Principles of Managerial Finance

9th Edition

Chapter 1

Overview of Managerial Finance

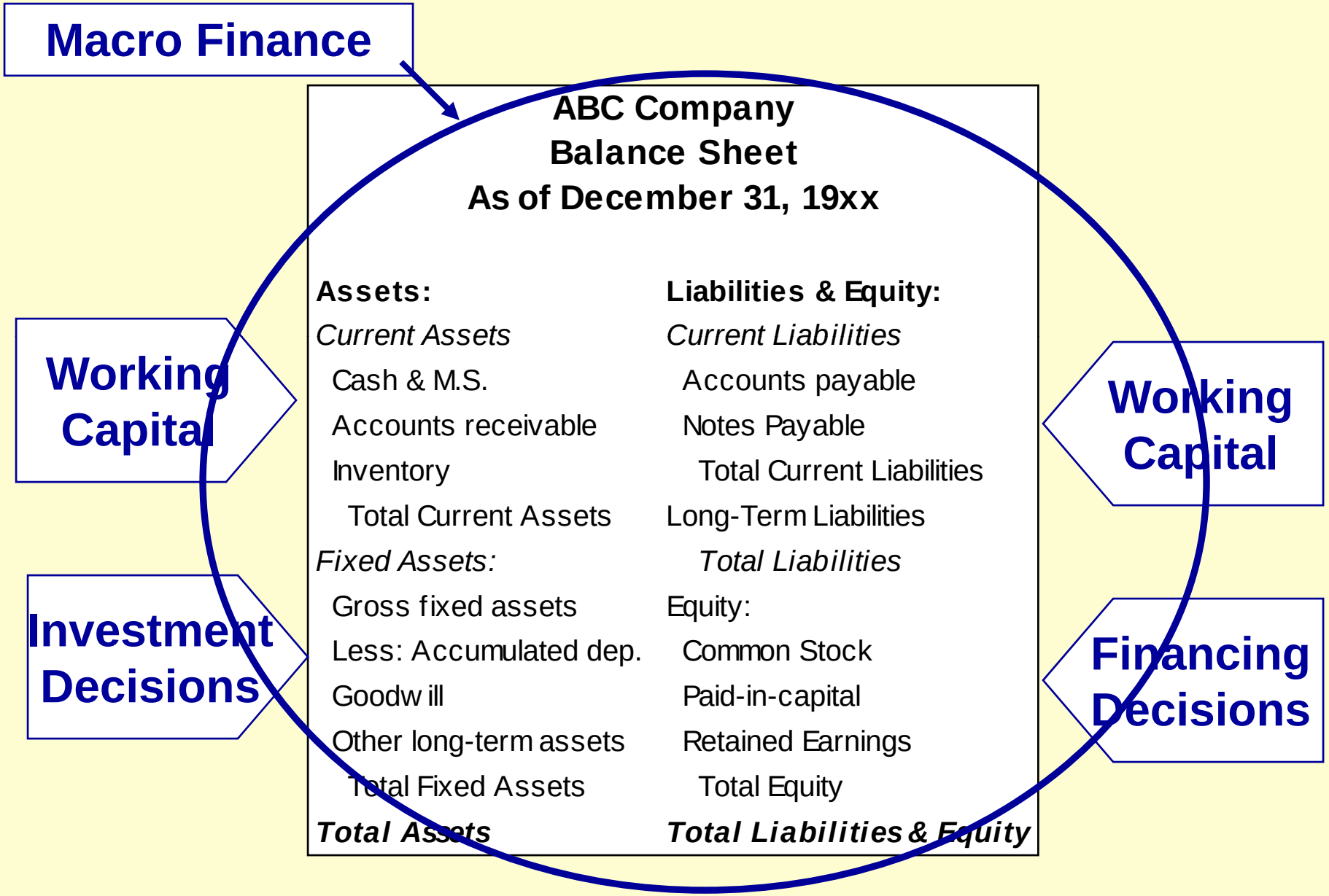
Learning Objectives

- Define finance and its major areas and opportunities.
- Review the basic forms of business organization.
- Describe the managerial finance function and its relationship to accounting and economics.
- Identify the financial manager’s key activities.
- Explain the wealth maximization goal of the financial manager and the role of ethics in the firm.
- Discuss the agency issue.

