personal financial decisions. We hope that this first exposure to the exciting field of finance will provide the foundation and initiative for further study and possibly even a future career.

→ REVIEW QUESTIONS

1–1 What is *finance*? Explain how this field affects all the activities in which businesses engage.
1–2 What is the *financial services* area of finance? Describe the field of *managerial finance*.
1–3 Which legal form of business organization is most common? Which form is dominant in terms of business revenues?
1–4 Describe the roles and the relationships among the major parties in a corporation: stockholders, board of directors, and managers. How are corporate owners rewarded for the risks they take?
1–5 Briefly name and describe some organizational forms other than corporations that provide owners with limited liability.
1–6 Why is the study of managerial finance important to your professional life regardless of the specific area of responsibility you may have within the business firm? Why is it important to your personal life?

LG 3

1.2 Goal of the Firm

What goal should managers pursue? There is no shortage of possible answers to this question. Some might argue that managers should focus entirely on satisfying customers. Progress toward this goal could be measured by the market share attained by each of the firm's products. Others suggest that managers must first inspire and motivate employees; in that case, employee turnover might be the key success metric to watch. Clearly, the goal managers select will affect many of the decisions they make, so choosing an objective is a critical determinant of how businesses operate.

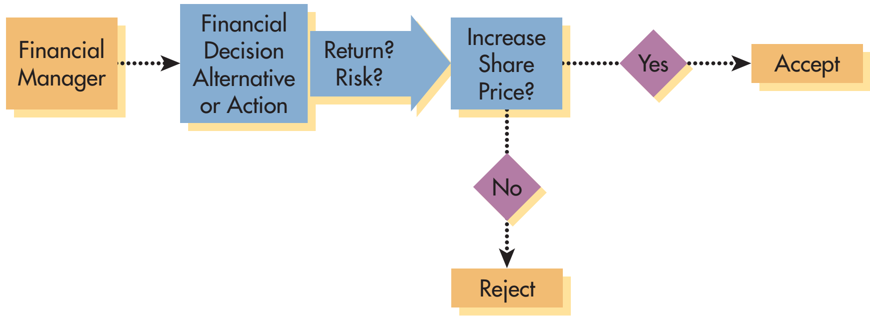
MAXIMIZE SHAREHOLDER WEALTH

Finance teaches that managers' primary goal should be to maximize the wealth of the firm's owners, the stockholders. The simplest and best measure of stockholder wealth is the firm's share price, so most textbooks (ours included) instruct managers to take actions that increase the firm's share price. A common misconception is that when firms strive to make their shareholders happy, they do so at the expense of other constituencies such as customers, employees, or suppliers. This line of thinking ignores that in most cases, to enrich shareholders, managers must first satisfy the demands of these other interest groups. Dividends that stockholders receive ultimately come from the firm's profits. It is unlikely that a firm whose customers are unhappy with its products, whose employees are looking for jobs at other firms, or whose suppliers are reluctant to ship raw materials will make shareholders rich because such a firm will likely be less profitable in the long run than one that better manages its relations with these stakeholder groups.

Therefore, we argue that the goal of the firm, and also of managers, should be *to maximize the wealth of the owners for whom it is being operated,* which in

FIGURE 1.2

Share Price Maximization
Financial decisions and share price



most instances is equivalent to *maximize the stock price*. This goal translates into a straightforward decision rule for managers: *Only take actions that are expected to increase the wealth of shareholders*. Although that goal sounds simple, implementing it is not always easy. To determine whether a particular course of action will increase or decrease shareholders' wealth, managers have to assess what return (that is, cash inflows net of cash outflows) the action will bring and how risky that return might be. Figure 1.2 depicts this process. In fact, we can say that *the key variables that managers must consider when making business decisions are return (cash flows) and risk*.

earnings per share (EPS)
The amount earned during the period on behalf of each outstanding share of common stock, calculated by dividing the period's total earnings available for the firm's common stockholders by the number of shares of common stock outstanding.

MAXIMIZE PROFIT?

It might seem intuitive that maximizing a firm's share price is equivalent to maximizing its profits. That thought is not always correct, however.

Corporations commonly measure profits in terms of **earnings per share (EPS)**, which represent the amount earned during the period on behalf of each outstanding share of common stock. EPS are calculated by dividing the period's total earnings available for the firm's common stockholders by the number of shares of common stock outstanding.

Example 1.1 ▸

MyFinanceLab Solution Video

Nick Dukakis, the financial manager of Neptune Manufacturing, a producer of marine engine components, is choosing between two investments, Rotor and Valve. The following table shows the EPS that each investment is expected to have over its 3-year life.

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

In terms of the profit maximization goal, Valve would be preferred over Rotor because it results in higher total earnings per share over the 3-year period ($3.00 EPS compared with $2.80 EPS).

