Part 1 of Principles of Managerial Finance discusses the role that financial managers play in businesses and the financial market environment in which firms operate. We argue that the goal of managers should be to maximize the value of the firm and by doing so maximize the wealth of its owners. Financial managers act on behalf of the firm’s owners by making operating and investment decisions whose benefits exceed their costs. These decisions create wealth for shareholders. Maximizing shareholder wealth is important because firms operate in a highly competitive financial market environment that offers shareholders many alternatives for investing their funds. To raise the financial resources necessary to fund the firm’s ongoing operations and future investment opportunities, managers have to deliver value to the firm’s investors. Without smart financial managers and access to financial markets, firms are unlikely to survive, let alone achieve the long-term goal of maximizing the value of the firm.
Why This Chapter Matters to You

In your **professional** life

**ACCOUNTING** You need to understand the relationships between the accounting and finance functions within the firm; how decision makers rely on the financial statements you prepare; why maximizing a firm’s value is not the same as maximizing its profits; and the ethical duty that you have when reporting financial results to investors and other stakeholders.

**INFORMATION SYSTEMS** You need to understand why financial information is important to managers in all functional areas; the documentation that firms must produce to comply with various regulations; and how manipulating information for personal gain can get managers into serious trouble.

**MANAGEMENT** You need to understand the various legal forms of a business organization; how to communicate the goal of the firm to employees and other stakeholders; the advantages and disadvantages of the agency relationship between a firm’s managers and its owners; and how compensation systems can align or misalign the interests of managers and investors.

**MARKETING** You need to understand why increasing a firm’s revenues or market share is not always a good thing; how financial managers evaluate aspects of customer relations such as cash and credit management policies; and why a firm’s brands are an important part of its value to investors.

**OPERATIONS** You need to understand the financial benefits of increasing a firm’s production efficiency; why maximizing profit by cutting costs may not increase the firm’s value; and how managers act on behalf of investors when operating a corporation.

In your **personal** life Many of the principles of managerial finance also apply to your personal life. Learning a few simple financial principles can help you manage your own money more effectively.

---

**Learning Goals**

1. Define finance and the managerial finance function.
2. Describe the legal forms of business organization.
3. Describe the goal of the firm, and explain why maximizing the value of the firm is an appropriate goal for a business.
4. Describe how the managerial finance function is related to economics and accounting.
5. Identify the primary activities of the financial manager.
6. Describe the nature of the principal–agent relationship between the owners and managers of a corporation, and explain how various corporate governance mechanisms attempt to manage agency problems.

---

**The Role of Managerial Finance**
In No Hurry to Go Public

Facebook founder and chief executive officer Mark Zuckerberg is in no hurry to go public, even though he concedes that it is an inevitable step in the evolution of his firm. The Facebook CEO is on record saying that "we’re going to go public eventually, because that’s the contract that we have with our investors and our employees. . . . [but] we are definitely in no rush." Nearly all public firms were at one time privately held by relatively few shareholders, but at some point the firms’ managers decided to go public. The decision to go public is one of the most important decisions managers can make.

Private firms are typically held by fewer shareholders and are subject to less regulation than are public firms. So why do firms go public at all? Often it is to provide an exit strategy for its private investors, gain access to investment capital, establish a market price for the firm’s shares, gain public exposure, or all of the above. Going public helps firms grow, but that and other benefits of public ownership must be weighed against the costs of going public.

Although taking Facebook public would likely make Zuckerberg one of the richest persons in the world under the age of 30, it would also mean that his firm would become subject to the influences of outside investors and government regulators. A public firm’s managers work for and are responsible to the firm’s investors, and government regulations require firms to provide investors with frequent reports disclosing material information about the firm’s performance. The regulatory demands placed on managers of public firms can sometimes distract managers from important aspects of running their businesses. This chapter will highlight the tradeoffs faced by financial managers as they make decisions intended to maximize the value of their firms.
The field of finance is broad and dynamic. Finance influences everything that firms do, from hiring personnel to building factories to launching new advertising campaigns. Because there are important financial dimensions to almost any aspect of business, there are many financially oriented career opportunities for those who understand the basic principles of finance described in this textbook. Even if you do not see yourself pursuing a career in finance, you’ll find that an understanding of a few key ideas in finance will help make you a smarter consumer and a wiser investor with your own money.

