
CHAPTER 1

An Introduction to the Foundations of Financial Management

CHAPTER ORIENTATION

This chapter lays a foundation for what will follow. First, it focuses on the goal of the firm, followed by the five principles that form the foundations of financial management and the role of finance in business. The chapter then reviews the legal forms of business organization and discusses the tax implications relating to financial decisions. Finally, the chapter discusses the multinational firm and its role in finance.

CHAPTER OUTLINE

I. The Goal of the Firm

- A. In this book, we will designate maximization of shareholder wealth to be the goal of the firm, by which we mean maximization of the total market value of the firm's common stock.
- B. We have chosen the goal of shareholder wealth maximization because the effects of all financial decisions are included in this goal.
- C. In order to employ this goal, we need not consider every price change to be a market interpretation of the worth of our decisions. What we do focus on is the effect that our decision *should* have on the stock price if everything were held constant.

II. Five Principles That Form the Foundations of Finance

- A. **Principle 1: Cash Flow Is What Matters.** In measuring value, we will use cash flows rather than accounting profits because it is only cash flows that the firm receives and is able to reinvest. In addition, in making business decisions, we will concern ourselves with only what happens as a result of that decision.
- B. **Principle 2: Money Has a Time Value.** Almost all financial decisions involve comparing money in different periods, perhaps investing today and receiving returns later, or borrowing money today and paying it off later. A dollar received today is worth more than a dollar received in the future because of the time value of money.

- C. **Principle 3: Risk Requires a Reward.** There is a risk-return trade-off in finance—typical risk-averse investors won't take additional risk unless they expect to be compensated with additional return. Almost all financial decisions involve some sort of risk-return trade-off.
- D. **Principle 4: Market Prices Are Generally Right.** In general, financial markets are quick to impound new information into stock prices, and the prices tend to be correct.
- E. **Principle 5: Conflicts of Interest Cause Agency Problems.** Self-interested managers will not work for the owners' best interest unless it is in the managers' best interest as well. The corporate agency problem is a result of the separation of ownership from the decision makers of the firm. As a result, managers may make decisions that are not in line with the goal of maximization of shareholder wealth.
- F. **The Global Financial Crisis.**
- G. **Avoiding Financial Crisis—Back to the Principles.** Many of the financial problems of the past can be traced back to ignoring the basic principles of finance.
- H. **The Essential Elements of Ethics and Trust.** Ethical behavior is doing the right thing, and ethical dilemmas are everywhere in finance. Ethical behavior is important in financial management, just as it is important in everything we do. Businesses cannot interact unless they trust each other. Unfortunately, precisely how we define what is and is not ethical behavior is sometimes difficult. Nevertheless, we should not give up the quest.

III. The Role of Finance in Business

- A. Three basic types of issues are addressed by the study of finance.
 - 1. What long-term investments should the firm undertake? This area of finance is generally referred to as capital budgeting.
 - 2. How should the firm raise money to fund these investments? The firm's funding choices are generally referred to as capital structure decisions.
 - 3. How can the firm best manage its cash flows as they arise in its day-to-day operations? This area of finance is generally referred to as working capital management.
- B. Why Study Finance? Every area of business involves making choices that relate to the management of money over time. A basic knowledge of finance is necessary even for nonfinance majors. An understanding of finance is also important for management of personal finances.
- C. The Role of the Financial Manager. Firms have many different organizational structures. Financial officers may fill any of the following roles: vice-president for finance, chief financial officer (CFO), treasurer, or controller.

IV. The Legal Forms of Business Organization

A. Sole Proprietorships

1. **Sole proprietorship:** A business owned by a single individual, which has a minimum amount of legal structure.
2. The predominant form of business organization in the United States in total numbers is the sole proprietorship.
3. There are several advantages of sole proprietorships.
 - a. They are easily established with few complications.
 - b. There are minimal organizational costs.
 - c. The owner does not have to share profits or control with others.
4. There are some disadvantages of sole proprietorships.
 - a. There is unlimited liability for the owner.
 - b. The owner must absorb all losses.
 - c. Equity capital is limited to the owner's personal investment.
 - d. The business terminates immediately upon owner's death.

B. Partnerships

1. **Partnership:** An association of two or more individuals coming together as co-owners to operate a business for profit.
2. Partnerships come in two types.
 - a. General partnership: This is a partnership in which all partners are fully liable for the indebtedness incurred by the partnership. The relationship between partners is dictated by the partnership agreement.
 - (1) General partnerships have some advantages.
 - (a) The organizational requirements are minimal.
 - (b) The government regulations are negligible.
 - (2) General partnerships have some disadvantages.
 - (a) All partners have unlimited liability.
 - (b) It can be difficult to raise large amounts of capital.
 - (c) The partnership is dissolved by the death or withdrawal of the general partner.
 - b. Limited partnership: This is a partnership in which one or more of the partners has limited liability, restricted to the amount of capital he or she invests in the partnership.
 - (1) Limited partnerships have some advantages.