Does profit maximization lead to the highest possible share price? For at least three reasons, the answer is often no. First, timing is important. An investment that provides a lower profit overall may be preferable to one that earns a lower profit in the short run. Second, profits and cash flows are not identical. The profit that a firm reports is simply an estimate of how it is doing, an estimate that is influenced by many different accounting choices firms make when assembling their financial reports. Cash flow is a more straightforward measure of the money flowing into and out of the company than profit is. Companies have to pay their bills with cash, not earnings, so cash flow is what matters most to financial managers. Third, risk matters a great deal. A firm that earns a low but reliable profit might be more valuable than another firm with profits that fluctuate a great deal (and therefore can be very high or very low at different times).

Timing

Because the firm can earn a return on funds it receives, *the receipt of funds sooner rather than later is preferred*. In our example, even though the total earnings from Rotor are smaller than those from Valve, Rotor provides much greater earnings per share in the first year. It's possible that by investing in Rotor, Neptune Manufacturing can reinvest the earnings that it receives in year 1 to generate higher profits overall than if it had invested in project Valve. If the rate of return that Neptune can earn on reinvested earnings is high enough, project Rotor may be preferred even though it does not alone maximize total profits.

Cash Flows

Profits do *not* necessarily result in cash flows available to the stockholders. There is no guarantee that the board of directors will increase dividends when profits increase. In addition, the accounting assumptions and techniques that a firm adopts can sometimes allow a firm to show a positive profit even when its cash outflows exceed its cash inflows.

Furthermore, higher earnings do not necessarily translate into a higher stock price. Only when earnings increases are accompanied by increased future cash flows is a higher stock price expected. For example, a firm with a high-quality product sold in a very competitive market could increase its earnings by significantly reducing its equipment maintenance expenditures. The firm's expenses would be reduced, thereby increasing its profits. If the reduced maintenance results in lower product quality, however, the firm may impair its competitive position, and its stock price could drop as many well-informed investors sell the stock in anticipation of lower future cash flows. In this case, the earnings increase was accompanied by lower future cash flows and therefore a lower stock price.

Risk

risk
The chance that actual outcomes may differ from those expected.

Profit maximization also fails to account for **risk**, the chance that actual outcomes may differ from those expected. A basic premise in managerial finance is that a trade-off exists between return (cash flow) and risk. *Return and risk are, in fact, the key determinants of share price, which represents the wealth of the owners in the firm.*

Cash flow and risk affect share price differently: Holding risk fixed, higher cash flow is generally associated with a higher share price. In contrast, holding cash flow fixed, higher risk tends to result in a lower share price because the

risk averse
Requiring compensation to bear risk.

stockholders do not like risk. In general, stockholders are **risk averse,** which means that they are only willing to bear risk if they expect compensation for doing so. In other words, investors expect to earn higher returns on riskier investments, and they will accept lower returns on relatively safe investments. The key point, which will be fully developed in Chapter 5, is that differences in risk can significantly affect the value of different investments.

WHAT ABOUT STAKEHOLDERS?

stakeholders
Groups such as employees, customers, suppliers, creditors, owners, and others who have a direct economic link to the firm.

Although maximization of shareholder wealth is the primary goal, many firms broaden their focus to include the interests of *stakeholders* as well as shareholders. **Stakeholders** are groups such as employees, customers, suppliers, creditors, owners, and others who have a direct economic link to the firm. A firm with a *stakeholder focus* consciously avoids actions that would prove detrimental to stakeholders. The goal is not to maximize stakeholder well-being but to preserve it.

The stakeholder view does not alter the goal of maximizing shareholder wealth. Such a view is often considered part of the firm's "social responsibility." It is expected to provide long-run benefit to shareholders by maintaining positive relationships with stakeholders. Such relationships should minimize stakeholder turnover, conflicts, and litigation. Clearly, the firm can better achieve its goal of shareholder wealth maximization by fostering cooperation with its other stakeholders rather than conflict with them.

THE ROLE OF BUSINESS ETHICS

business ethics
Standards of conduct or moral judgment that apply to persons engaged in commerce.

Business ethics are the standards of conduct or moral judgment that apply to persons engaged in commerce. Violations of these standards in finance involve a variety of actions: "creative accounting," earnings management, misleading financial forecasts, insider trading, fraud, excessive executive compensation, options backdating, bribery, and kickbacks. The financial press has reported many such violations in recent years, involving such well-known companies as JP Morgan and Capital One. As a result, the financial community is developing and enforcing ethical standards. The goal of these ethical standards is to motivate business and

