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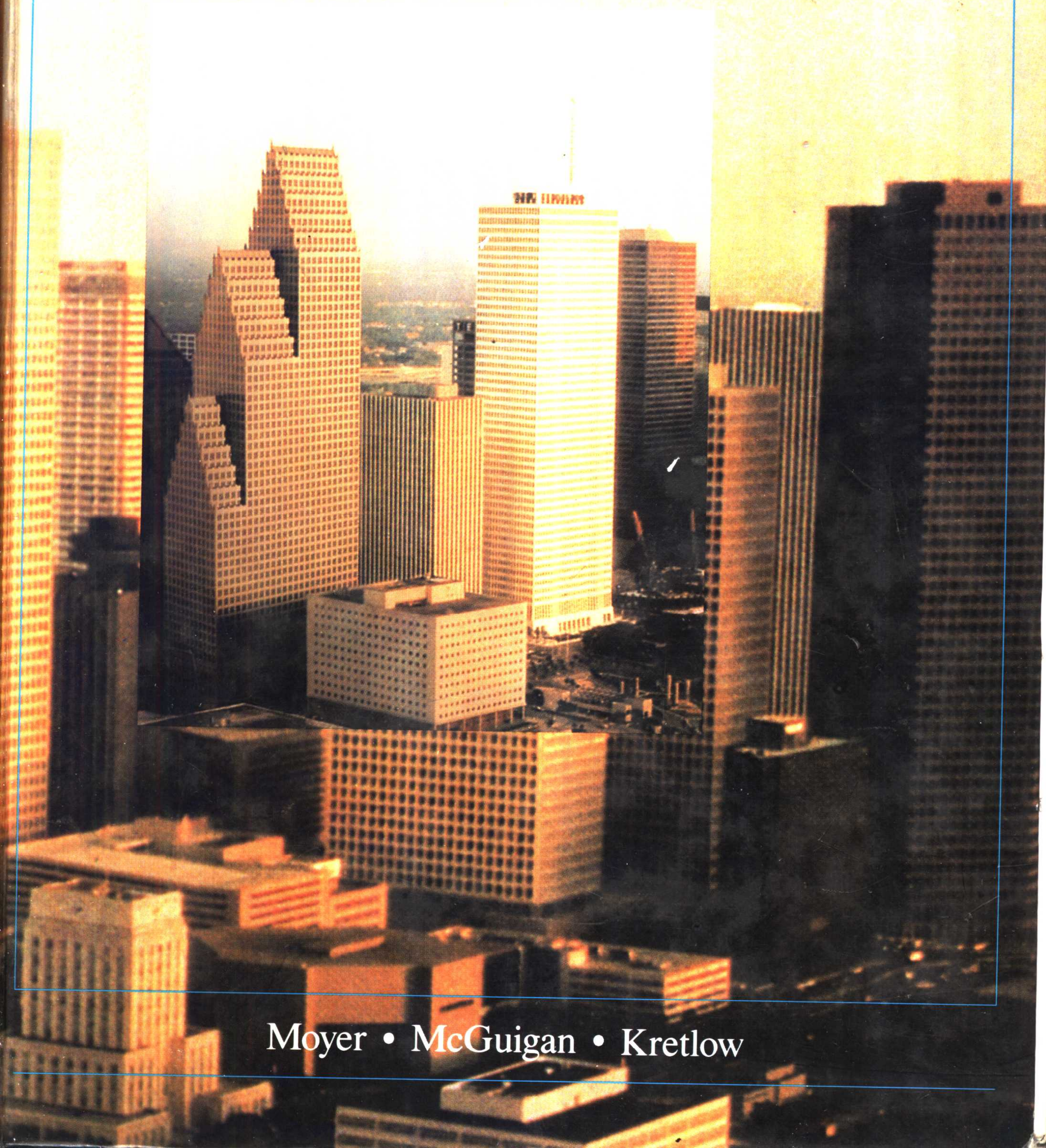

