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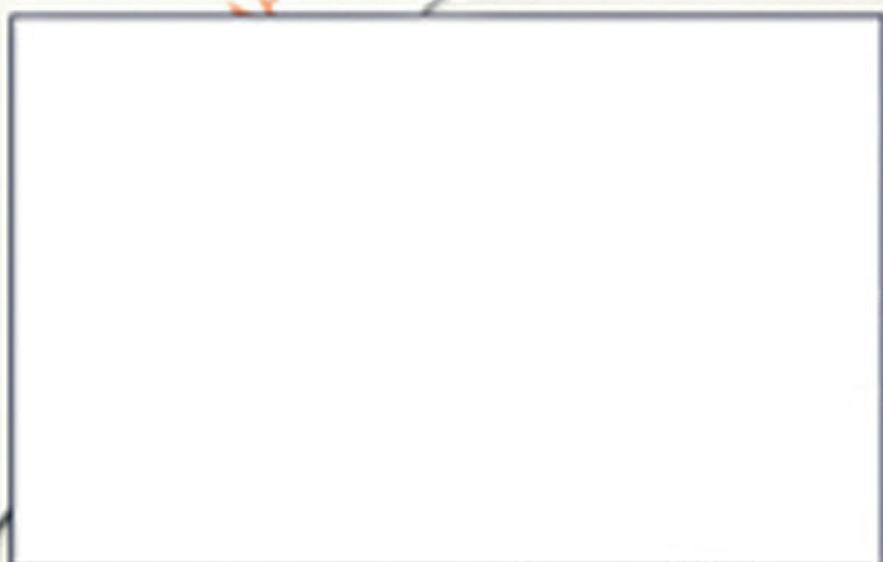

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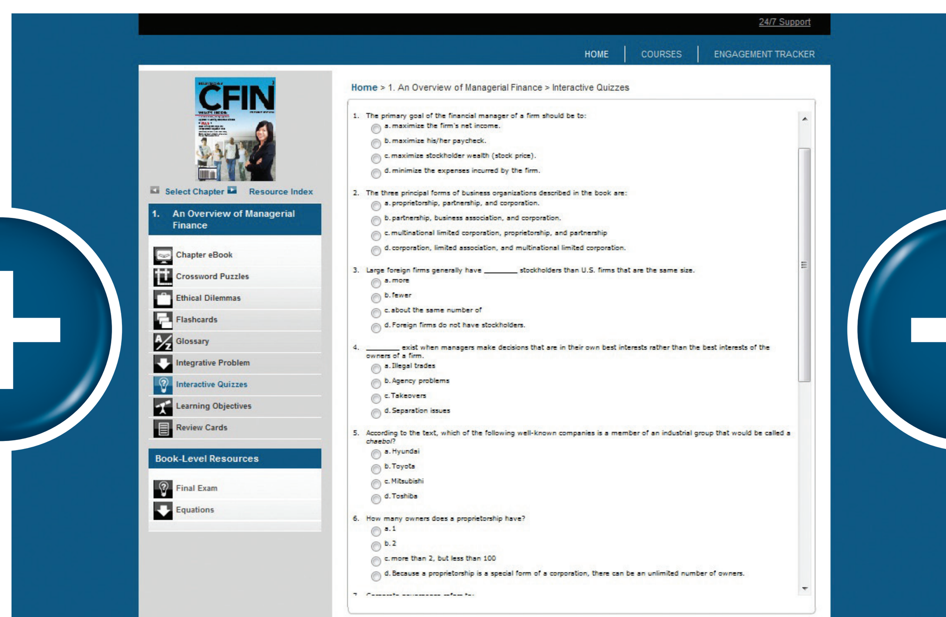

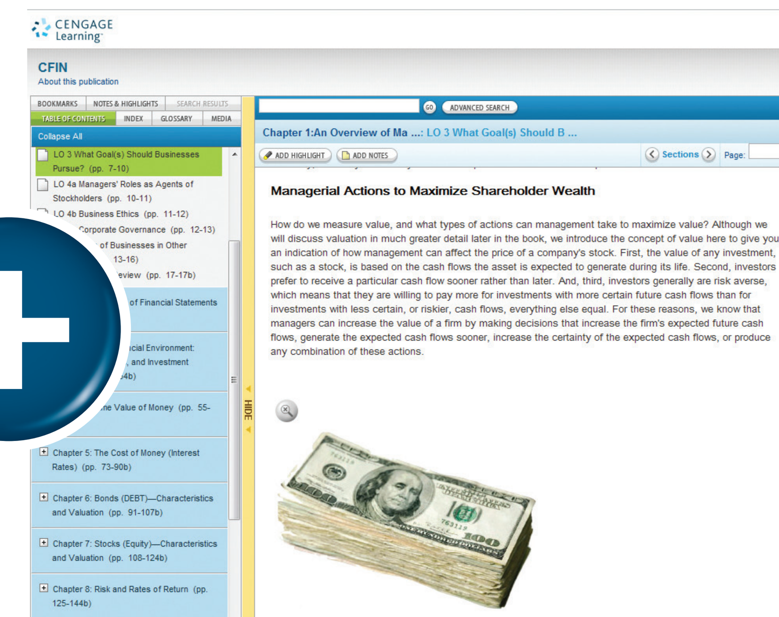

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Contents

PART 1 Introduction to Managerial Finance 1

1 An Overview of Managerial Finance 1

1-1 What is Finance? 2
- 1-1a General Areas of Finance 2
- 1-1b The Importance of Finance in Non-Finance Areas 2