Matter of fact

Firms Accelerate Dividends So That Shareholders Save on Taxes

One way firms can take actions that maximize the wealth of shareholders is by thinking carefully about the taxes their shareholders must pay on dividend payments. Starting with the Bush tax cuts in 2003, shareholders faced a modest 15 percent tax rate on most dividends. However, absent congressional action to extend the 2003 tax cuts, the tax rate on dividends would jump dramatically in 2013. With a political compromise looking unlikely in the 2012 election year, many firms announced plans to accelerate dividend payments that they had planned to make in early 2013 to late 2012. Washington Post Company, for example, announced that on December 27, 2012, it would pay out the entire $9.80 per share dividend that they had planned to distribute in 2013. What was the stock market's reaction to that announcement? Washington Post shares rose $5. By accelerating their dividend payments, companies such as Washington Post, Expedia, Inc., and luxury goods producer Coach, Inc., were increasing the wealth of their shareholders by helping them save taxes.

market participants to adhere to both the letter and the spirit of laws and regulations concerned with business and professional practice. Most business leaders believe that businesses actually strengthen their competitive positions by maintaining high ethical standards.

Considering Ethics

Robert A. Cooke, a noted ethicist, suggests that the following questions be used to assess the ethical viability of a proposed action.[1]

1. Is the action arbitrary or capricious? Does it unfairly single out an individual or group?
2. Does the action violate the moral or legal rights of any individual or group?
3. Does the action conform to accepted moral standards?
4. Are there alternative courses of action that are less likely to cause actual or potential harm?

Clearly, considering such questions before taking an action can help ensure its ethical viability.

Today, many firms are addressing the issue of ethics by establishing corporate ethics policies that outline a set of fundamental principles that guide what firms' employees must do or what they must not do. Some firms go further and make their ethical standards a centerpiece of their corporate image. For example, Google famously adopted the motto, "Don't be evil." Even for Google, however, ethical dilemmas are unavoidable in business. The *Focus on Ethics* box provides an example of ethical concerns raised by a new Google product, Google Glass.

A major impetus toward the development of ethics policies has been the Sarbanes-Oxley Act of 2002. The act requires firms to disclose whether they have a code of ethics in place, and firms must report any waivers of those codes for senior management. Companies that do not have a code of ethics must explain why they have not adopted one. Many firms require their employees to sign a formal pledge to uphold the firm's ethics policies. Such policies typically apply to employee actions in dealing with all corporate stakeholders, including the public.

ETHICS AND SHARE PRICE

An effective ethics program can enhance corporate value by producing a number of positive benefits. It can reduce potential litigation and judgment costs, maintain a positive corporate image, build shareholder confidence, and gain the loyalty, commitment, and respect of the firm's stakeholders. Such actions, by maintaining and enhancing cash flow and reducing perceived risk, can positively affect the firm's share price. *Ethical behavior is therefore viewed as necessary for achieving the firm's goal of owner wealth maximization.*

→ REVIEW QUESTIONS

1–7 What is the goal of the firm and, therefore, of all managers and employees? Discuss how one measures achievement of this goal.

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1. Robert A. Cooke, "Business Ethics: A Perspective," in *Arthur Andersen Cases on Business Ethics* (Chicago: Arthur Andersen, September 1991), pp. 2 and 5.

focus on **ETHICS**

Critics See Ethical Dilemmas in Google Glass?

in practice On June 27, 2012, at the Google I/O conference, Google introduced an exciting new product called Glass. Essentially a computer that users wear like a pair of eyeglasses, Google Glass performs many of the functions of a smart phone without requiring people to use their hands. To demonstrate the new product's capabilities, Google cofounder Sergey Brin parachuted out of a zeppelin wearing Glass and transmitted his descent live to those attending the conference.

Google offers an interesting case study on value maximization and corporate ethics. In 2004, Google's founders provided "An Owner's Manual" for shareholders, which stated that "Google is not a conventional company" and that the company's ultimate goal "is to develop services that significantly improve the lives of as many people as possible." The founders stressed that it was not enough for Google to run a successful business; they also want to use the company to make the world a better place. Brin's skydiving stunt made it clear that Google had come up with yet another product that would thrill customers. But what effect would Google Glass have on the general public? Reporters who wrote about high-tech products quickly shifted the focus of their stories from what it would be like to wear Google Glass to what it would be like to be around someone else wearing the product. The device obviously raised big concerns about the privacy of non-users. One Twitter user posted: "There is a kid using Google Glasses at this restaurant, which, until just now, used to be my favorite spot."

Google's famous corporate motto, "Don't Be Evil," is intended to convey Google's willingness to do the right thing even when doing so requires the firm to sacrifice in the short run. Google's approach does not appear to be limiting its ability to maximize value, as the company's share price increased more than 700 percent from 2004 to 2013! As this book was going to press, however, it remained unclear how Google might respond to critics of its Glass device.

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

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

Sources: **Creativegood.com**, "The Google Glass Feature No One Is Talking About," February 28, 2013; **slog.thestranger.com**, "The Closer Google Glass Gets, the More Ethical Dilemmas Appear," March 5, 2013.