What is Finance?

- At the macro level, finance is the study of financial institutions and financial markets and how they operate within the financial system in both the U.S. and global economies.
- At the micro level, finance is the study of financial planning, asset management, and fund raising for businesses and financial institutions.
- Financial management can be described in brief using the following balance sheet.

What is Finance?



What is Finance?

- A well-developed financial system is a hallmark and essential characteristic of any modern developed nation.
- Financial markets, financial intermediaries, and financial management are the important components.
- Financial markets and financial intermediaries facilitate the flow of funds from borrowers to savers.
- Financial management involves the efficient use of financial resources in the production of goods.

Career Opportunities in Finance

- Capital Budgeting Analyst
- Project Finance Manager
- Cash Manager
- Banking & Financial Institutions
- Personal Financial Planning
- Investments
- Pension Fund Manager
- Real Estate
- Insurance
- Financial Analyst

Managerial Finance

- Managerial finance is concerned with the duties of the financial manager in the business firm.
- The financial manager actively manages the financial affairs of any type of business, whether private or public, large or small, profit-seeking or not-for-profit.
- Increasing globalization has complicated the financial management function.
- Changing economic and regulatory conditions also complicate the financial management function.

Basic Forms of Business Organization

- Sole Proprietorships
- Partnerships
- Corporations

Sole Proprietorships

- Account for majority of small businesses
- Most Businesses start out as Sole Proprietorships
- 75 percent of all businesses in the U.S. are sole proprietorships

Advantages of Sole Proprietorships

- Inexpensive to Start
- Complete Management Control
- Income “flows through” to Owner and is taxed at Owners Personal Marginal Tax Rate

Disadvantages of Sole Proprietorships

- Limited Availability of Capital
- Unlimited Legal Liability of the Owner
- Difficult to Transfer Ownership
- Limited Life

Partnerships

- Two or more owners
- Account for 10 percent of all businesses.
- Finance, insurance, and real estate firms are the most common types of partnerships.

Advantages of Partnerships

- Easier and Greater Access to capital
- Pooling of expertise

Disadvantages of Partnerships

- More expensive and difficult to manage and control than proprietorship
- Each partner is liable for all of the debts of the partnership.
- Cannot change ownership composition
- Difficult to transfer ownership

Corporations

- Separate legal entity
- Although only 15% of all businesses are incorporated, corporations account for nearly 90% of receipts and 80% of net profits.
- Most growing small businesses eventually become corporations