1-2 Alternative Forms of Business Organization 4
- 1-2a Proprietorship 4
- 1-2b Partnership 5
- 1-2c Corporation 5
- 1-2d Hybrid Forms of Business: LLP, LLC, and S Corporation 6

1-3 What Goal(s) Should Businesses Pursue? 7
- 1-3a Managerial Actions to Maximize Shareholder Wealth 8
- 1-3b Should Earnings per Share (EPS) Be Maximized? 9
- 1-3c Managers' Roles as Agents of Stockholders 10

1-4 What Roles do Ethics and Governance Play in Business Success? 11
- 1-4a Business Ethics 11
- 1-4b Corporate Governance 12

1-5 Forms of Businesses in Other Countries 12
- 1-5a Multinational Corporations 14
- 1-5b Multinational versus Domestic Managerial Finance 15

Key Managerial Finance Concepts 16

PART 2 Essential Concepts in Managerial Finance 18

2 Analysis of Financial Statements 18

2-1 Financial Reports 19

2-2 Financial Statements 19
- 2-2a The Balance Sheet 19
- 2-2b The Income Statement 23
- 2-2c Statement of Cash Flows 25
- 2-2d Statement of Retained Earnings 27

2-3 Financial Statement (Ratio) Analysis 27
- 2-3a Liquidity Ratios 28
- 2-3b Asset Management Ratios 28
- 2-3c Debt Management Ratios 31
- 2-3d Profitability Ratios 32
- 2-3e Market Value Ratios 33
- 2-3f Comparative Ratios (Benchmarking) and Trend Analysis 33
- 2-3g Summary of Ratio Analysis: The DuPont Analysis 34

2-4 Uses and Limitations of Ratio Analysis 35

Key Financial Statement Analysis Concepts 36

3 The Financial Environment: Markets, Institutions, and Investment Banking 38

3-1 What Are Financial Markets? 39
- 3-1a Importance of Financial Markets 39

3-1b Flow of Funds 39
3-1c Market Efficiency 40
3-2 Types of Financial Markets 41
3-2a Stock Markets 42
3-2b Types of General Stock Market Activities 42
3-2c Physical Stock Exchanges 43
3-2d The Over-the-Counter (OTC) Market and NASDAQ 44
3-2e Electronic Communications Networks (ECN) 45
3-2f Competition Among Stock Markets 45
3-2g Regulation of Securities Markets 46
3-3 The Investment Banking Process 46
3-3a Raising Capital: Stage I Decisions 46
3-3b Raising Capital: Stage II Decisions 47
3-3c Raising Capital: Selling Procedures 48
3-4 Financial Intermediaries and Their Roles in Financial Markets 49
3-4a Types of Financial Intermediaries 50
3-5 International Financial Markets 51
3-5a Financial Organizations in Other Parts of the World 52
3-5b Recent Legislation of Financial Markets 53
Key Financial Environment Concepts 53

4 Time Value of Money 56

4-1 Cash Flow Patterns 57
4-2 Future Value (FV) 58
4-2a FV of a Lump-Sum Amount—FV_n 58
4-2b FV of an Ordinary Annuity—FVA_n 60
4-2c FV of an Annuity Due—$FVA(DUE)_n$ 60
4-2d FV of an Uneven Cash Flow Stream—$FVCF_n$ 61
4-3 Present Value (PV) 62
4-3a PV of a Lump-Sum Amount—PV 63
4-3b PV of an Ordinary Annuity—PVA_n 63
4-3c PV of an Annuity Due—$PVA(DUE)_n$ 64
4-3d Perpetuities 64
4-3e PV of an Uneven Cash flow Stream—$PVCF_n$ 65
4-3f Comparison of Future Value with Present Value 66
4-4 Solving for Interest Rates (r) or Time (n) 67
4-4a Solving for r 67
4-4b Solving for n 67
4-5 Annual Percentage Rate (APR) and Effective Annual Rate (EAR) 67
4-5a Semiannual and Other Compounding Periods 67
4-5b Comparison of Different Interest Rates 68
4-6 Amortized Loans 70
Key Time Value of Money Concepts 71

PART 3 Valuation—Financial Assets 73

5 The Cost of Money (Interest Rates) 73

5-1 The Cost of Money 74
5-1a Realized Returns (Yields) 74
5-1b Factors That Affect the Cost of Money 74
5-1c Interest Rate Levels 75
5-2 Determinants of Market Interest Rates 77
5-2a The Nominal, or Quoted, Risk-Free Rate of Interest, r_{RF} 78
5-2b Inflation Premium (IP) 78
5-2c Default Risk Premium (DRP) 78
5-2d Liquidity Premium (LP) 79
5-2e Maturity Risk Premium (MRP) 79
5-3 The Term Structure of Interest Rates 80
5-3a Why Do Yield Curves Differ? 80
5-3b Does the Yield Curve Indicate Future Interest Rates? 84
5-4 Other Factors That Influence Interest Rate Levels 85
5-4a Federal Reserve Policy 85
5-4b Federal Deficits 86
5-4c International Business (Foreign Trade Balance) 86
5-4d Business Activity 86
5-5 Interest Rate Levels and Stock Prices 86
5-5a The Cost of Money as a Determinant of Value 87
Key Cost of Money (Interest Rate) Concepts 87