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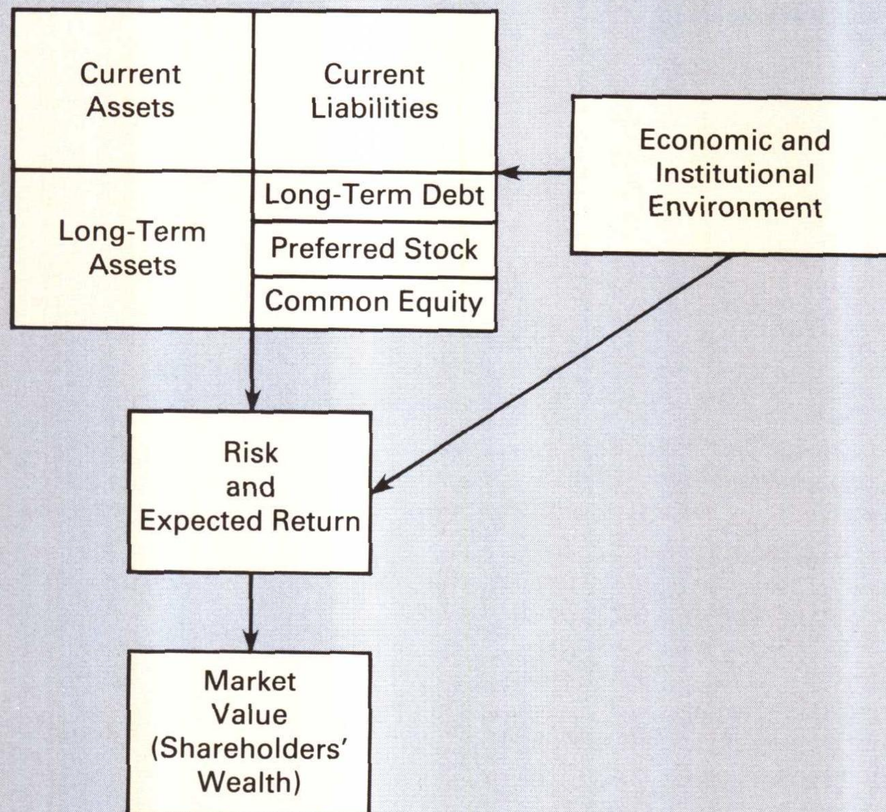
# PART ONE

# *INTRODUCTION*




Part I of the text provides an overview introduction to the field of financial management. Chapter 1 discusses the relationship between finance and other business disciplines, the organization of the financial management function in a firm, and the history of the financial management field. This chapter also introduces the overall objective of the firm—shareholder wealth maximization. Appendix 1A details career opportunities in finance. Chapter 2 looks at the relationship between the firm and the economic/institutional environment. Economic and institutional factors have a major impact on the expected returns and the risk of these returns generated by the firm. Risk and expected return are two of the key determinants of the value of a firm and its securities. Appendix 2A highlights some aspects of Federal income tax law that are relevant to many financial management decisions.

# 1

# *THE FINANCE FUNCTION: AN OVERVIEW*

## A Financial Dilemma

**Problems in Financial Management**

- In 1983 Chevron acquired Gulf Oil for $80 a share, more than twice what the Gulf Oil stock was selling for prior to the takeover battle.
- During the early 1980s investors who committed funds to J. David & Company in hopes of earning very high returns wound up losing a total of $150 million, once again confirming the old financial adage that high returns normally can only be earned by assuming high risks.
- In 1985 Middle South Utilities, with annual revenues of $3 billion, omitted its quarterly dividend payment because of severe cash flow problems.
- During the 1970s Lockhead's stock price dropped from $73 to $3 a share partly as a result of cost overruns in some of its military projects and as a result of the costs of developing its L-1011 wide-bodied commercial jet.
- In 1985 Hercules, Inc., a U.S. chemicals manufacturer, issued debt denominated in European Currency Units instead of U.S. dollars in order to hedge its European assets.
- In 1982 Braniff Airlines crash landed in financial failure, shortly after embarking on an aggressive expansion program.
- In October 1979 underwriters of IBM's $1 billion debt issue lost an estimated $15 million on the issue of which they had earlier fought hard to get control.

Each of these situations was the direct result of financial decision making. Financial management is not an abstract field of study. Financial decisions made within various enterprises—whether large or small; international, national, or local; profit seeking or not for profit—help to determine the kinds of products and services we consume, their price, availability, and quality. In short, financial decision making has results that are felt throughout our entire economy.

