

Chapter 1

The Role of Accounting and Finance

Chapter Topics

1. Finance in the organization structure of the firm
2. Responsibilities of financial managers
 - a. Supporting all activities of the firm
 - b. Developing information flow systems
 - c. R&D and investment decisions (capital budgeting)
 - d. Financing sources, forms, and methods
 - e. Payout policies
 - f. Corporate governance
 - g. Complying with new regulatory requirements
 - h. Contribution to the firm's ethical reputation
3. Goals of the firm
4. The changing economic and financial environments
5. Organization of this book
6. The Hershey Company
7. Key concepts

Answers to Questions

1.1. The main functions of financial managers are:

- To raise funds from external financial sources.
- To allocate funds among different uses.
- To manage the flow of funds involved in the operation of the enterprise.
- To provide for returns to investors and other sources of financing of the firm.

In short, the main functions of financial managers are to plan for, acquire, and utilize funds to make the maximum contribution to the efficient operation of an organization.

1.2.

- a. The argument for the divisional vice president of finance to report to the division president directly is that the division is a profit center.
- b. The argument for the divisional vice president of finance to report directly to the corporate CFO is that the overall performance of the firm is what really matters. Optimization for the firm should dominate segment optimization.

1.3. The reason is that all major endeavors have significant financial implications.

1.4. Profit maximization would have to be from a long-run standpoint to be meaningful at all. However, it would still be deficient in not considering the risk of alternative income streams. Wealth maximization is a better goal because it takes into account both the stream of income, or cash flow, over a period of years and the appropriate capitalization factor which reflects the degree of risk involved.

1.5. One interpretation is that shareholders may seek to maximize their wealth at the expense of bondholders, so that there could be a difference between firm value maximization and shareholder wealth maximization. Our emphasis, however, is that there should be no difference between these goals. We hold that shareholders should seek to maximize their wealth and the wealth of bondholders as well, so that firm value is maximized at the same time.

1.6. The conflicts of interest between stockholders and managers have been referred to in the text as the "agency problem." Managers "control" the firm and may do things in their own self-interest at the expense of the owners. Four methods are used to resolve the agency problem:

- Establish outside audit committees to review and limit abuses.
 - Limit the authority of lower levels of management over potentially troublesome items. For example, hiring of additional staff, use of company cars, etc.
 - Provide managers with stock options, stock bonuses and other forms of compensation that make their interests identical with those of shareholders.
 - The market for corporate control – tender offers and mergers – will lead to a takeover if managers abuse their responsibilities, with the new owners replacing the old managers.
- 1.7. Shareholders have limited liability, but receive all the returns after the fixed payments to bondholders are made. After obtaining funds from bondholders, the shareholders may seek to make more risky investments because they can benefit without limit, but the bondholders are still limited to the returns that have already been fixed.

These conflicts are resolved in two ways. The contract for obtaining funds (called the bond indenture) will have written provisions (called covenants) restricting the ability of the shareholders (or managers) from taking actions that increase the risks to bondholders. The second protection to bondholders is that they may require a high rate of interest in advance because of the risk that the bond covenants may not fully anticipate all the ways that the shareholders may take actions adverse to the bondholders.

- 1.8. The operations of business firms, when added up, have considerable impact, and, therefore, financial managers should take into account the effects of their policies and actions on society as a whole. No one should neglect the obligation for responsible citizenship. Managers in general, including financial managers, may be viewed as agents who mediate the concerns and demands of a number of interest groups, or shareholders, including the firm's customers, employees, suppliers of capital, and government. The problem is that it is difficult to know what is best for society and what is desired by various interest groups. By what authority do financial managers have the right to allocate funds in terms of their own particular views of the social good? Long term wealth maximization is an operational guide to efficiency in the business firm. If this guides the firm to be as efficient as possible, then the gross product that the firm contributes to the economy will provide a maximum amount of social output to be divided among all of the interest groups who seek to establish their claims on the social product. Developing a reputation for being a good corporate citizen is good for a business firm and the community. So another consideration is to take into account social expectations.
- 1.9. The choice of the industry or risk class of the firm influences both profitability opportunities and risk. When the choice of industry or risk class has been made, both profitability and risk are determined by decisions relating to the size of the firm, the types of equipment used, the extent to which debt is employed, the firm's liquidity position, etc. Such decisions generally affect both risk and profitability. An increase in the cash position reduces risk; however, since cash is not an earning asset, converting other assets to cash also reduces profitability. Similarly, the use of additional debt raises the rate of profitability on stockholders' net worth;

but more debt usually means more risk. The financial manager seeks to balance the choice of product mix as well as liquidity and leverage policies in such a way as to maximize the value of the firm. This is the basic risk-return trade-off faced in financial decision making.