6 Bonds (Debt)—Characteristics and Valuation 90

6-1 Characteristics and Types of Debt 91
- 6-1a Debt Characteristics 91
- 6-1b Types of Debt 91
- 6-1c Short-Term Debt 91
- 6-1d Long-Term Debt 93
- 6-1e Bond Contract Features 95
- 6-1f Foreign Debt Instruments 96

6-2 Bond Ratings 96
- 6-2a Bond Rating Criteria 96
- 6-2b Importance of Bond Ratings 97
- 6-2c Changes in Ratings 98

6-3 Valuation of Bonds 98
- 6-3a The Basic Bond Valuation Model 98
- 6-3b Bond Values with Semiannual Compounding 99

6-4 Finding Bond Yields (Market Rates): Yield to Maturity and Yield to Call 100
- 6-4a Yield to Maturity (YTM) 100
- 6-4b Yield to Call (YTC) 100

6-5 Interest Rates and Bond Values 101
- 6-5a Changes in Bond Values over Time 102
- 6-5b Interest Rate Risk on a Bond 103
- 6-5c Bond Prices in Recent Years 105

Key Bond Valuation and Characteristics Concepts 106

7 Stocks (Equity)—Characteristics and Valuation 108

7-1 Types of Equity 109
- 7-1a Preferred Stock 109
- 7-1b Common Stock 110
- 7-1c Equity Instruments in International Markets 112

7-2 Stock Valuation—The Dividend Discount Model (DDM) 113
- 7-2a Expected Dividends as the Basis for Stock Values 113
- 7-2b Valuing Stocks with Constant, or Normal, Growth (g) 114
- 7-2c Valuing Stocks with Nonconstant Growth 117

7-3 Other Stock Valuation Methods 120
- 7-3a Valuation Using P/E Ratios 120
- 7-3b Evaluating Stocks Using the Economic Value Added Approach 120

7-4 Changes in Stock Prices 121

Key Stock Valuation Concepts 122

8 Risk and Rates of Return 125

8-1 Defining and Measuring Risk 126
- 8-1a Probability Distributions 126

8-2 Expected Rate of Return 126
- 8-2a Measuring Total (Stand-Alone) Risk: The Standard Deviation (σ) 127
- 8-2b Coefficient of Variation (Risk/Return Ratio) 128
- 8-2c Risk Aversion and Required Returns 129

8-3 Portfolio Risk—Holding Combinations of Investments 129
- 8-3a Firm-Specific Risk versus Market Risk 132
- 8-3b The Concept of Beta 134
- 8-3c Portfolio Beta Coefficients 136

8-4 The Relationship between Risk and Rates of Return: The CAPM 136
- 8-4a The Impact of Inflation 138
- 8-4b Changes in Risk Aversion 138
- 8-4c Changes in a Stock's Beta Coefficient 139
- 8-4d A Word of Caution 139

8-5 Stock Market Equilibrium 139

8-6 Different Types of Risk 140

Key Risk and Return Concepts 142

PART 4 Valuation—Real Assets (Capital Budgeting) 144

9 Capital Budgeting Techniques 144

9-1 Importance of Capital Budgeting 145
- 9-1a Generating Ideas for Capital Projects 145

9-1b Project Classifications 146
9-1c The Post-Audit 146
9-2 Evaluating Capital Budgeting Projects 147
9-2a Net Present Value (NPV) 147
9-2b Internal Rate of Return (IRR) 149
9-3 Comparison of the NPV and IRR Methods 150
9-3a NPVs and Required Rates of Return—NPV Profiles 151
9-3b Independent Projects 152
9-3c Mutually Exclusive Projects 152
9-3d Cash Flow Patterns and Multiple IRRs 153
9-4 Modified Internal Rate of Return 154
9-5 Use of Capital Budgeting Techniques in Practice 156
9-5a Payback Period: Traditional (Nondiscounted) and Discounted 156
9-5b Conclusions on the Capital Budgeting Decision Methods 158
9-5c Capital Budgeting Methods Used in Practice 159
Key Capital Budgeting Concepts 160

10 Project Cash Flows and Risk 163

10-1 Cash Flow Estimation 164
10-1a Relevant Cash Flows 164
10-1b Incremental (Marginal) Cash Flows 165
10-1c Identifying Incremental Cash Flows 166
10-2 Capital Budgeting Project Evaluation 168
10-2a Expansion Projects 168
10-2b Replacement Analysis 171
10-3 Incorporating Risk in Capital Budgeting Analysis 174
10-3a Stand-Alone Risk 174
10-3b Corporate (Within-Firm) Risk 177
10-3c Beta (Market) Risk 177
10-3d Project Risk Conclusions 179
10-3e How Project Risk Is Considered in Capital Budgeting Decisions 179
10-4 Multinational Capital Budgeting 180
Key Concepts about Project Cash Flows and Risk 181
Appendix 10A Depreciation 183