The situations described above pose a number of questions in financial management which are examined in this text.

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## Key Chapter Concepts

1. Shareholder wealth is defined as the present value of the expected future returns to the owners of the firm. It is measured by the market value of the shareholders' common stock holdings.
2. The primary normative goal of the firm is the maximization of shareholder wealth.
3. The finance function within a large firm is usually headed by a (senior) vice-president or chief financial officer.
   a. Financial management responsibilities are often divided between the controller and treasurer.
   b. The controller normally has responsibility for all accounting related activities.
   c. The treasurer is normally concerned with the acquisition, custody, and expenditure of funds.
4. Other important topics include:
   a. Profit maximization goal
   b. Social responsibility goals
   c. Agency relationships
   d. History of the financial management field
   e. Relation of financial management to other academic disciplines
   f. Organization of the text

## Glossary of New Terms

**Agency relationships** occur when one or more individuals (principals) hire another individual (agent) to perform a service on behalf of the principals. Agency relationships often lead to agency problems and agency costs. One of the most important agency relationships in finance is between stockholders (owners) and managers.

**Present value** The current value of some future payment or stream of payments, evaluated at an appropriate discount rate.

**Shareholder wealth** Present value of the expected future returns to the owners (that is, shareholders) of the firm. It is measured by the market value of the shareholders' common stock holdings.

## Introduction

The field of financial management is an exciting and challenging one. Students who choose to major in finance will find a wide range of rewarding job opportunities open in the fields of corporate financial management, investment analysis and management, banking, real estate, insurance, and the public sector—to name only a few broad areas of potential career opportunities. (Career opportunities in finance are examined in the appendix to this chapter.) Students who do not choose to major in finance still will be confronted with important financial decisions—both in their career and in their personal life—on a nearly daily basis.

The importance and relevance of the skills that can be learned in this finance course are apparent from the results of a recent survey of graduates of business schools. *By a wide margin, these executives indicated that the courses taken in financial management were the most useful courses in their business school curriculum.*[1]

Any business—whether large or small, profit seeking or not for profit—is a financial concern, and as such its success or failure depends in a large part on the quality of its financial decisions. Thus, financial management is an exciting area of business administration. Nearly every key decision made by a firm's managers has important financial implications, and managers daily face questions like the following:

- Will a particular investment be profitable?
- Where will the funds come from to finance the investment?
- Does the firm have adequate cash or access to cash—through bank borrowing agreements, for example—to meet its daily operating needs?
- Which customers should be offered credit and how much should they be offered?
- How much inventory should be held?
- Is a merger or acquisition advisable?
- How should profits be used or distributed? That is, what is the optimal dividend policy?
- In trying to arrive at the best financial management decisions, how should risk and return be balanced?

This text presents an introduction to the theory, institutional background, and analytical tools essential for proper decision making in these and related areas.

The remaining sections of this chapter discuss the goals of the firm, organization of the financial management function, history of the financial management field, relationship between financial management and other academic disciplines, and organization of the text.

## Goals of the Firm

Financial decision making requires an understanding of the goal(s) of the firm. What objective(s) *should* guide business decision making? That is, what *should* management try to achieve for the owners of the firm? The

[1] John A. Pollock, J.R. Bartol, B.C. Sherony, and G.R. Carnaham, "Executives' Perceptions of Future MBA Programs." *Collegiate News and Views* (Spring 1983): 23–25.

generally accepted normative goal that management should pursue is the maximization of the value of the firm to the owners, that is, *shareholder wealth.* Before defining shareholder wealth more precisely later in this section, let us first consider the normative goal of profit maximization.

**Profit Maximization**

It is easy to assume that profit maximization is a primary objective of financial management. After all, it is the predominant objective of microeconomic models, and the marginal decision-making rules implied by this objective can be very useful to the financial manager in handling certain specific problems. Unfortunately, however, this objective has a number of limitations.