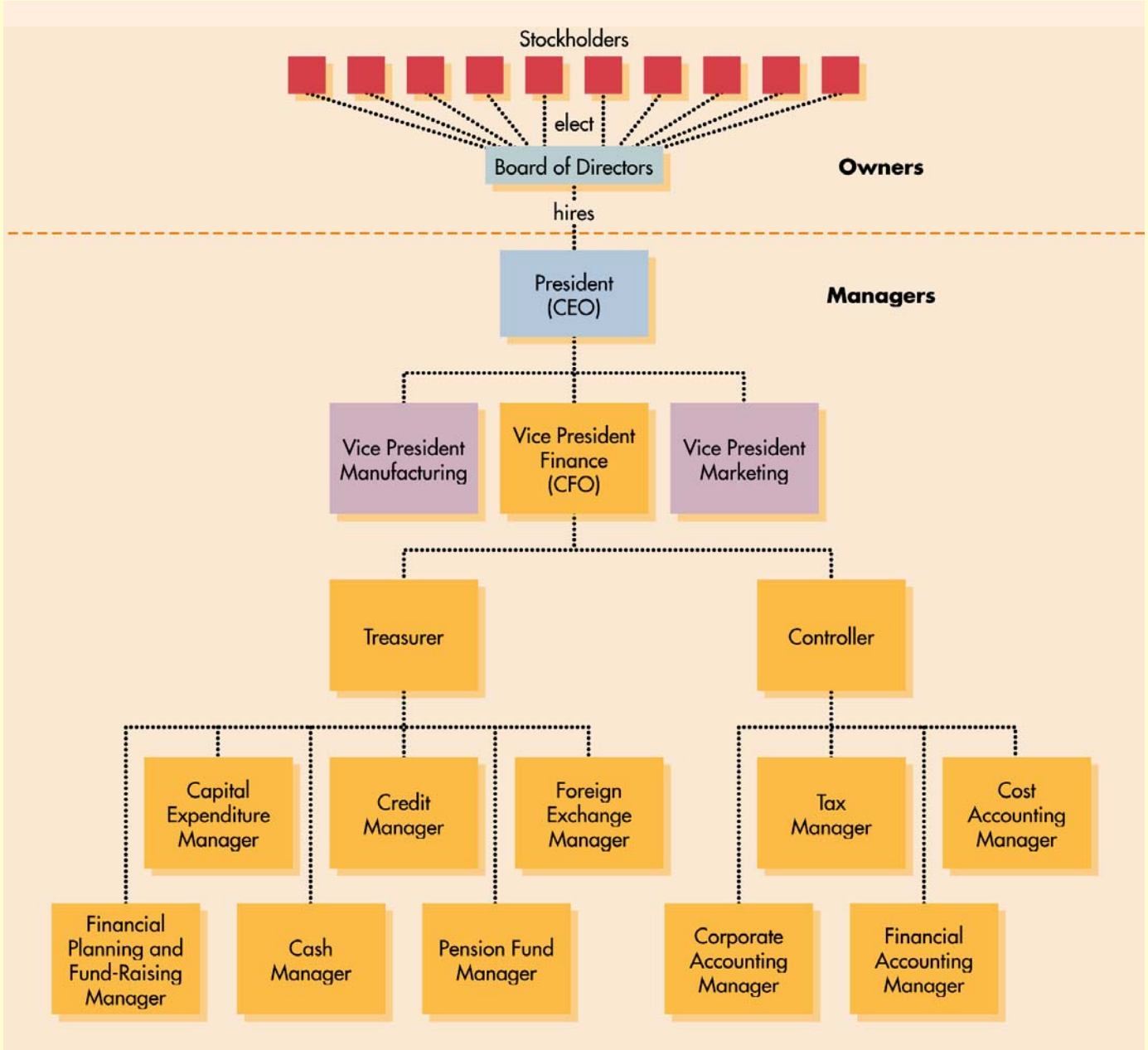
Advantages of Corporations

- Limited Liability (but not necessarily for small firms)
- Greater Access to Capital
- Unlimited Life
- Ease of Transfer of Ownership

Disadvantages of Corporations

- Double Taxation
- More Complex to Manage
- More Expensive to Maintain

Corporate Organization



Other Limited Liability Organizations

Limited Partnerships (LPs)

- A limited partnership is a partnership in which one or more partners can be designated as having limited liability as long as one partner (the general partner) has unlimited liability.
- Furthermore, limited partners are prohibited from being active in the firm's management; they are passive investors.

Other Limited Liability Organizations

S Corporations (S-Corps)

- Established under Subchapter S of the Internal Revenue Code, an S-Corp is a tax-reporting entity that may have no more than 75 shareholders and can elect to be taxed as partners.
- Shareholders receive all of the organizational benefits of a corporation and the tax advantages of a partnership.

Other Limited Liability Organizations

Limited Liability Corporations (LLCs)

- Permitted in most states, LLCs (like S-Corps) have limited liability and are taxed as partnerships.
- Unlike S-Corps, however, LLCs can own more than 80% of another corporation or partnership, and non-U.S. residents can own LLC shares.

Other Limited Liability Organizations

Limited Liability Partnerships (LLPs)

- An LLP is a partnership is a partnership in which all LLP partners have limited liability with regard to the business.
- Partners are not personally liable for other partners' malpractice.
- Also, the LLP is taxed as a partnership.

The Managerial Finance Function

- The size and importance of the managerial finance function depends on the size of the firm.
- In small companies, the finance function may be performed by the company president or accounting department.
- As the business expands, finance typically evolves into a separate department linked to the president.