1–8 For what three main reasons is profit maximization inconsistent with wealth maximization?

1–9 What is *risk*? Why must risk as well as return be considered by the financial manager who is evaluating a decision alternative or action?

1–10 Describe the role of corporate ethics policies and guidelines, and discuss the relationship that is believed to exist between ethics and share price.

LG 4 LG 5

1.3 Managerial Finance Function

People in all areas of responsibility within the firm must interact with finance personnel and procedures to get their jobs done. For financial personnel to make useful forecasts and decisions, they must be willing and able to talk to individuals in other areas of the firm. For example, when considering a new product, the financial manager needs to obtain sales forecasts, pricing guidelines, and advertising and promotion budget estimates from marketing personnel. The managerial finance function can be broadly described by considering its role within the organization, its relationship to economics and accounting, and the primary activities of the financial manager.

ORGANIZATION OF THE FINANCE FUNCTION

The size and importance of the managerial finance function depend on the size of the firm. In small firms, the finance function is generally performed by the accounting department. As a firm grows, the finance function typically evolves into a separate department linked directly to the company president or CEO through the chief financial officer (CFO). The lower portion of the organizational chart in Figure 1.1 on page 54 shows the structure of the finance function in a typical medium- to large-size firm.

treasurer
The firm's chief financial manager, who manages the firm's cash, oversees its pension plans, and manages key risks.

controller
The firm's chief accountant, who is responsible for the firm's accounting activities, such as corporate accounting, tax management, financial accounting, and cost accounting.

Reporting to the CFO are the treasurer and the controller. The **treasurer** (the chief financial manager) typically manages the firm's cash, investing surplus funds when available and securing outside financing when needed. The treasurer also oversees a firm's pension plans and manages critical risks related to movements in foreign currency values, interest rates, and commodity prices. The **controller** (the chief accountant) typically handles the accounting activities, such as corporate accounting, tax management, financial accounting, and cost accounting. The treasurer's focus tends to be more external, whereas the controller's focus is more internal.

foreign exchange manager
The manager responsible for managing and monitoring the firm's exposure to loss from currency fluctuations.

If international sales or purchases are important to a firm, it may well employ one or more finance professionals whose job is to monitor and manage the firm's exposure to loss from currency fluctuations. A trained financial manager can "hedge," or protect against such a loss, at a reasonable cost by using a variety of financial instruments. These **foreign exchange managers** typically report to the firm's treasurer.

RELATIONSHIP TO ECONOMICS

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

The field of finance is closely related to economics. Financial managers must understand the economic framework and be alert to the consequences of varying levels of economic activity and changes in economic policy. They must also be able to use economic theories as guidelines for efficient business operation. Examples include supply-and-demand analysis, profit-maximizing strategies, and price theory. The primary economic principle used in managerial finance is **marginal cost–benefit analysis,** the principle that financial decisions should be made and actions taken only when the added benefits exceed the added costs. Nearly all financial decisions ultimately come down to an assessment of their marginal benefits and marginal costs.

Example 1.2 ▸

Jamie Teng is a financial manager for Nord Department Stores, a large chain of upscale department stores operating primarily in the western United States. She is currently trying to decide whether to replace one of the firm's computer servers with a new, more sophisticated one that would both speed processing and handle a larger volume of transactions. The new computer would require a cash outlay of $8,000, and the old computer could be sold to net $2,000. The total benefits from the new server (measured in today's dollars) would be $10,000. The benefits over a similar time period from the old computer (measured in today's dollars) would be $3,000. Applying marginal cost–benefit analysis, Jamie organizes the data as follows:

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

Because the marginal (added) benefits of $7,000 exceed the marginal (added) costs of $6,000, Jamie recommends that the firm purchase the new computer to replace the old one. The firm will experience a net benefit of $1,000 as a result of this action.

RELATIONSHIP TO ACCOUNTING

The firm's finance and accounting activities are closely related and generally overlap. In small firms, accountants often carry out the finance function; in large firms, financial analysts often help compile accounting information. There are, however, two differences between finance and accounting; one is related to the emphasis on cash flows, and the other is related to decision making.

Emphasis on Cash Flows

accrual basis
In preparation of financial statements, recognizes revenue at the time of sale and recognizes expenses when they are incurred.

cash basis
Recognizes revenues and expenses only with respect to actual inflows and outflows of cash.