PART 5 Cost of Capital and Capital Structure Concepts 185

11 The Cost of Capital 185

11-1 Component Costs of Capital 186
11-1a Cost of Debt, r_{dT} 186
11-1b Cost of Preferred Stock, r_{ps} 187
11-1c Cost of Retained Earnings (Internal Equity), r_s 188
11-1d Cost of Newly Issued Common Stock (External Equity), r_e 190
11-2 Weighted Average Cost of Capital (WACC) 191
11-2a Determining WACC 192
11-2b The Marginal Cost of Capital (MCC) 193
11-2c The MCC Schedule 193
11-2d Other Breaks in the MCC Schedule 195
11-3 Combining the MCC and Investment Opportunity Schedules (IOS) 197
11-4 WACC versus Required Rate of Return of Investors 199
Key Cost of Capital Concepts 201

12 Capital Structure 204

12-1 The Target Capital Structure 205
12-1a Business Risk 205
12-1b Financial Risk 206
12-2 Determining the Optimal Capital Structure 207
12-2a EPS Analysis of the Effects of Financial Leverage 208
12-2b EBIT/EPS Examination of Financial Leverage 211
12-2c The Effect of Capital Structure on Stock Prices and the Cost of Capital 212
12-3 Degree of Leverage 213
12-3a Degree of Operating Leverage (DOL) 214
12-3b Degree of Financial Leverage (DFL) 215
12-3c Degree of Total Leverage (DTL) 216
12-4 Liquidity and Capital Structure 217
12-5 Capital Structure Theory 218
12-5a Trade-Off Theory 218
12-5b Signaling Theory 219

12-6 Variations in Capital Structures among Firms 220
12-6a Capital Structures around the World 221
Key Capital Structure Concepts 222

13 Distribution of Retained Earnings: Dividends and Stock Repurchases 225

13-1 Dividend Policy and Stock Value 226
13-1a Information Content, or Signaling 226
13-1b Clientele Effect 227
13-1c Free Cash Flow Hypothesis 227
13-2 Dividend Payments in Practice 228
13-2a Residual Dividend Policy 228
13-2b Stable, Predictable Dividends 229
13-2c Constant Payout Ratio 230
13-2d Low Regular Dividend Plus Extras 231
13-2e Application of the Different Types of Dividend Payments: An Illustration 231
13-2f Payment Procedures 231
13-2g Dividend Reinvestment Plans (DRIPs) 233
13-3 Factors Influencing Dividend Policy 233
13-4 Stock Dividends and Stock Splits 234
13-4a Stock Splits 234
13-4b Stock Dividends 235
13-4c Price Effects of Stock Splits and Stock Dividends 235
13-4d Balance Sheet Effects of Stock Splits and Stock Dividends 235
13-5 Stock Repurchases 236
13-5a Advantages and Disadvantages of Stock Repurchases 237
13-6 Dividend Policies Around the World 238
Key Distribution of Retained Earnings Concepts 239

PART 6 Working Capital Management 242

14 Working Capital Policy 242

14-1 Working Capital 243
14-1a The Requirement for External Working Capital Financing 243
14-1b The Relationships among Working Capital Accounts 245
14-2 The Cash Conversion Cycle 248
14-3 Working Capital Investment and Financing Policies 252
14-3a Alternative Current Asset Investment Policies 252
14-3b Alternative Current Asset Financing Policies 253
14-4 Advantages and Disadvantages of Short-Term Financing 255
14-4a Speed 255
14-4b Flexibility 255
14-4c Cost of Long-Term versus Short-Term Debt 256
14-4d Risk of Long-Term versus Short-Term Debt 256
14-5 Multinational Working Capital Management 256
Key Working Capital Policy Concepts 257

15 Managing Short-Term Assets 260

15-1 Cash Management 261
15-1a The Cash Budget 261
15-1b Cash Management Techniques 265
15-1c Acceleration of Receipts 265
15-1d Disbursement Control 266
15-2 Marketable Securities 267
15-3 Credit Management 267
15-3a Credit Policy 267
15-3b Receivables Monitoring 268
15-3c Analyzing Proposed Changes in Credit Policy 269
15-4 Inventory Management 270
15-4a Types of Inventory 272
15-4b Optimal Inventory Level 272
15-4c Inventory Control Systems 275
15-5 Multinational Working Capital Management 276
15-5a Cash Management 276
15-5b Credit Management 276
15-5c Inventory Management 277
Key Concepts for Managing Short-Term Assets 277

16 Managing Short-Term Liabilities (Financing) 280

16-1 Sources of Short-Term Financing 281
- 16-1a Accruals 281
- 16-1b Accounts Payable (Trade Credit) 281
- 16-1c Short-Term Bank Loans 282
- 16-1d Commercial Paper 284

16-2 Computing the Cost of Short-Term Credit 285
- 16-2a Computing the Cost of Trade Credit (Accounts Payable) 286
- 16-2b Computing the Cost of Bank Loans 286
- 16–2c Computing the Cost of Commercial Paper 287
- 16–2d Borrowed (Principal) Amount versus Required (Needed) Amount 288

16–3 Use of Secured Short-Term Financing 289
- 16–3a Accounts Receivable Financing 290
- 16–3b Inventory Financing 291

Key Concepts for Managing Short-Term Liabilities 293

PART 7 Strategic Planning and Financing Decisions 295

17 Financial Planning and Control 295

17-1 Projected (Pro Forma) Financial Statements 296
- 17-1a Step 1: Forecast the Income Statement 296
- 17-1b Step 2: Forecast the Balance Sheet 297
- 17-1c Step 3: Raising the Additional Funds Needed 299
- 17-1d Step 4. Accounting for Financing Feedbacks 299
- 17-1e Analysis of the Forecast 300