The Managerial Finance Function

Relationship to Economics

- The field of finance is actually an outgrowth of economics.
- In fact, finance is sometimes referred to as financial economics.
- Financial managers must understand the economic framework within which they operate in order to react or anticipate to changes in conditions.

The Managerial Finance Function

Relationship to Economics

- The primary economic principal used by financial managers is marginal analysis which says that financial decisions should be implemented only when benefits exceed costs.

The Managerial Finance Function

Relationship to Accounting

- The firm's finance (treasurer) and accounting (controller) functions are closely-related and overlapping.
- In smaller firms, the financial manager generally performs both functions.

The Managerial Finance Function

Relationship to Accounting

- One major difference in perspective and emphasis between finance and accounting is that accountants generally use the accrual method while in finance, the focus is on cash flows.
- The significance of this difference can be illustrated using the following simple example.

The Managerial Finance Function

Relationship to Accounting

- The Zasloff Corporation experienced the following activity last year:

Sales:	**$100,000 (50% still uncollected)**
Cost of Goods:	**$ 60,000 (all paid in full under supplier terms)**
Expenses:	**$ 30,000 (all paid in full)**

- Now contrast the differences in performance under the accounting method versus the cash method.

The Managerial Finance Function

Relationship to Accounting

INCOME STATEMENT SUMMARY

	ACCRUAL	CASH
Sales	$100,000	$ 50,000
-COGS	(60,000)	(60,000)
Gross Margin	$ 40,000	$(10,000)
-Expenses	(30,000)	(30,000)
Net Profit/(Loss)	$ 10,000	$(40,000)