WHAT IS FINANCE?

Finance can be defined as the science and art of managing money. At the personal level, finance is concerned with individuals’ decisions about how much of their earnings they spend, how much they save, and how they invest their savings. In a business context, finance involves the same types of decisions: how firms raise money from investors, how firms invest money in an attempt to earn a profit, and how they decide whether to reinvest profits in the business or distribute them back to investors. The keys to good financial decisions are much the same for businesses and individuals, which is why most students will benefit from an understanding of finance regardless of the career path they plan to follow. Learning the techniques of good financial analysis will not only help you make better financial decisions as a consumer, but it will also help you understand the financial consequences of the important business decisions you will face no matter what career path you follow.

CAREER OPPORTUNITIES IN FINANCE

Careers in finance typically fall into one of two broad categories: (1) financial services and (2) managerial finance. Workers in both areas rely on a common analytical “tool kit,” but the types of problems to which that tool kit is applied vary a great deal from one career path to the other.

Financial Services

Financial services is the area of finance concerned with the design and delivery of advice and financial products to individuals, businesses, and governments. It involves a variety of interesting career opportunities within the areas of banking, personal financial planning, investments, real estate, and insurance.

Managerial Finance

Managerial finance is concerned with the duties of the financial manager working in a business. Financial managers administer the financial affairs of all types of businesses—private and public, large and small, profit seeking and not for profit. They perform such varied tasks as developing a financial plan or budget, extending credit to customers, evaluating proposed large expenditures, and raising money to fund the firm’s operations. In recent years, a number of factors have increased the importance and complexity of the financial manager’s duties. These factors include the recent global financial crisis and subsequent responses.
by regulators, increased competition, and technological change. For example, globalization has led U.S. corporations to increase their transactions in other countries, and foreign corporations have done likewise in the United States. These changes increase demand for financial experts who can manage cash flows in different currencies and protect against the risks that arise from international transactions. These changes increase the finance function's complexity, but they also create opportunities for a more rewarding career. The increasing complexity of the financial manager's duties has increased the popularity of a variety of professional certification programs outlined in the Focus on Practice box below. Financial managers today actively develop and implement corporate strategies aimed at helping the firm grow and improving its competitive position. As a result, many corporate presidents and chief executive officers (CEOs) rose to the top of their organizations by first demonstrating excellence in the finance function.

LEGAL FORMS OF BUSINESS ORGANIZATION

One of the most basic decisions that all businesses confront is how to choose a legal form of organization. This decision has very important financial implications because how a business is organized legally influences the risks that the

CHAPTER 1  The Role of Managerial Finance

Professional Certifications in Finance

Certified Treasury Professional (CTP)—The CTP program requires students to pass a single exam that is focused on the knowledge and skills needed for those working in a corporate treasury department. The program emphasizes topics such as liquidity and working capital management, payment transfer systems, capital structure, managing relationships with financial service providers, and monitoring and controlling financial risks.

Certified Financial Planner (CFP)—To obtain CFP status, students must pass a 10-hour exam covering a wide range of topics related to personal financial planning. The CFP program also requires 3 years of full-time relevant experience. The program focuses primarily on skills relevant for advising individuals in developing their personal financial plans.

American Academy of Financial Management (AAFM)—The AAFM administers a host of certification programs for financial professionals in a wide range of fields. Their certifications include the Chartered Portfolio Manager, Chartered Asset Manager, Certified Risk Analyst, Certified Cost Accountant, Certified Credit Analyst, and many other programs. See the AAFM website for complete details on all of the AAFM educational programs.