- (a) For the limited partners, liability is limited to the amount of capital invested in the company.
 - (b) The withdrawal or death of a limited partner does not affect the continuity of the business.
 - (c) Limited partners have a stronger incentive to invest, improving the partnership's ability to raise capital.
- (2) Limited partnerships have some disadvantages .
- (a) At least one general partner must have unlimited liability in the partnership.
 - (b) The names of the limited partners may not appear in the name of the firm.
 - (c) The limited partners may not participate in the management of the business.
 - (d) It is more expensive to organize than a general partnership, as a written agreement is mandatory.

C. Corporations

1. **Corporation:** An “impersonal” legal entity having the power to purchase, sell, and own assets and to incur liabilities while existing separately and apart from its owners.
2. Ownership of a corporation is evidenced by shares of stock.
3. The corporate form of organization has several advantages .
 - a. The owners have limited liability.
 - b. Transferability of ownership is relatively easy through the sale of one's shares of stock.
 - c. The death of an owner does not result in the discontinuance of the firm.
 - d. The ability to raise large amounts of capital is increased.
4. The corporate form of organization has some disadvantages.
 - a. It is the most difficult and expensive form of business to establish.
 - b. Control of the corporation is not guaranteed by partial ownership of stock.
 - c. Corporations also suffer from a double taxation of dividends. The firm first pays taxes on the income it earns; after paying taxes on this income, the income is paid to investors in the form of dividends. The investor then pays personal taxes on that dividend income.

D. Organizational Form and Taxes: The Double Taxation on Dividends

E. S-Corporations and Limited Liability Companies (LLC)

1. The S-corporation provides limited liability while allowing the business owners to be taxed as if they were a partnership—that is, distributions back to the owners are not taxed twice as is the case with dividends paid by corporations.
2. The limited liability company (LLC) is a cross between a partnership and a corporation. The LLC retains limited liability for its owners but is run and taxed like a partnership.

F. Which Organizational Form Should Be Chosen?

V. Finance and the Multinational Firm: The New Role

ANSWERS TO END-OF-CHAPTER REVIEW QUESTIONS

- 1-1. There are some practical problems implementing the goal of maximization of shareholder wealth, i.e., maximization of the market value of the firm's common stock. Many things affect stock prices, so identifying which changes in stock price are due to management decisions and which changes are due to external factors such as the state of the economy may be difficult. There may also be uncertainty about the eventual financial pay-off of certain business investments. Managers and investors may have different time horizons and different risk preferences, which can affect their valuation of the firm. In addition, managers may not always act in the best interest of shareholders, a classic case of an agency problem.
- 1-2. No. The goal of shareholder wealth maximization must be viewed as a long-run goal. As such, the public image of the firm may be of concern inasmuch as it may affect sales and potential legislation. Thus, while these actions may not directly result in increased profits, they may affect consumers' and legislators' attitudes. In addition, charitable contributions are a form of marketing for the firm. If people who hear about the donations buy more products in the future, the expenditure today may lead to increased revenue and profit in the future.
- 1-3. Almost all financial decisions involve some sort of risk-return trade-off. The more risk the firm is willing to accept, the higher the expected return for the given course of action. For example, in the area of working capital management, the less inventory held, the higher the expected return, but also the greater the risk of running out of inventory. While one manager might accept a given level of risk, another more risk-averse manager may not accept that level of risk. This does not mean that one manager is correct and one is not; rather, it only means that not all managers will view the risk-return trade-off in the same manner.
- 1-4. The corporate agency problem is a result of the separation of ownership from management, where managers do what is in their own best interests rather than what is in the best interest of the shareholders. Large firms are typically run by professional managers who own a small fraction of the firms' equity. The individual actions of these managers are often motivated by self-interest, which may result in managers not acting in the best interests of the firm's owners. When this happens, the value of the firm will decrease.
- 1-5. a. A sole proprietorship is a business owned by a single individual who maintains complete title to the assets and is also personally liable for all indebtedness incurred.
- b. A partnership is an association of two or more individuals coming together as co-owners for the purpose of operating a business. The partnership is similar to the sole proprietorship, except that the partnership has multiple owners.
- c. A corporation is a legal entity functioning separate and apart from its owners. It can individually sue and be sued, purchase, sell, or own property, and be subject to criminal punishment for crimes.