17-2 Other Considerations in Forecasting 301
- 17-2a Excess Capacity 301
- 17-2b Economies of Scale 302
- 17-2c Lumpy Assets 302

17-3 Financial Control—Budgeting and Leverage 302
- 17-3a Operating Breakeven Analysis 302
- 17-3b Operating Leverage 305
- 17-3c Financial Breakeven Analysis 307
- 17-3d Financial Leverage 309
- 17-3e Combining Operating and Financial Leverage—Degree of Total Leverage (DTL) 311

17-4 Using Leverage and Forecasting for Control 312

Key Financial Planning and Control Concepts 313

Appendix A Using Spreadsheets to Solve Financial Problems 315

A-1 Setting up Mathematical Relationships 315

A–2 Solving Time Value of Money (TVM) Problems Using Preprogrammed Spreadsheet Functions 316
- A-2a Solving for Future Value (FV): Lump-Sum Amount and Annuity 317
- A-2b Solving for Present Value (PV): Lump-Sum Amount and Annuity 319
- A-2c Solving for r: Lump-Sum Amount and Annuity 320
- A-2d Solving for n: Lump-Sum Amount and Annuity 320
- A-2e Solving for Present Value and Future Value: Uneven Cash Flows 321
- A-2f Setting Up an Amortization Schedule 322

PART 1

Introduction to Managerial Finance

CHAPTER 1

An Overview of Managerial Finance

Learning Outcomes

- LO.1 Explain what finance entails and why everyone should have an understanding of basic financial concepts.
- LO.2 Identify different forms of business organization as well as the advantages and disadvantages of each.
- LO.3 Identify major goal(s) that firms pursue and what a firm's primary goal should be.
- LO.4 Explain the roles that ethics and good governance play in successful businesses.
- LO.5 Describe how foreign firms differ from U.S. firms and identify factors that affect financial decisions in multinational firms.

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

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1-1 What is Finance?

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

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

1-1a General Areas of Finance

The study of finance consists of four interrelated areas:

1. ***Financial markets and institutions***—Financial institutions, which include banks, insurance companies, savings and loans, and credit unions, are an integral part of the general financial services marketplace. The success of these organizations requires an understanding of factors that cause interest rates and other returns in the financial markets to rise and fall, regulations that affect such institutions, and various types of financial instruments, such as mortgages, automobile loans, and certificates of deposit, that financial institutions offer.

2. ***Investments***—This area of finance focuses on the decisions made by businesses and individuals as they choose securities for their investment portfolios. The major functions in the investments area are (a) determining the values, risks, and returns associated with such financial assets as stocks and bonds and (b) determining the optimal mix of securities that should be held in a portfolio of investments.

3. ***Financial services***—*Financial services* refer to functions provided by organizations that deal with the management of money. Persons who work in these organizations, which include banks, insurance companies, brokerage firms, and similar companies, provide services that help individuals and companies determine how to invest money to achieve such goals as home purchase, retirement, financial stability and sustainability, budgeting, and so forth.

4. ***Managerial (business) finance***—*Managerial finance* deals with decisions that all firms make concerning their cash flows, including both inflows and outflows. As a consequence, managerial finance is important in all types of businesses, whether they are public or private, and whether they deal with financial services or the manufacture of products. The duties encountered in managerial finance range from making decisions about plant expansions to choosing what types of securities should be issued to finance such expansions. Financial managers also have the responsibility for deciding the credit terms under which customers can buy, how much inventory the firm should carry, how much cash to keep on hand, whether to acquire other firms (merger analysis), and how much of each year's earnings should be paid out as dividends versus how much should be reinvested in the firm.

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

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

Everyone is exposed to finance concepts almost every day. For example, when you borrow to buy a car or house, finance concepts are used to determine the monthly

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

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

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

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

3. ***Accounting***—In many firms (especially small ones), it is difficult to distinguish between the finance function and the accounting function. Because the two disciplines are closely related, often accountants are involved in finance decisions and financial managers are involved in accounting decisions. As our discussions will show, financial managers rely heavily on accounting information, because making decisions about the future requires information that accountants provide about the past. As a consequence, accountants must understand how financial managers use accounting information in planning and decision making so that it can be provided in an accurate and timely fashion. Similarly, accountants must understand how accounting data are viewed (used) by investors, creditors, and others who are interested in the firm's operations.

4. ***Information Systems***—To make sound decisions, financial managers rely on accurate information that is available when needed. The process by which the delivery of such information is planned, developed, and implemented is costly, but so are the problems caused by a lack of good information. Without appropriate information, decisions relating to finance, management, marketing, and accounting could prove disastrous. Different types of information require different information systems, so information system specialists work with financial managers to determine what information is needed, how it should be stored, how it should be delivered, and how managing information affects the profitability of the firm.

5. ***Economics***—Finance and economics are so similar that some universities offer courses related to these two subjects in the same functional area (department). Many tools used to make financial decisions evolved from theories or models developed by economists. Perhaps the most noticeable difference between finance and economics is that financial managers evaluate information and make decisions about cash flows associated with a particular firm or a group of firms, whereas economists analyze information and forecast changes in activities associated with entire industries and the economy as a whole. It is important that financial managers understand economics and that economists understand finance, because economic activity and policy impact financial decisions, and vice versa.