Professional Certifications in Accounting—Most professionals in the field of managerial finance need to know a great deal about accounting to succeed in their jobs. Professional certifications in accounting include the Certified Public Accountant (CPA), Certified Management Accountant (CMA), Certified Internal Auditor (CIA), and many other programs.

Why do employers value having employees with professional certifications?
firm’s owners must bear, how the firm can raise money, and how the firm’s profits will be taxed. The three most common legal forms of business organization are the sole proprietorship, the partnership, and the corporation. More businesses are organized as sole proprietorships than any other legal form. However, the largest businesses are almost always organized as corporations. Even so, each type of organization has its advantages and disadvantages.

Sole Proprietorships

A sole proprietorship is a business owned by one person who operates it for his or her own profit. About 73 percent of all businesses are sole proprietorships. The typical sole proprietorship is small, such as a bike shop, personal trainer, or plumber. The majority of sole proprietorships operate in the wholesale, retail, service, and construction industries.

Typically, the owner (proprietor), along with a few employees, operates the proprietorship. The proprietor raises capital from personal resources or by borrowing, and he or she is responsible for all business decisions. As a result, this form of organization appeals to entrepreneurs who enjoy working independently. A major drawback to the sole proprietorship is unlimited liability, which means that liabilities of the business are the entrepreneur’s responsibility, and creditors can make claims against the entrepreneur’s personal assets if the business fails to pay its debts. The key strengths and weaknesses of sole proprietorships are summarized in Table 1.1.

Partnerships

A partnership consists of two or more owners doing business together for profit. Partnerships account for about 7 percent of all businesses, and they are typically larger than sole proprietorships. Partnerships are common in the finance, insurance, and real estate industries. Public accounting and law partnerships often have large numbers of partners.

Most partnerships are established by a written contract known as articles of partnership. In a general (or regular) partnership, all partners have unlimited liability, and each partner is legally liable for all of the debts of the partnership. Table 1.1 summarizes the strengths and weaknesses of partnerships.

---

**Matter of fact**

BizStats.com Total Receipts by Type of U.S. Firm

Although there are vastly more sole proprietorships than there are partnerships and corporations combined, they generate the lowest level of receipts. In total, sole proprietorships generated more than $969 billion in receipts, but this number hardly compares to the more than $17 trillion in receipts generated by corporations.

<table>
<thead>
<tr>
<th>BizStats.com Total Receipts by Type of U.S. Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of firms (millions)</strong></td>
</tr>
<tr>
<td><strong>Percentage of all firms</strong></td>
</tr>
<tr>
<td><strong>Total receipts ($ billions)</strong></td>
</tr>
<tr>
<td><strong>Percentage of all receipts</strong></td>
</tr>
</tbody>
</table>
Corporations

A corporation is an entity created by law. A corporation has the legal powers of an individual in that it can sue and be sued, make and be party to contracts, and acquire property in its own name. Although only about 20 percent of all U.S. businesses are incorporated, the largest businesses nearly always are; corporations account for nearly 90 percent of total business revenues. Although corporations engage in all types of businesses, manufacturing firms account for the largest portion of corporate business receipts and net profits. Table 1.1 lists the key strengths and weaknesses of corporations.

The owners of a corporation are its stockholders, whose ownership, or equity, takes the form of either common stock or preferred stock. Unlike the owners of sole proprietorships or partnerships, stockholders of a corporation enjoy limited liability, meaning that they are not personally liable for the firm’s debts. Their losses are limited to the amount they invested in the firm when they purchased shares of stock. In Chapter 7 you will learn more about common and preferred stock, but for now it is enough to say that common stock is the purest and most basic form of corporate ownership. Stockholders expect to earn a