The accountant's primary function is to develop and report data for measuring the performance of the firm, assess its financial position, comply with and file reports required by securities regulators, and file and pay taxes. Using generally accepted accounting principles, the accountant prepares financial statements that recognize revenue at the time of sale (whether payment has been received or not) and recognize expenses when they are incurred. This approach is referred to as the **accrual basis.**

The financial manager, on the other hand, places primary emphasis on *cash flows,* the intake and outgo of cash. He or she maintains the firm's solvency by planning the cash flows necessary to satisfy its obligations and to acquire assets needed to achieve the firm's goals. The financial manager uses this **cash basis** to recognize the revenues and expenses only with respect to actual inflows and outflows of cash. Whether a firm earns a profit or experiences a loss, *it must have a sufficient flow of cash to meet its obligations as they come due.*

Example 1.3 ▸

MyFinanceLab Solution Video

Nassau Corporation, a small yacht dealer, sold one yacht for $100,000 in the calendar year just ended. Nassau originally purchased the yacht for $80,000. Although the firm paid in full for the yacht during the year, at year-end it has yet to collect the $100,000 from the customer. The accounting view and the financial view of the firm's performance during the year are given by the following income and cash flow statements, respectively.

Accounting view (accrual basis)	
Nassau Corporation income statement for the year ended 12/31	
Sales revenue	$100,000
Less: Costs	80,000
Net profit	$ 20,000

Financial view (cash basis)	
Nassau Corporation cash flow statement for the year ended 12/31	
Cash inflow	$ 0
Less: Cash outflow	80,000
Net cash flow	($80,000)

In an accounting sense, Nassau Corporation is profitable, but in terms of actual cash flow, it is a financial failure. Its lack of cash flow resulted from the uncollected accounts receivable of $100,000. Without adequate cash inflows to meet its obligations, the firm will not survive, regardless of its level of profits.

As the example shows, accrual accounting data do not fully describe the circumstances of a firm. Thus, the financial manager must look beyond financial statements to obtain insight into existing or developing problems. Of course, accountants are well aware of the importance of cash flows, and financial managers use and understand accrual-based financial statements. Nevertheless, the financial manager, by concentrating on cash flows, should be able to avoid insolvency and achieve the firm's financial goals.

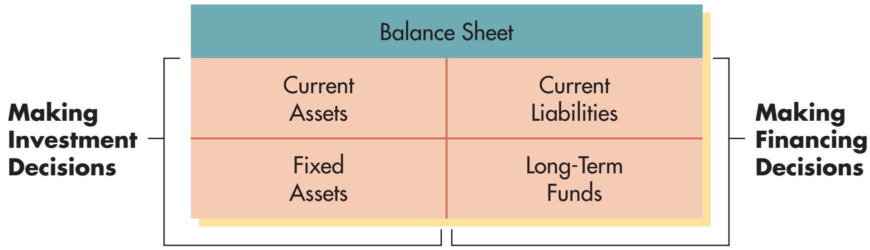
Personal Finance Example 1.4 ▶ Individuals do not use accrual concepts. Rather, they rely solely on cash flows to measure their financial outcomes. Generally, individuals plan, monitor, and assess their financial activities using cash flows over a given period, typically a month or a year. Ann Bach projects her cash flows during October 2015 as follows:

	Amount	
Item	**Inflow**	**Outflow**
Net pay received	$4,400	
Rent		−$1,200
Car payment		−450
Utilities		−300
Groceries		−800
Clothes		−750
Dining out		−650
Gasoline		−260
Interest income	220	
Misc. expense		−425
Totals	$4,620	−$4,835

Ann subtracts her total outflows of $4,835 from her total inflows of $4,620 and finds that her *net cash flow* for October will be −$215. To cover the $215 shortfall, Ann will have to either borrow $215 (putting it on a credit card is a form

FIGURE 1.3

Financial Activities
Primary activities of the financial manager



of borrowing) or withdraw $215 from her savings. Alternatively, she may decide to reduce her outflows in areas of discretionary spending such as clothing purchases, dining out, or areas that make up the $425 of miscellaneous expense.

Decision Making

The second major difference between finance and accounting has to do with decision making. Accountants devote most of their attention to the *collection and presentation of financial data*. Financial managers evaluate the accounting statements, develop additional data, and *make decisions* on the basis of their assessment of the associated returns and risks. Of course, it does not mean that accountants never make decisions or that financial managers never gather data but rather that the primary focuses of accounting and finance are distinctly different.

PRIMARY ACTIVITIES OF THE FINANCIAL MANAGER

In addition to ongoing involvement in financial analysis and planning, the financial manager's primary activities are making investment and financing decisions. Investment decisions determine what types of assets the firm holds. Financing decisions determine how the firm raises money to pay for the assets in which it invests. One way to visualize the difference between a firm's investment and financing decisions is to refer to the balance sheet shown in Figure 1.3. Investment decisions generally refer to the items that appear on the left-hand side of the balance sheet, and financing decisions relate to the items on the right-hand side. Keep in mind, though, that financial managers make these decisions based on their effect on the value of the firm, not on the accounting principles used to construct a balance sheet.

→ REVIEW QUESTIONS

1–11 In what financial activities does a corporate treasurer engage?
1–12 What is the primary economic principle used in managerial finance?
1–13 What are the major differences between accounting and finance with respect to emphasis on cash flows and decision making?
1–14 What are the two primary activities of the financial manager that are related to the firm's balance sheet?