First, the standard microeconomic model of profit maximization is *static;* that is, it lacks a time dimension. Specifically, the profit maximization objective provides no explicit basis for comparing long-term and short-term profits. Major decisions made by financial managers, however, *must* reflect the time dimension. For example, capital expenditure decisions, which are central to the finance function, have a long-term impact on the performance of the firm. Financial managers must constantly make tradeoffs between short-run and long-run profits in conjunction with these long-term decisions.

The second limitation has to do with the definition of profits. Should a firm attempt to maximize the *dollar amount* of profits or the *rate* of profit? If the latter is chosen, what specific rate should be emphasized—profit in relation to sales, total assets, or shareholders' equity? What measure of profits should be used—the readily available measure of accounting profits or the economist's broader definition of profits, which includes (among other things) the opportunity cost of funds committed by the owners of an enterprise? (This definition is an important concept, but it is very difficult to calculate.)

The third problem associated with this objective is that it provides no real way for the financial manager to consider the risk associated with alternative decisions. For example, two projects generating identical future expected revenues and requiring identical outlays may be vastly different with respect to their *degree of risk.* The financial manager should attempt to incorporate risk analysis in resource allocation decisions where the outcomes are not known with certainty.

The profit-maximization model of firm behavior has produced a wide range of valuable insights into the efficient allocation of economic (and financial) resources. In spite of these successes, the shortcomings of this goal have led to the development of the more comprehensive normative goal of shareholder wealth maximization.

**Shareholder Wealth Maximization**

The shareholder wealth maximization goal states that management *should* seek to maximize the *present value* of the *expected future returns* to the owners (that is, shareholders) of the firm. These returns can take the form of periodic dividend payments or proceeds from the sale of the stock. Present value is defined as the value today of some future payment or stream of payments, evaluated at an appropriate discount rate. It takes

into account the returns that are available from alternative investment opportunities during a specific (future) time period.

Shareholder wealth is measured by the market value of the shareholders' common stock holdings. *Market value* is defined as the price at which the stock trades in the marketplace, such as on the New York Stock Exchange. Thus, total shareholder wealth equals the number of shares outstanding times the market price per share.

The objective of shareholder wealth maximization has a number of distinct advantages. First, it is conceptually possible to determine whether a particular financial decision is consistent with this objective. If a decision made by a firm has the effect of increasing the market price of the firm's stock, it is a good decision. If it appears that a certain action will not achieve this result, the action should not be taken (at least not voluntarily).

Second, shareholder wealth maximization is an *impersonal* objective. Stockholders who may be offended by a firm's policies are free to sell their shares *under more favorable terms* (that is, at a higher price) *than are available under any other strategy* and invest their funds elsewhere.

Third, this objective allows the financial manager to consider the elements of both timing and risk when making various decisions. (This advantage will become more apparent later during the discussion of capital expenditure analysis.)

For these reasons, the shareholder wealth maximization objective is the primary normative goal in financial management.

### Social Responsibility Goals

The success of the firm is often linked to various constituent groups, including employees, suppliers, customers, and community neighbors. Likewise, the welfare of many of these groups is closely related to the continued growth and prosperity of the firm. Some have argued that business should (as it to some degree does) seek to balance the interests of all these constituencies, rather than be concerned with shareholder wealth maximization alone. In many cases these social responsibilities can take on almost as much importance as laws and other formal obligations.

A wide diversity of opinion exists as to what corporate social responsibility actually entails. The concept is somewhat subjective and is neither perceived uniformly nor applied uniformly by all firms. As yet no satisfactory mechanism has been suggested that specifies how these social responsibility commitments can be balanced with the interests of the owners of the firm. It can be argued, however, that a concern for the interests of all the competing constituencies of the company is justified on the basis that it is in the firm's interest to create an environment in which the goal of shareholder wealth maximization can be pursued more easily.

### Other Goals of the Firm

The normative goal of shareholder wealth maximization specifies how financial decisions *should* be made. It has been observed that, in practice, not all management decisions are consistent with this objective. In other words, there is often a divergence between the shareholder wealth maximization goal and the *actual* (or *descriptive*) goals pursued by

management. What is the reason for this divergency? The primary reason has been attributed to *separation of ownership and control* (management) in corporations.