---

**TABLE 1.1** Strengths and Weaknesses of the Common Legal Forms of Business Organization

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Partnership</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner receives all profits (and sustains all losses)</td>
<td>Can raise more funds than sole proprietorships</td>
<td>Owners have limited liability, which guarantees that they cannot lose more than they invested</td>
</tr>
<tr>
<td>Low organizational costs</td>
<td>Borrowing power enhanced by more owners</td>
<td>Can achieve large size via sale of ownership (stock)</td>
</tr>
<tr>
<td>Income included and taxed on proprietor’s personal tax return</td>
<td>More available brain power and managerial skill</td>
<td>Ownership (stock) is readily transferable</td>
</tr>
<tr>
<td>Independence</td>
<td>Income included and taxed on partner’s personal tax return</td>
<td>Long life of firm</td>
</tr>
<tr>
<td>Secrecy</td>
<td></td>
<td>Can hire professional managers</td>
</tr>
<tr>
<td>Ease of dissolution</td>
<td></td>
<td>Has better access to financing</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Weaknesses</th>
<th>Partnership</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner has unlimited liability—total wealth can be taken to satisfy debts</td>
<td>Owners have unlimited liability and may have to cover debts of other partners</td>
<td>Taxes generally higher because corporate income is taxed, and dividends paid to owners are also taxed at a maximum 15% rate</td>
</tr>
<tr>
<td>Limited fund-raising power tends to inhibit growth</td>
<td>Partnership is dissolved when a partner dies</td>
<td>More expensive to organize than other business forms</td>
</tr>
<tr>
<td>Proprietor must be jack-of-all-trades</td>
<td>Difficult to liquidate or transfer partnership</td>
<td>Subject to greater government regulation</td>
</tr>
<tr>
<td>Difficult to give employees long-run career opportunities</td>
<td></td>
<td>Lacks secrecy because regulations require firms to disclose financial results</td>
</tr>
<tr>
<td>Lacks continuity when proprietor dies</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**corporation**
An entity created by law.

**stockholders**
The owners of a corporation, whose ownership, or equity, takes the form of either common stock or preferred stock.

**limited liability**
A legal provision that limits stockholders’ liability for a corporation’s debt to the amount they initially invested in the firm by purchasing stock.

**common stock**
The purest and most basic form of corporate ownership.
return by receiving **dividends**—periodic distributions of cash—or by realizing gains through increases in share price. Because the money to pay dividends generally comes from the profits that a firm earns, stockholders are sometimes referred to as *residual claimants*, meaning that stockholders are paid last—after employees, suppliers, tax authorities, and lenders receive what they are owed. If the firm does not generate enough cash to pay everyone else, there is nothing available for stockholders.

As noted in the upper portion of Figure 1.1, control of the corporation functions a little like a democracy. The stockholders (owners) vote periodically to elect members of the *board of directors* and to decide other issues such as amending the corporate charter. The *board of directors* is typically responsible for approving strategic goals and plans, setting general policy, guiding corporate affairs, and approving major expenditures. Most importantly, the board decides when to hire or fire top managers and establishes compensation packages for the most senior executives. The board consists of “inside” directors, such as key corporate executives, and “outside” or “independent” directors, such as executives from other companies, major shareholders, and national or community leaders. Outside directors for major corporations receive compensation in the form of cash, stock, and stock options. This compensation often totals $100,000 per year or more.
The president or chief executive officer (CEO) is responsible for managing day-to-day operations and carrying out the policies established by the board of directors. The CEO reports periodically to the firm’s directors.

It is important to note the division between owners and managers in a large corporation, as shown by the dashed horizontal line in Figure 1.1. This separation and some of the issues surrounding it will be addressed in the discussion of the agency issue later in this chapter.

Other Limited Liability Organizations

A number of other organizational forms provide owners with limited liability. The most popular are limited partnership (LP), S corporation (S corp), limited liability company (LLC), and limited liability partnership (LLP). Each represents a specialized form or blending of the characteristics of the organizational forms described previously. What they have in common is that their owners enjoy limited liability, and they typically have fewer than 100 owners.

WHY STUDY MANAGERIAL FINANCE?

An understanding of the concepts, techniques, and practices presented throughout this text will fully acquaint you with the financial manager’s activities and decisions. Because the consequences of most business decisions are measured in financial terms, the financial manager plays a key operational role. People in all areas of responsibility—accounting, information systems, management, marketing, operations, and so forth—need a basic awareness of finance so they will understand how to quantify the consequences of their actions.