LG 6

1.4 Governance and Agency

The majority of owners of a corporation are normally distinct from its managers. Managers are nevertheless entrusted to only take actions or make decisions that are in the best interests of the firm's owners, its shareholders. In most cases, if managers fail to act on the behalf of the shareholders, they will also fail to achieve the goal of maximizing shareholder wealth. To help ensure that managers act in ways that are consistent with the interests of shareholders and mindful of obligations to other stakeholders, firms aim to establish sound corporate governance practices.

CORPORATE GOVERNANCE

corporate governance
The rules, processes, and laws by which companies are operated, controlled, and regulated.

Corporate governance refers to the rules, processes, and laws by which companies are operated, controlled, and regulated. It defines the rights and responsibilities of the corporate participants such as the shareholders, board of directors, officers and managers, and other stakeholders as well as the rules and procedures for making corporate decisions. A well-defined corporate governance structure is intended to benefit all corporate stakeholders by ensuring that the firm is run in a lawful and ethical fashion, in accordance with best practices, and subject to all corporate regulations.

A firm's corporate governance is influenced by both internal factors such as the shareholders, board of directors, and officers as well as external forces such as clients, creditors, suppliers, competitors, and government regulations. The corporate organization, depicted in Figure 1.1 on page 54, helps shape a firm's corporate governance structure. In particular, the stockholders elect a board of directors, who in turn hire officers or managers to operate the firm in a manner consistent with the goals, plans, and policies established and monitored by the board on behalf of the shareholders.

Individual versus Institutional Investors

individual investors
Investors who own relatively small quantities of shares so as to meet personal investment goals.

To better understand the role that shareholders play in shaping a firm's corporate governance, it is helpful to differentiate between the two broad classes of owners: individuals and institutions. Generally, **individual investors** own relatively few shares and as a result do not typically have sufficient means to influence a firm's corporate governance. To influence the firm, individual investors often find it necessary to act as a group by voting collectively on corporate matters. The most important corporate matter individual investors vote on is the election of the firm's board of directors. The corporate board's first responsibility is to the shareholders. The board not only sets policies that specify ethical practices and provide for the protection of stakeholder interests, but it also monitors managerial decision making on behalf of investors.

institutional investors
Investment professionals such as banks, insurance companies, mutual funds, and pension funds that are paid to manage and hold large quantities of securities on behalf of others.

Although they also benefit from the presence of the board of directors, institutional investors have advantages over individual investors when it comes to influencing the corporate governance of a firm. **Institutional investors** are investment professionals that are paid to manage and hold large quantities of securities on behalf of individuals, businesses, and governments. Institutional investors include banks, insurance companies, mutual funds, and pension funds. Unlike individual investors, institutional investors often monitor and directly influence a firm's corporate governance by exerting pressure on management to perform or communicating their concerns to the firm's board. These large investors can also threaten to exercise their voting rights or liquidate their holdings if the board does not respond positively to their concerns. Because individual and institutional investors share the same goal, individual investors benefit from the shareholder activism of institutional investors.

Government Regulation

Unlike the effect that clients, creditors, suppliers, or competitors can have on a particular firm's corporate governance, government regulation generally shapes the corporate governance of all firms. During the past decade, corporate governance has received increased attention due to several high-profile corporate scandals involving abuse of corporate power and, in some cases, alleged criminal activity by corporate officers. The misdeeds derived from two main types of issues: (1) false disclosures in financial reporting and other material information releases and (2) undisclosed conflicts of interest between corporations and their analysts, auditors, and attorneys and between corporate directors, officers, and shareholders.

Asserting that an integral part of an effective corporate governance regime is provisions for civil or criminal prosecution of individuals who conduct unethical or illegal acts in the name of the firm, in July 2002 the U.S. Congress passed the **Sarbanes-Oxley Act of 2002** (commonly called **SOX**). Sarbanes-Oxley is intended to eliminate many of the disclosure and conflict of interest problems that can arise when corporate managers are not held personally accountable for their firm's financial decisions and disclosures. SOX accomplished the following: established an oversight board to monitor the accounting industry, tightened audit regulations and controls, toughened penalties against executives who commit corporate fraud, strengthened accounting disclosure requirements and ethical guidelines for corporate officers, established corporate board structure and membership guidelines, established guidelines with regard to analyst conflicts of interest, mandated instant disclosure of stock sales by corporate executives, and increased securities regulation authority and budgets for auditors and investigators.

Sarbanes-Oxley Act of 2002 (SOX)
An act aimed at eliminating corporate disclosure and conflict of interest problems. Contains provisions about corporate financial disclosures and the relationships among corporations, analysts, auditors, attorneys, directors, officers, and shareholders.