1.10. Inflation affects financial management in a number of ways:

Distortion of Accounting Profits – The sale of low-cost inventories results in higher reported earnings, but actually reduces net cash flows as firms must pay taxes on the higher reported profits and are forced to restock with higher cost goods. Similarly, depreciation charges (a non-cash expense) are based on the historical costs of fixed assets; these charges are too low relative to the replacement cost of plant and equipment, and again result in higher reported profits, but lower cash flows.

Planning Problems – High inflation and, particularly, unstable inflation make it even more difficult to forecast the future costs and revenues necessary for both intermediate and long-range planning.

Demand for Capital and Interest Rates – Inflation creates a need for more financing to support higher cost levels even when the physical volume of operations may be unchanged. Financial managers will have to compete for the same pool of loanable funds, driving up interest rates. Furthermore, if the Federal Reserve Bank (the "Fed") attempts to ease inflation by tightening the supply of loanable funds, interest rates may rise higher still.

In addition to these effects, all interest rates reflect the so-called "real rate of interest" plus a premium for anticipated future inflation over the duration of the loan.

Effect on Long-term Debt (Bonds) – An increase in interest rates causes the value of outstanding bonds to fall. Thus, investors (or lenders) will be reluctant to hold long-term bonds locked into a low interest rate. Thus, financial managers will be forced to use more short-term debt and/or to use longer-term debt with an interest rate indexed to the general level of interest rates.

1.11. Opportunities Created by International Competition:

- Globalization means larger markets for U.S. products
- Encourages increased efficiency (including via mergers and restructuring) to compete effectively
- Access to international financial markets
- Opportunities to learn from foreign firms (for example, G.M.-Toyota joint venture)

Threats Created by International Competition:

- Added uncertainty of fluctuating currency exchange rates
- Competition from lower-cost producers in developing countries
- Increased world capacity and conditions of supply may create downward pressures on prices and profit margins.
- New foreign industry started from scratch, avoids mistakes or need for modernizing plant and equipment (Japanese car plants more efficient than old U.S. plants)

1.12. Positive/negative effects:

		Effects	
		Short-Term	Long-Term
a. Increase in prices:			
Stockholders	+		?
Customers	–		?
Government	+		?
b. Increase in ingredient costs:			
Stockholders	–		–
Employees	–		–
Bondholders	–		–
c. Decreased demand for product:			
Stockholders	–		–
Management	–		–
Employees	–		–
Suppliers	–		–
d. Opening of a major international market			
Stockholders	+		+
Management	+		+
Employees	+		+
Suppliers	+		+
Community	+		+

Problem Solutions

- 1.1. Company History, from the website:
 - a. Hershey was founded in 1893 as a wholly owned subsidiary of the Lancaster Caramel Company.
 - b. By 1895, the company introduced 114 new products. Many quickly gave way to other products or were simply discontinued. But some of the successful products that endure today are (year of introduction):
 - Hershey Cocoa (1894)
 - Hershey Chocolate Bar (1900)
 - Hershey Kisses (1907)
 - Hershey Chocolate Bar with Almonds (1908)
 - Mr. Goodbar (1925)
 - Chocolate Syrup (1926)
 - Hershey Chocolate Chips (1928)
 - c. The movie “E.T.” sharpened Hershey’s promotions. The movie “tie-in” stimulated the sales of Reese’s Pieces.
- 1.2. Milton S. Hershey, from the website:
 - a. Mr. Hershey went bankrupt at least two times in his early career including 1876 at the age of 18 and ten years later in 1886. But with the founding of the Lancaster Caramel Company, he became the top producer of caramels in the U.S. within four years.
 - b. His enduring legacy is the Milton Hershey Trust and the Milton Hershey School for orphans.
- 1.3. The process of making chocolate includes: raw ingredients, cocoa bean processing, milling & pressing, mixing the ingredients, refining, and the final product.
- 1.4. Code of Conduct, from the website:
 - a. Community needs; employees; consumers (you and me); customers (Wal-Mart, Costco, Target, and so on); shareholders.
 - b. In the order listed in “a.”
 - c. This statement suggests that Hershey will take a long-term approach when making decisions so that shareholder value will be increased over time.
 - d. Growth for growth’s sake does not make sense. But growth that provides income and cash flow over time will add great value.
- 1.5. The presentations rotate through this website. The instructor should review the presentations to be the most up-to-date.
 - a. Past themes included growth strategies, long-term forecasts, and so on.
 - b. Traditional financial information varies per presentation.
 - c. Non-traditional financial information also varies per presentation.

- 1.6. Hershey is a mature company that struggles with growth. Profitability, solid cash flow, and a strong balance sheet have been maintained. Its recent historical financial information forms the basis for chapters 2 and 7.