Separation of ownership and control has permitted managers to pursue goals more consistent with their own self-interests, subject, of course, to the constraint that they satisfy shareholders sufficiently to maintain control of the corporation. Instead of seeking to maximize some objective (such as shareholder wealth), management is said to "satisfice" or seek acceptable levels of performance.

Maximization of their own personal welfare (or utility) may lead managers to be concerned with long-run survival (job security). The concern for long-run survival may lead management to minimize (or limit) the amount of risk incurred by the firm, since unfavorable outcomes can lead to their dismissal or possible bankruptcy for the firm. Likewise, the desire for job security is cited as one reason why management often opposes takeover offers (mergers) by other companies. Giving senior management "golden parachute" contracts to compensate them if they lose their positions as the result of a merger is one approach designed to ensure that they will act in the interests of shareholders in merger decisions, rather than in their own interests.

**Agency Problems**

*Agency relationships* occur when one or more individuals (the principals) hire another individual (the agent) to perform a service on behalf of the principals.[2] In an agency relationship, decision-making authority is often delegated to the agent from the principals. In the context of finance, one of the most important agency relationships is between stockholders (owners) and managers.

Inefficiencies that arise because of agency relationships have been called "agency problems." These problems occur because each party to a transaction is assumed to act in a manner consistent with maximizing his or her own utility (welfare). The example cited earlier of the concern by management for long-run survival (job security), rather than shareholder wealth maximization, is an example of an agency problem. Another example is the consumption of on-the-job perquisites (such as the use of company airplanes, limousines, and luxurious offices) by managers who have no (or only a partial) ownership interest in the firm. Shirking by managers is also an agency-related problem.

These agency problems give rise to a number of *agency costs*, which are incurred by shareholders to minimize agency problems. Examples of agency costs include:

1. Expenditures to structure the organization in such a way that will minimize the incentives for management to take actions contrary to shareholder interests, such as providing a portion of management's compensation in the form of stock of the corporation.
2. Expenditures to monitor management's actions, such as paying for

[2] See Amir Barnea, R. Haugen, and L. Senbet, *Agency Problems and Financial Contracting.* Englewood Cliffs, N.J.: Prentice-Hall, 1985, for a complete overview of the agency problem issue.

audits of managerial performance and internal audits of the firm's expenditures.

3. Bonding expenditures to protect the owners from managerial dishonesty.
4. The opportunity cost of lost profits arising from complex organizational structures that prevent management from making timely responses to opportunities.

Financial theory has shown that agency problems and their associated costs can be greatly reduced if the financial markets operate efficiently. Some agency problems can be reduced by the use of complex financial contracts. Remaining agency problems give rise to costs that show up as a reduction in the value of the firm's shares in the marketplace.

## Organization of the Financial Management Function

Most large corporations divide the decision-making responsibilities of management among several different officers of the corporation, which often include manufacturing, marketing, finance, personnel, and engineering. A sample organization chart, emphasizing the finance function, is shown in Figure 1-1. The finance function is usually headed by a (senior) vice-president of finance or *chief financial officer* who reports to the president. The chief financial officer may also distribute the financial management responsibilities between the *controller* and the *treasurer*.[3]

The controller normally has responsibility for all accounting related activities. These include such functions as:

- **Financial Accounting** This function involves the preparation of the financial statements for the firm, such as the balance sheet, income statement, and the sources and uses of funds statement.
- **Cost Accounting** This department often has responsibility for preparing the firm's operating budgets and monitoring the performance of the departments and divisions within the firm.
- **Taxes** This unit prepares the reports that the company must file with the various government (local, state, and federal) agencies.
- **Data Processing** Given its responsibilities involving corporate accounting and payroll activities, the controller may also have management responsibility for the company's data processing operations.

The treasurer is normally concerned with the acquisition, custody, and expenditure of funds. These duties often include:

- **Cash and Marketable Securities Management** This group monitors the firm's short-term finances—forecasting its cash needs, obtaining funds from bankers and other sources when needed, and investing any excess funds in short-term interest-earning securities.
- **Capital Budgeting Analysis** This department is responsible for analyzing

[3] In smaller companies, the owner may supervise the activities of the controller and treasurer, or the chief financial officer may perform both activities under the title of controller, treasurer, or vice-president of finance.

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