Finance will be a part of your life no matter what career you choose. There will be a number of times during your life, both in business and in your personal finances, that you will make finance-related decisions. Therefore, it is vitally important that you have some understanding of general finance concepts. *There are financial implications in virtually all business decisions,*

and non-financial executives must know enough finance to incorporate these implications into their own specialized analyses. For this reason, every student of business, regardless of his or her major, should be concerned with finance.

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

1-2 Alternative Forms of Business Organization

There are three major forms of business organization in the United States: (1) proprietorships, (2) partnerships, and (3) corporations. In terms of numbers, 70–75 percent of businesses are operated as proprietorships, 8–10 percent are partnerships, and the remaining 15–20 percent are corporations. Based on the dollar value of sales, however, approximately 83 percent of all business is conducted by corporations, while the remaining 17 percent is generated by proprietorships (3–4 percent) and partnerships (13–14 percent).[1] Because most business is conducted by corporations, we will focus on that form in this book. However, it is important to understand the differences among the three major forms of business, as well as the popular "hybrid" forms of business that have evolved from these major forms.

1-2a Proprietorship

A **proprietorship** is an unincorporated business owned by one individual. Starting a proprietorship is fairly easy—just begin business operations.

proprietorship An unincorporated business owned by one individual.

The proprietorship has three important advantages:

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

The proprietorship also has four important limitations:

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

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

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

1-2b Partnership

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

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

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

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

1-2c Corporation

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

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

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

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

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

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

partnership An unincorporated business owned by two or more persons.

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. Setting up a corporation, as well as periodic 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 that initially will be issued, and so forth, must be filed with the secretary of the state in which the firm incorporates; and (b) a set of rules, called **bylaws**, that specify how the corporation will be governed must be drawn up by the founder.
2. Because the earnings of the corporation are taxed at the corporate level and then any earnings paid out as dividends are again taxed as income to stockholders, corporate earnings are subject to *double taxation*.[3]

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

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

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

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

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

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

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

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

[3]There was a push in Congress in 2003 to eliminate the double taxation of dividends by either treating dividends paid by corporations the same as interest—that is, making them a tax-deductible 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.

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

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. All else equal, *the lower the firm's risk, the higher its market value.*
2. *A firm's current value is related to its future growth opportunities,* and corporations can more easily attract funds to take advantage of growth opportunities than can unincorporated businesses (only corporations can issue stocks and bonds to raise funds).
3. Corporate ownership can be transferred more easily than ownership of either a proprietorship or a partnership. Therefore, all else equal, investors would be willing to pay more for a corporation than for a proprietorship or partnership, which means that the corporate form of organization can *enhance the value* of a business.

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

1-3 What Goal(s) Should Businesses Pursue?

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

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

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

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

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.

sustainable 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.[4]

1-3a 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 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 they are willing to pay more for investments with more certain future cash flows than for 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.

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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 them 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 a firm's value, because they affect the amount, timing, and riskiness of the cash flows the firm produces.

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

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. Based on both internal and 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 cash flows, the timing of these cash flows, as well as their eventual transfer to stockholders in the form of dividends, and the degree of risk inherent in the expected cash flows.

Figure 1.1 diagrams the general relationships involved in the valuation process. As you can see, and as 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 rates 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 restated in current dollars—that is, the *present (current) value* of the future cash flows.

[4]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 exists in the United States, prices are constrained by competition and consumer resistance. If a firm raises its prices beyond reasonable levels, it will simply lose its market share. Of course, firms want to earn more, and they constantly try to cut costs or develop new products in an attempt 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 that normal profits are generated; again, the main long-term beneficiary is the consumer.