THE AGENCY ISSUE

We know that the duty of the financial manager is to maximize the wealth of the firm's owners. Shareholders give managers decision-making authority over the firm; thus, managers can be viewed as the *agents* of the firm's shareholders. Technically, any manager who owns less than 100 percent of the firm is an agent acting on behalf of other owners. This separation of owners and managers is shown by the dashed horizontal line in Figure 1.1 on page 54, and it is representative of the classic **principal–agent relationship,** where the shareholders are the principals. In general, a contract is used to specify the terms of a principal–agent relationship. This arrangement works well when the agent makes decisions that are in the principal's best interest but doesn't work well when the interests of the principal and agent differ.

principal–agent relationship
An arrangement in which an agent acts on the behalf of a principal. For example, shareholders of a company (principals) elect management (agents) to act on their behalf.

In theory, most financial managers would agree with the goal of shareholder wealth maximization. In reality, however, managers are also concerned with their personal wealth, job security, and fringe benefits. Such concerns may cause managers to make decisions that are not consistent with shareholder wealth maximization. For example, financial managers may be reluctant or unwilling to take more than moderate risk if they perceive that taking too much risk might jeopardize their job or reduce their personal wealth.

The Agency Problem

An important theme of corporate governance is to ensure the accountability of managers in an organization through mechanisms that try to reduce or eliminate the principal–agent problem; when these mechanisms fail, however, agency problems arise. **Agency problems** arise when managers deviate from the goal of maximization of shareholder wealth by placing their personal goals ahead of the goals of shareholders. These problems in turn give rise to agency costs. **Agency costs** are costs borne by shareholders due to the presence or avoidance of agency problems and in either case represent a loss of shareholder wealth. For example, shareholders incur agency costs when managers fail to make the best investment decision or when managers have to be monitored to ensure that the best investment decision is made because either situation is likely to result in a lower stock price.

agency problems
Problems that arise when managers place personal goals ahead of the goals of shareholders.

agency costs
Costs arising from agency problems that are borne by shareholders and represent a loss of shareholder wealth.

Management Compensation Plans

In addition to the roles played by corporate boards, institutional investors, and government regulations, corporate governance can be strengthened by ensuring that managers' interests are aligned with those of shareholders. A common approach is to *structure management compensation* to correspond with firm performance. In addition to combating agency problems, the resulting performance-based compensation packages allow firms to compete for and hire the best managers available. The two key types of managerial compensation plans are incentive plans and performance plans.

Incentive plans tie management compensation to share price. One incentive plan grants **stock options** to management. If the firm's stock price rises over time, managers will be rewarded by being able to purchase stock at the market price in effect at the time of the grant and then to resell the shares at the prevailing higher market price.

Many firms also offer **performance plans** that tie management compensation to performance measures such as earnings per share (EPS) or growth in EPS. Compensation under these plans is often in the form of performance shares or cash bonuses. **Performance shares** are shares of stock given to management as a result of meeting the stated performance goals, whereas **cash bonuses** are cash payments tied to the achievement of certain performance goals.

The execution of many compensation plans has been closely scrutinized in light of the past decade's corporate scandals and financial woes. Both individual and institutional stockholders as well as the Securities and Exchange Commission (SEC) and other government entities continue to publicly question the appropriateness of the multimillion-dollar compensation packages that many corporate executives receive. The total compensation in 2012 for the chief executive officers of the 500 largest U.S. companies is considerable. For example, the three highest-paid CEOs in 2012 were Larry Ellison of Oracle Corp., who earned $96.2 million; Richard Bracken of HCA, who earned $38.6 million; and Robert Iger of Disney, who earned $37.1 million.

incentive plans
Management compensation plans that tie management compensation to share price; one example involves the granting of *stock options.*

stock options
Options extended by the firm that allow management to benefit from increases in stock prices over time.

performance plans
Plans that tie management compensation to measures such as EPS or growth in EPS. *Performance shares, cash bonuses,* or both are used as compensation under these plans.

performance shares
Shares of stock given to management for meeting stated performance goals.

cash bonuses
Cash paid to management for achieving certain performance goals.

Matter of fact

How Closely Are Pay and Performance Linked?

A quick look at the compensation awarded to some of the highest paid CEOs in 2012 reveals that the link between pay and performance is not as strong as one might think. Oracle CEO Larry Ellison earned the highest pay during a year in which Oracle stock lost 22 percent of its value. Whirlpool's chairman, Jeff Fettig, earned less than one-seventh as much as Ellison, but Whirlpool's stock earned a return of almost 120 percent in 2012 (not shown in the table).