OK, so you’re not planning to major in finance! You still will need to understand how financial managers think to improve your chance of success in your chosen business career. Managers in the firm, regardless of their job descriptions, usually have to provide financial justification for the resources they need to do their job. Whether you are hiring new workers, negotiating an advertising budget, or upgrading the technology used in a manufacturing process, understanding the financial aspects of your actions will help you gain the resources you need to be successful. The “Why This Chapter Matters to You” section that appears on each chapter opening page should help you understand the importance of each chapter in both your professional and personal life.

As you study this text, you will learn about the career opportunities in managerial finance, which are briefly described in Table 1.2 on page 10. Although this text focuses on publicly held profit-seeking firms, the principles presented here are equally applicable to private and not-for-profit organizations. The decision-making principles developed in this text can also be applied to personal financial decisions. We hope that this first exposure to the exciting field of finance will provide the foundation and initiative for further study and possibly even a future career.

REVIEW QUESTIONS

1–1 What is finance? Explain how this field affects all of the activities in which businesses engage.

1–2 What is the financial services area of finance? Describe the field of managerial finance.
1–3 Which legal form of business organization is most common? Which form is dominant in terms of business revenues?

1–4 Describe the roles and the basic relationships among the major parties in a corporation—stockholders, board of directors, and managers. How are corporate owners rewarded for the risks they take?

1–5 Briefly name and describe some organizational forms other than corporations that provide owners with limited liability.

1–6 Why is the study of managerial finance important to your professional life regardless of the specific area of responsibility you may have within the business firm? Why is it important to your personal life?

### TABLE 1.2  Career Opportunities in Managerial Finance

<table>
<thead>
<tr>
<th>Position</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial analyst</td>
<td>Prepares the firm’s financial plans and budgets. Other duties include financial forecasting, performing financial comparisons, and working closely with accounting.</td>
</tr>
<tr>
<td>Capital expenditures manager</td>
<td>Evaluates and recommends proposed long-term investments. May be involved in the financial aspects of implementing approved investments.</td>
</tr>
<tr>
<td>Cash manager</td>
<td>Maintains and controls the firm’s daily cash balances. Frequently manages the firm’s cash collection and disbursement activities and short-term investments and coordinates short-term borrowing and banking relationships.</td>
</tr>
<tr>
<td>Credit analyst/manager</td>
<td>Administers the firm’s credit policy by evaluating credit applications, extending credit, and monitoring and collecting accounts receivable.</td>
</tr>
<tr>
<td>Pension fund manager</td>
<td>Oversees or manages the assets and liabilities of the employees’ pension fund.</td>
</tr>
<tr>
<td>Foreign exchange manager</td>
<td>Manages specific foreign operations and the firm’s exposure to fluctuations in exchange rates.</td>
</tr>
</tbody>
</table>

#### 1.2 Goal of the Firm

What goal should managers pursue? There is no shortage of possible answers to this question. Some might argue that managers should focus entirely on satisfying customers. Progress toward this goal could be measured by the market share attained by each of the firm’s products. Others suggest that managers must first inspire and motivate employees; in that case, employee turnover might be the key success metric to watch. Clearly the goal that managers select will affect many of the decisions that they make, so choosing an objective is a critical determinant of how businesses operate.

**MAXIMIZE SHAREHOLDER WEALTH**

Finance teaches that managers’ primary goal should be to maximize the wealth of the firm’s owners—the stockholders. The simplest and best measure of stockholder wealth is the firm’s share price, so most textbooks (ours included) instruct
managers to take actions that increase the firm’s share price. A common misconception is that when firms strive to make their shareholders happy, they do so at the expense of other constituencies such as customers, employees, or suppliers. This line of thinking ignores the fact that in most cases, to enrich shareholders, managers must first satisfy the demands of these other interest groups. Recall that dividends that stockholders receive ultimately come from the firm’s profits. It is unlikely that a firm whose customers are unhappy with its products, whose employees are looking for jobs at other firms, or whose suppliers are reluctant to ship raw materials will make shareholders rich because such a firm will likely be less profitable in the long run than one that better manages its relations with these stakeholder groups.