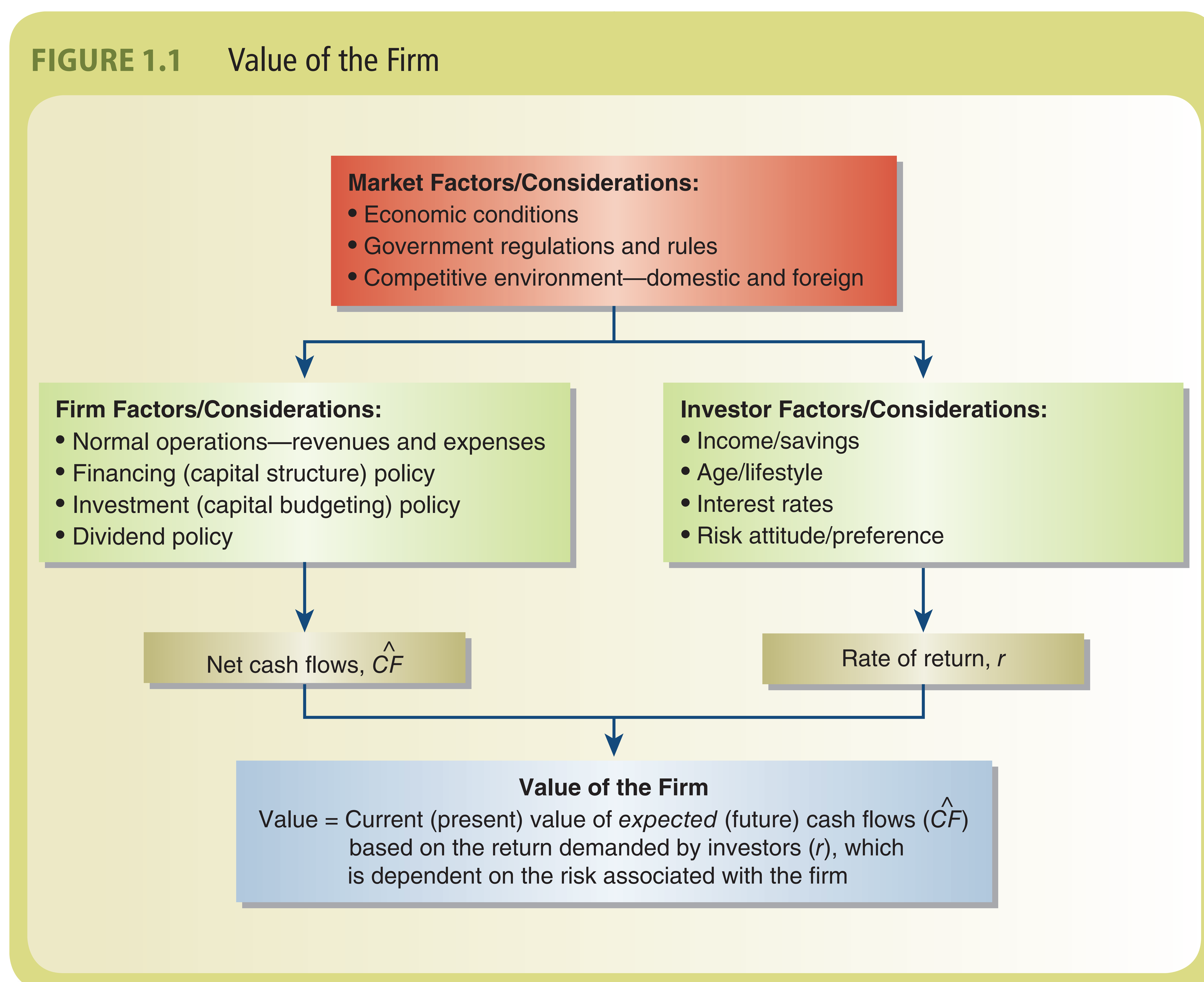

FIGURE 1.1 Value of the Firm

1-3b Should Earnings per Share (EPS) Be Maximized?

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, EPS = 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 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 those 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 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, consider 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 that 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 risk level 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 those cash flows are expected to occur, and (3) the risk associated with those cash flows. As we proceed through the book, you will discover that every significant corporate decision should be analyzed in terms of these factors and their effects on the firm's value, and hence the price of its stock.

1-3c Managers' Roles as Agents of Stockholders

Because they generally are not involved in day-to-day operations, stockholders of large corporations "permit" (empower) the executives to make decisions about 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. If a firm is a proprietorship, there is no agency relationship because the owner–manager operates 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.[5] However, if the owner–manager incorporates and sells some of the firm's stock to outsiders, potential conflicts of interest immediately arise. For example, the owner–manager (agent) might now decide not to work as hard to maximize shareholder (principals') wealth because less of the firm's wealth will go to him or her, or he or she 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 extremely 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 salaries, or more power, than about maximizing shareholder wealth.

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

Mechanisms used by large corporations to motivate managers to act in the shareholders' best interests include:

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 its performance in any particular year. For example, a company might implement a compensation plan where managers earn 100 percent of a specified reward when the company achieves a targeted growth rate. If the performance is above the target, higher rewards can 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 should be designed to accomplish two things: (1) Provide inducements to executives to act on those factors under their control in a manner that will contribute to stock price maximization. (2) 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 often "flex their muscles" to ensure that firms pursue goals that are in the best interests of shareholders rather than of the managers (where conflicts might arise). In addition, many institutional investors 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

[5]Perquisites (or "perks") 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.

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 noticed by corporate management.

In situations where large blocks of the stock are owned by a relatively few large institutions that 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 past years include Coca-Cola, General Motors, and United Airlines.

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 inefficient operations that result from poor management. In a hostile takeover, the managers of the acquired firm generally are fired, and those who stay on typically lose the power they had prior to the acquisition. Thus, to avoid takeover threats, managers have a strong incentive to take actions that maximize stock prices.

Because wealth maximization is a long-term goal rather than a short-term goal, management must be able to convey to stockholders that their best interests are being pursued. As you proceed through this book, you will discover that many factors affect the value of a stock, which make 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, because stockholders can generally determine which major decisions increase value and which ones decrease value.

1-4 What Roles do Ethics and Governance Play in Business Success?

In the previous section, we explained how the managers of a firm, who act as the agents of the owners, should make decisions that are in the best interests of the firm's investors. Would you consider it unethical for managers to act in their own best interests rather than the best interests of the owners? Would you invest in a firm that espoused unethical practices or had no direction about how the company's day-to-day operations should be handled? Probably not. In this section, we discuss business ethics and corporate governance, and the roles each of these concepts play in successful businesses.

1-4a Business Ethics

The word *ethics* can be defined as "moral behavior" or "standards of conduct." **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 it deals with 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.

Although most firms have policies that espouse ethical business conduct, there are many instances of large corporations that have engaged in unethical behavior. 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. Not long ago, the number of high-profile instances in which unethical behavior provided substantial gains for executives at the expense of stockholders' positions increased to the point where public outcry resulted in legislation aimed at arresting the apparent tide of unethical behavior in the corporate world. 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. As a result, Congress passed the Sarbanes-Oxley Act of 2002.