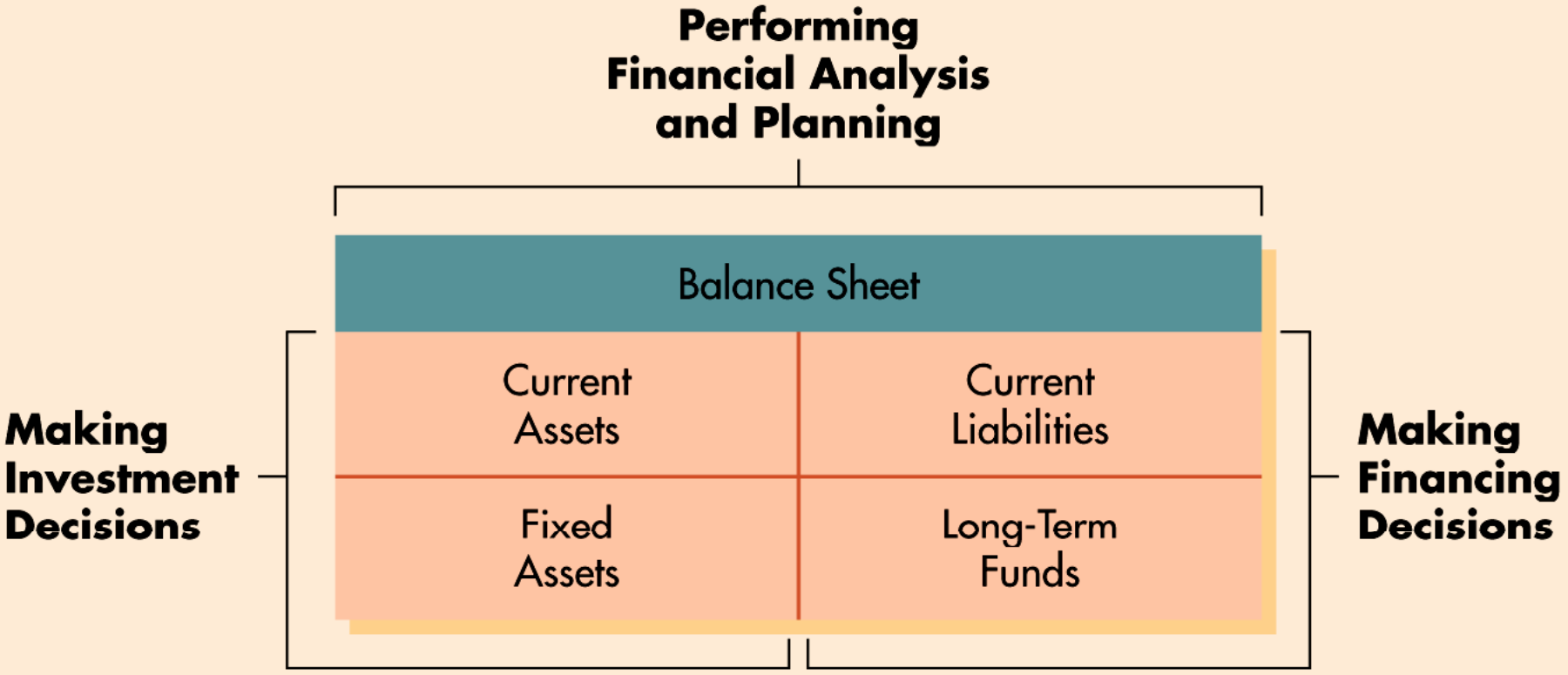
The Managerial Finance Function

Relationship to Accounting

- Finance and accounting also differ with respect to decision-making.
- While accounting is primarily concerned with the presentation of financial data, the financial manager is primarily concerned with analyzing and interpreting this information for decision-making purposes.
- The financial manager uses this data as a vital tool for making decisions about the financial aspects of the firm.

Key Activities of the Financial Manager

Relationship to Accounting



Goal of the Financial Manager

Maximize Profit???

Which Investment is Preferred?				
	EPS ($)			
Investment	Year 1	Year 2	Year 3	Total
A	$ 2.90	$ -	$ -	$ 2.80
B	$ -	$ -	$ 3.00	$ 3.00

Profit maximization fails to account for differences in the level of cash flows (as opposed to profits), the timing of these cash flows, and the risk of these cash flows.

Goal of the Financial Manager

Maximize Shareholder Wealth!!!

- Why?
- Because maximizing shareholder wealth properly considers cash flows, the timing of these cash flows, and the risk of these cash flows.
- This can be illustrated using the following simple valuation equation:

$$\text{Share Price} = \frac{\text{Future Dividends}}{\text{Required Return}}$$

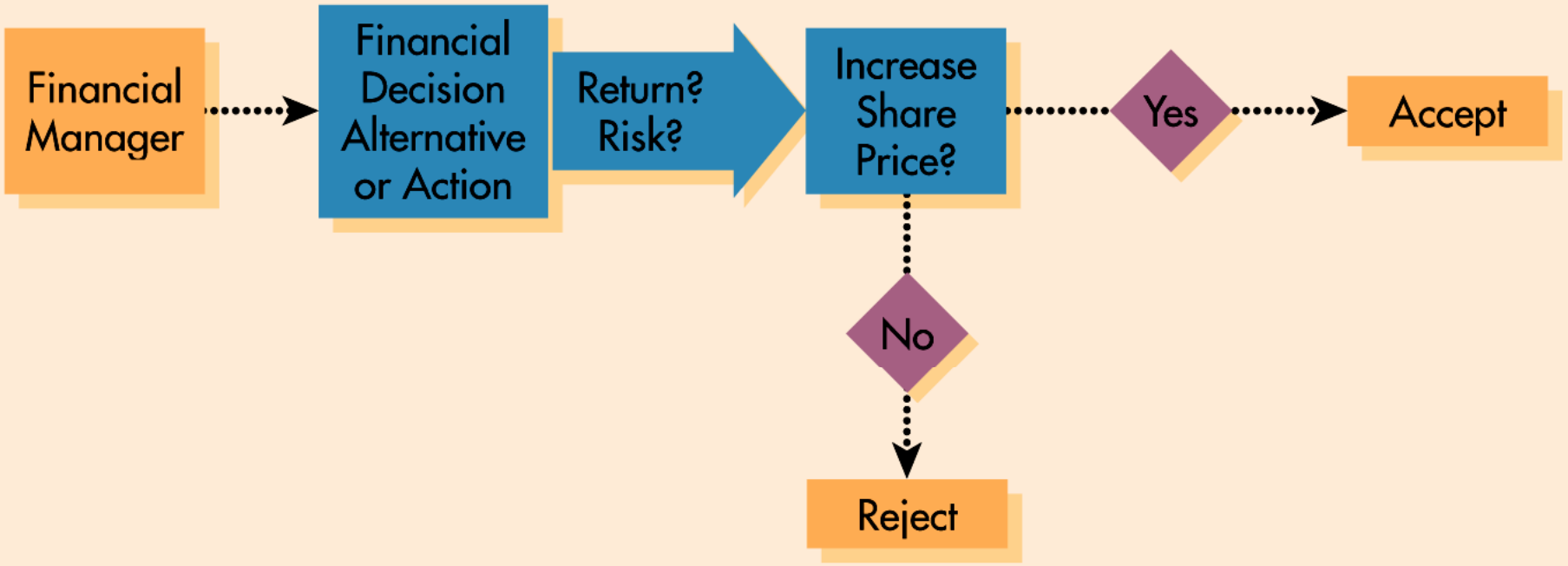
level & timing of cash flows

risk of cash flows

Goal of the Financial Manager

Maximize Shareholder Wealth!!!

- It can also be described using the following flow chart:



Goal of the Financial Manager

Economic Value Added (EVA)

- Economic value added (EVA) is a popular measure used by many firms to determine whether an investment - proposed or existing - positively contributes to the owners wealth.
- EVA is calculated by subtracting the cost of funds used to finance an investment from its after-tax operating profits.
- Investments with positive EVAs increase shareholder wealth and those with negative EVAs reduce shareholder value.

Goal of the Financial Manager

What About Other Stakeholders?

- Stakeholders include all groups of individuals who have a direct economic link to the firm including:
  - Employees
  - Customers
  - Suppliers
  - Creditors
  - Owners
- The "Stakeholder View" prescribes that the firm make a conscious effort to avoid actions that could be detrimental to the wealth position of its stakeholders.
- Such a view is considered to be "socially responsible."

The Role of Ethics

- Definition
- Opinions
- Considering Ethics
- Ethics and Share Price

The Role of Ethics

Ethics Defined

- Ethics - the standards of conduct or moral judgment - have become an overriding issue in both our society and the financial community
- Ethical violations attract widespread publicity
- Negative publicity often leads to negative impacts on a firm

The Role of Ethics

Opinions

- A wide majority (94%) of business school deans, business leaders, and members of Congress responding to a recent survey felt that the business community is troubled by ethical issues
- A majority (63%) of the respondents perceived that a firm strengthens its competitive position by maintaining high ethical standards

The Role of Ethics

Considering Ethics

- To assess the ethical viability of a proposed action, ask:
  - Does the action unfairly single out an individual or group?
  - Does the action affect the morals, or legal rights of any individual or group?
  - Does the action conform to accepted moral standards?
  - Are there alternative courses of action that are less likely to cause actual or potential harm?

The Role of Ethics

Ethics & Share Price

- Ethics programs seek to:
  - reduce litigation and judgment costs
  - maintain a positive corporate image
  - build shareholder confidence
  - gain the loyalty and respect of all stakeholders
- The expected result of such programs is to positively affect the firm's share price.

The Agency Issue

The Problem

- Whenever a manager owns less than 100% of the firm's equity, a potential agency problem exists.
- In theory, managers would agree with shareholder wealth maximization.
- However, managers are also concerned with their personal wealth, job security, fringe benefits, and lifestyle.
- This would cause managers to act in ways that do not always benefit the firm shareholders.

The Agency Issue

Resolving the Problem

- Market Forces such as major shareholders and the threat of a hostile takeover act to keep managers in check.
- Agency Costs may be incurred to ensure management acts in shareholders interests.

The Agency Issue

Resolving the Problem

- Examples would include bonding or monitoring management behavior, and structuring management compensation to make shareholders interests their own.
- However, recent studies have failed to find a strong relationship between CEO compensation and share price.