- 1-6. a. The sole proprietor maintains title to the firm's assets, has unlimited liability, and is entitled to the profits from the business, but must also absorb any losses realized. This form of business is easily initiated. Termination of the business comes by the owner discontinuing the business or upon his or her death.
- b. In a partnership, all general partners have unlimited liability. Each partner is liable for the actions of the other partners. The partnership agreement dictates the basic relationships among the partners within the firm. As with the sole proprietorship, the partnership is terminated upon the desires of any partner within the organization, or upon a partner's death. Under certain conditions, a partner's liability may be restricted to the amount of capital invested in the partnership. However, at least one general partner must remain in the association for whom the privilege of limited liability does not apply.
- c. The corporation is legally separate from its owners. Ownership of the corporation is determined by the number of shares of common stock owned by an individual. Because the shares are transferable, the ownership in a corporation may be easily transferred. Investors' liability is limited to the amount of their investment. The life of the corporation does not depend on the status of the investors. The death or withdrawal of an investor does not disrupt the corporate life. However, the cost of forming a corporation is more expensive than a proprietorship or partnership.
- 1-7. a. Organizational requirements and costs favor the sole proprietorship or possibly the general partnership depending upon the approach taken in forming the partnership.
- b. With a corporation, owners have minimum liabilities.
- c. Here the corporation is definitely the most favorable form of business organization because it provides for the continuity of the business regardless of an owner's withdrawal or death.
- d. If ease of ownership transferability is desired, the corporation is best. However, because of certain circumstances, the owners may prefer that ownership not be easily transferred, in which case the partnership would be the most desirable.
- e. The sole proprietor is able to maintain complete and ultimate control and minimize regulations.
- f. The corporation is the strongest form of legal entity in terms of the ease of raising capital from external investors.
- g. In regard to income taxes, it is difficult to determine which form of business is the most advantageous. Such a selection is dependent upon individual circumstances including the tax benefits available to a company and an owner's tax bracket.
- 1-8. This is an Internet question. Answers will vary.
- 1-9. This is an Internet question. Answers will vary.
- 1-10. This is an Internet question. Answers will vary.

SOLUTION TO MINI CASE

- a. The goal of profit maximization is too simplistic in that it assumes away the problems of uncertainty of returns and the timing of returns. Rather than use this goal, we have chosen maximization of shareholders' wealth—that is, maximization of the market value of the firm's common stock—because the effects of all financial decisions are included. Shareholders react to poor investment or dividend decisions by causing the total value of the firm's stock to fall and react to good decisions by pushing the price of the stock upward. In this way, all financial decisions are evaluated, and all financial decisions affect shareholder wealth.
- b. Simply put, investors will not put their money in risky investments unless they are compensated for taking on that additional risk. In effect, the return investors expect is made up of two parts. First, they receive a return for delaying consumption, which must be greater than the anticipated rate of inflation. Second, they receive a return for taking on added risk. Otherwise, both risky and safe investments would have the same expected return associated with them, and no one would take on the risky investments.
- c. The firm receives cash flows and is able to reinvest them, which cannot be done with accounting profits. In effect, accounting profits are shown when they are earned rather than when the money is actually in hand. Unfortunately, a firm's accounting profits and cash flows may not be timed to occur together. For example, capital expenses, such as the purchase of a new plant or piece of equipment, are depreciated over several years, with the annual depreciation subtracted from profits. However, the cash flow associated with these expenses generally occurs immediately. It is the cash inflows that can be reinvested and cash outflows that involve paying out money. Therefore, cash flows correctly reflect the true timing of the benefits and costs of financial decisions.
- d. In an efficient market, information is impounded into security prices with such speed that investors have no opportunities to profit from publicly available information. Actually, what types of information are immediately reflected in security prices and how quickly that information is reflected determine how efficient the market actually is. The implications for us are that stock prices reflect all publicly available information regarding the value of the company. This means we can implement our goal of maximization of shareholder wealth by focusing on the effect each decision should have on the stock price, all else held constant. It also means that earnings manipulations through accounting changes should not result in price changes. In effect, our preoccupation with cash flows is validated.
- e. An agency problem occurs when an agent (someone acting on behalf of another person) takes action that is not in the best interest of the principal (the person engaging the agent to perform some task). For companies where management is separate from ownership, managers may make decisions that are not in line with the goal of maximization of shareholder wealth. To control this problem, shareholders monitor managers through oversight by a board of directors and try to align the interests of shareholders and managers by various contractual means. The interests of shareholders and managers can be aligned by setting up appropriate compensation packages with stock options, bonuses,

and perquisites that are tied directly to how closely management decisions coincide with the interest of shareholders.

- f. Business interaction is based upon trust, and there is no way that trust can be eliminated quicker than through an ethical violation. The fall of Ivan Boesky and Drexel, Burnham, Lambert, the near collapse of Salomon Brothers in the 1980s, and the collapse of Enron and WorldCom in the 2000s illustrate this fact. As a result, acting in an ethical manner is not only morally correct, but it is congruent with our goal of maximization of shareholder wealth.
- g.
 - (1) A sole proprietorship is a business owned by a single individual who maintains complete title to the assets and is also personally liable for all indebtedness incurred.
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