The 11 sections *(titles)* in the Sarbanes-Oxley Act of 2002 establish standards

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

business ethics A company's attitude and conduct toward its stakeholders (employees, customers, stockholders, and community). Ethical behavior requires fair and honest treatment of all parties.

for accountability and responsibility in reporting financial information for publicly traded 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 chief executive officer (CEO) and CFO must certify financial reports that are submitted to the Securities and Exchange Commission. The act also stiffens the criminal penalties that can be imposed for producing fraudulent financial information and gives regulatory bodies greater authority to prosecute 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 large firms have in place strong codes of ethical behavior, and they conduct training programs designed to ensure that all employees understand what the correct behavior is in different business situations. It is imperative that executives and 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. Investors expect nothing less.

1-4b Corporate Governance

The term *corporate governance* has become a regular part of business vocabulary. As a result of the scandals uncovered at Arthur Andersen, Enron, WorldCom, 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. 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 with an understanding of 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, most firms carefully write their corporate governance policies so that all **stakeholders**—managers, stockholders, creditors, customers, suppliers, and employees—better understand their rights and responsibilities.[6] In addition, from our previous discussions, it should be clear that maximizing shareholder wealth requires the fair treatment of all stakeholders.

corporate governance Deals with 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, including managers, employees, customers, suppliers, creditors, stockholders, and other parties with an interest in the firm's well-being.

Studies show firms that practice good corporate governance generate higher returns to stockholders than those that don't have good governance policies. Good corporate governance includes a board of directors with members who 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).[7]

1-5 Forms of Businesses in Other Countries

Large 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. While most developed

[6]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 treats both human stakeholders and environmental stakeholders fairly. A firm that destroys either the trust of its employees, customers, and shareholders, or the environment in which it operates, destroys itself.

[7]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.

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,* which means their stocks are widely dispersed among a large number of different investors, both individuals and institutions. 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, other domestic companies represent the primary group of shareholders, followed by families. Although banks in these countries do not hold large numbers of shares of stock, they can greatly influence companies because many shareholders assign banks their **proxy votes** for the directors of the companies. In addition, often the family unit has concentrated ownership and thus represents a major influence in many large companies in developed countries such as these. The ownership structures of these firms and many other large non-U.S. companies often are concentrated in the hands of a relatively few investors or investment groups. Such firms are considered *closed* because shares of stock often are not publicly traded, relatively few individuals or groups own the stock, and major stockholders generally are involved in the firms' daily operations.

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 can provide businesses with a greater variety of services than U.S. banks can, including short-term loans, long-term financing, and even stock ownership. 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 do not need to go public, and thus relinquish control in order to finance additional growth. The opposite is true in the United States, where large firms do not have comparable "one-stop" financing outlets. Hence, their growth generally must be financed by bringing in outside owners, which results in more widely dispersed ownership.

In some parts of the world, firms belong to **industrial groups**, which are organizations composed of companies in different industries that have common ownership interests and, in some instances, shared management. Firms in an industrial group are linked 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 create an organization that ties together all the functions of production and sales from start to finish by including firms that provide the materials and services required to manufacture and sell the group's products. Thus, an industrial group encompasses firms involved in manufacturing, financing, marketing, and distribution of products: 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,* while it is called a *chaebol* in Korea. Well-known *keiretsus* include Mitsubishi, Toshiba, and Toyota, while Hyundai probably is the most recognizable *chaebol*. 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 in 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

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

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

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 on short-term earnings, because these 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 both short-term and long-term survival. On the other hand, it also has been argued that the ownership structures of non-U.S. firms create an environment where it is difficult to change managers, especially if they are significant stockholders. Such entrenchment could be detrimental to firms if management is inefficient. Whether the ownership structure of non-U.S. firms is an advantage or a disadvantage is debatable. What we do know is that the greater concentration of ownership in non-U.S. firms permits greater monitoring and control by individuals or groups than do the more dispersed ownership structures of U.S. firms.

1-5a 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. Because large **multinational companies** are involved in all phases of the production process, from extraction of raw materials, through the manufacturing process, to distribution to consumers throughout the world, managers of such firms face a wide range of issues that are not present when a company operates in a single country.

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 that 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.

multinational companies
Firms that operate in two or more countries.

4. ***To seek production efficiency***—Companies in countries where production costs are high tend to shift production to low-cost countries. 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 U.K. drug company Beecham to merge in 1989 was the desire to

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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.

The substantial growth that has occurred in multinational business during the past few decades has created 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.

1-5b 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 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:

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 multinational financial analyses.
2. ***Economic and legal ramifications***—Each country in which the firm operates has its own 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 after-tax consequences that differ substantially depending on where a transaction occurs. In addition, 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. Persons born and educated in the United States often are at a disadvantage because they generally are fluent only in English, whereas European and Asian 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 American firms to penetrate international markets.
4. ***Cultural differences***—Even within geographic regions long considered fairly homogeneous, different countries have distinctive 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 by direct negotiation between the host government and the multinational corporation rather than in the marketplace. This is essentially a political process, and it must be treated as such.
6. ***Political risk***—The main characteristic that differentiates a nation from a multinational corporation is that the nation exercises sovereignty over the

exchange rates The prices at which the currency of one country can be converted into the currencies of other countries.