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

Most studies have failed to find a strong relationship between the performance that companies achieve and the compensation that CEOs receive. From 2007 to 2010, publicity surrounding these large compensation packages combined with weakness in the overall economy put downward pressure on executive compensation. Among the 500 largest U.S. companies, average CEO pay fell roughly 50 percent during this period. Contributing to negative publicity surrounding the pay-for-performance issue is the SEC requirement that publicly traded companies disclose to shareholders and others the amount of compensation paid to their CEO, CFO, three other highest-paid executives, and directors; the method used to determine it; and a narrative discussion regarding the underlying compensation policies. At the same time, new compensation plans that better link managers' performance to their compensation are being developed and implemented. As evidence of this trend, a survey of 50 large companies revealed that in 2009 only 35 percent of the compensation paid to CEOs was tied to company performance, but by 2012, those same 50 companies reported that 51 percent of CEO pay was linked to performance.

The Threat of Takeover

When a firm's internal corporate governance structure is unable to keep agency problems in check, it is likely that rival managers will try to gain control of the firm. Because agency problems represent a misuse of the firm's resources and impose agency costs on the firm's shareholders, the firm's stock is generally depressed, making the firm an attractive takeover target. The *threat of takeover* by another firm that believes it can enhance the troubled firm's value by restructuring its management, operations, and financing can provide a strong source of external corporate governance. The constant threat of a takeover tends to motivate management to act in the best interests of the firm's owners.

Unconstrained, managers may have other goals in addition to share price maximization, but much of the evidence suggests that share price maximization—the focus of this text—is the primary goal of most firms.

→ REVIEW QUESTIONS

1-15 What is *corporate governance*? How has the Sarbanes-Oxley Act of 2002 affected it? Explain.

1-16 Define *agency problems*, and describe how they give rise to *agency costs*. Explain how a firm's *corporate governance structure* can help avoid agency problems.

1-17 How can the firm *structure management compensation* to minimize agency problems? What is the current view with regard to the execution of many compensation plans?

1-18 How do market forces—both shareholder activism and the threat of takeover—act to prevent or minimize the *agency problem*? What role do *institutional investors* play in shareholder activism?

Summary

FOCUS ON VALUE

This chapter established the primary goal of the firm: **to maximize the wealth of the owners for whom the firm is being operated.** For public companies, value at any time is reflected in the stock price. Therefore, management should act only on those opportunities that are expected to create value for owners by increasing the stock price. Doing so requires management to consider the returns (magnitude and timing of cash flows), the risk of each proposed action, and their combined effect on value.

REVIEW OF LEARNING GOALS

LG 1 **Define** finance **and the managerial finance function.** Finance is the science and art of managing money. It affects virtually all aspects of business. Managerial finance is concerned with the duties of the *financial manager* working in a business. Financial managers administer the financial affairs of all types of businesses: private and public, large and small, profit seeking and not for profit. They perform such varied tasks as developing a financial plan or budget, extending credit to customers, evaluating proposed large expenditures, and raising money to fund the firm's operations.

LG 2 **Describe the legal forms of business organization.** The legal forms of business organization are the sole proprietorship, the partnership, and the corporation. The corporation is dominant in terms of business receipts, and its owners are its stockholders. Stockholders expect to earn a return by receiving dividends or by realizing gains through increases in share price.

LG 3 **Describe the goal of the firm, and explain why maximizing the value of the firm is an appropriate goal for a business.** The goal of the firm is to maximize its value and therefore the wealth of its shareholders. Maximizing the value of the firm means running the business in the interest of those who own it, the shareholders. Because shareholders are paid after other stakeholders, it is generally necessary to satisfy the interests of other stakeholders to enrich shareholders.

LG 4 **Describe how the managerial finance function is related to economics and accounting.** All areas of responsibility within a firm interact with finance personnel and procedures. The financial manager must understand the economic environment and rely heavily on the economic principle of marginal cost–benefit analysis to make financial decisions. Financial managers use accounting but concentrate on cash flows and decision making.

LG 5 **Identify the primary activities of the financial manager.** The primary activities of the financial manager, in addition to ongoing involvement in financial analysis and planning, are making investment decisions and making financing decisions.

LG 6 **Describe the nature of the principal–agent relationship between the owners and managers of a corporation, and explain how various corporate governance mechanisms attempt to manage agency problems.** This separation of owners and managers of the typical firm is representative of the classic principal–agent relationship, where the shareholders are the principals and managers are the agents. This arrangement works well when the agent makes decisions that are in the principal's best interest, but it can lead to agency problems when the interests of the principal and agent differ. A firm's corporate governance structure is intended to help ensure that managers act in the best interests of the firm's shareholders and other stakeholders, and it is usually influenced by both internal and external factors.

Opener-in-Review

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

Self-Test Problem (Solution in Appendix)

LG 4 **ST1–1** **Emphasis on Cash Flows** Worldwide Rugs is a rug importer located in the United States that resells its import products to local retailers. Last year, Worldwide Rugs imported $2.5 million worth of rugs from around the world, all of which were paid