Therefore, we argue that the goal of the firm, and also of managers, should be to maximize the wealth of the owners for whom it is being operated, or equivalently, to maximize the stock price. This goal translates into a straightforward decision rule for managers—only take actions that are expected to increase the share price. Although that goal sounds simple, implementing it is not always easy. To determine whether a particular course of action will increase or decrease a firm’s share price, managers have to assess what return (that is, cash inflows net of cash outflows) the action will bring and how risky that return might be. Figure 1.2 depicts this process. In fact, we can say that the key variables that managers must consider when making business decisions are return (cash flows) and risk.

MAXIMIZE PROFIT?

It might seem intuitive that maximizing a firm’s share price is equivalent to maximizing its profits, but that is not always correct.

Corporations commonly measure profits in terms of earnings per share (EPS), which represent the amount earned during the period on behalf of each outstanding share of common stock. EPS are calculated by dividing the period’s total earnings available for the firm’s common stockholders by the number of shares of common stock outstanding.
Nick Dukakis, the financial manager of Neptune Manufacturing, a producer of marine engine components, is choosing between two investments, Rotor and Valve. The following table shows the EPS that each investment is expected to have over its 3-year life.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total for years 1, 2, and 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rotor</td>
<td>$1.40</td>
<td>$1.00</td>
<td>$0.40</td>
<td>$2.80</td>
</tr>
<tr>
<td>Valve</td>
<td>$0.60</td>
<td>1.00</td>
<td>1.40</td>
<td>3.00</td>
</tr>
</tbody>
</table>

In terms of the profit maximization goal, Valve would be preferred over Rotor because it results in higher total earnings per share over the 3-year period ($3.00 EPS compared with $2.80 EPS).

But does profit maximization lead to the highest possible share price? For at least three reasons the answer is often no. First, timing is important. An investment that provides a lower profit in the short run may be preferable to one that earns a higher profit in the long run. Second, profits and cash flows are not identical. The profit that a firm reports is simply an estimate of how it is doing, an estimate that is influenced by many different accounting choices that firms make when assembling their financial reports. Cash flow is a more straightforward measure of the money flowing into and out of the company. Companies have to pay their bills with cash, not earnings, so cash flow is what matters most to financial managers. Third, risk matters a great deal. A firm that earns a low but reliable profit might be more valuable than another firm with profits that fluctuate a great deal (and therefore can be very high or very low at different times).

**Timing**

Because the firm can earn a return on funds it receives, *the receipt of funds sooner rather than later is preferred.* In our example, in spite of the fact that the total earnings from Rotor are smaller than those from Valve, Rotor provides much greater earnings per share in the first year. The larger returns in year 1 could be reinvested to provide greater future earnings.

**Cash Flows**

Profits do *not* necessarily result in cash flows available to the stockholders. There is no guarantee that the board of directors will increase dividends when profits increase. In addition, the accounting assumptions and techniques that a firm adopts can sometimes allow a firm to show a positive profit even when its cash outflows exceed its cash inflows.

Furthermore, higher earnings do not necessarily translate into a higher stock price. Only when earnings increases are accompanied by increased future cash flows is a higher stock price expected. For example, a firm with a high-quality product sold in a very competitive market could increase its earnings by significantly reducing its equipment maintenance expenditures. The firm’s expenses would be reduced, thereby increasing its profits. But if the reduced maintenance...
results in lower product quality, the firm may impair its competitive position, and its stock price could drop as many well-informed investors sell the stock in anticipation of lower future cash flows. In this case, the earnings increase was accompanied by lower future cash flows and therefore a lower stock price.

Risk
Profit maximization also fails to account for risk—the chance that actual outcomes may differ from those expected. A basic premise in managerial finance is that a trade-off exists between return (cash flow) and risk. Return and risk are, in fact, the key determinants of share price, which represents the wealth of the owners in the firm.

Cash flow and risk affect share price differently: Holding risk fixed, higher cash flow is generally associated with a higher share price. In contrast, holding cash flow fixed, higher risk tends to result in a lower share price because the stockholders do not like risk. For example, Apple’s CEO, Steve Jobs, took a leave of absence to battle a serious health issue, and the firm’s stock suffered as a result. This occurred not because of any near-term cash flow reduction but in response to the firm’s increased risk—there’s a chance that the firm’s lack of near-term leadership could result in reduced future cash flows. Simply put, the increased risk reduced the firm’s share price. In general, stockholders are risk averse—that is, they must be compensated for bearing risk. In other words, investors expect to earn higher returns on riskier investments, and they will accept lower returns on relatively safe investments. The key point, which will be fully developed in Chapter 5, is that differences in risk can significantly affect the value of different investments.

WHAT ABOUT STAKEHOLDERS?
Although maximization of shareholder wealth is the primary goal, many firms broaden their focus to include the interests of stakeholders as well as shareholders. Stakeholders are groups such as employees, customers, suppliers, creditors, owners, and others who have a direct economic link to the firm. A firm with a stakeholder focus consciously avoids actions that would prove detrimental to stakeholders. The goal is not to maximize stakeholder well-being but to preserve it.

The stakeholder view does not alter the goal of maximizing shareholder wealth. Such a view is often considered part of the firm’s “social responsibility.” It is expected to provide long-run benefit to shareholders by maintaining positive relationships with stakeholders. Such relationships should minimize stakeholder turnover, conflicts, and litigation. Clearly, the firm can better achieve its goal of shareholder wealth maximization by fostering cooperation with its other stakeholders, rather than conflict with them.

THE ROLE OF BUSINESS ETHICS
Business ethics are the standards of conduct or moral judgment that apply to persons engaged in commerce. Violations of these standards in finance involve a variety of actions: “creative accounting,” earnings management, misleading financial forecasts, insider trading, fraud, excessive executive compensation, options backdating, bribery, and kickbacks. The financial press has reported many such violations in recent years, involving such well-known companies as
Apple and Bank of America. As a result, the financial community is developing and enforcing ethical standards. The goal of these ethical standards is to motivate business and market participants to adhere to both the letter and the spirit of laws and regulations concerned with business and professional practice. Most business leaders believe businesses actually strengthen their competitive positions by maintaining high ethical standards.

**Considering Ethics**

Robert A. Cooke, a noted ethicist, suggests that the following questions be used to assess the ethical viability of a proposed action.¹

1. Is the action arbitrary or capricious? Does it unfairly single out an individual or group?
2. Does the action violate the moral or legal rights of any individual or group?
3. Does the action conform to accepted moral standards?
4. Are there alternative courses of action that are less likely to cause actual or potential harm?

Clearly, considering such questions before taking an action can help to ensure its ethical viability.

Today, many firms are addressing the issue of ethics by establishing corporate ethics policies. The *Focus on Ethics* box provides an example of ethics policies at Google. A major impetus toward the development of ethics policies has been the Sarbanes-Oxley Act of 2002. Frequently, employees are required to sign a formal pledge to uphold the firm’s ethics policies. Such policies typically apply to employee actions in dealing with all corporate stakeholders, including the public.

**Ethics and Share Price**

An effective ethics program can enhance corporate value by producing a number of positive benefits. It can reduce potential litigation and judgment costs, maintain a positive corporate image, build shareholder confidence, and gain the loyalty, commitment, and respect of the firm’s stakeholders. Such actions, by maintaining and enhancing cash flow and reducing perceived risk, can positively affect the firm’s share price. **Ethical behavior is therefore viewed as necessary for achieving the firm’s goal of owner wealth maximization.**

**REVIEW QUESTIONS**

1–7 What is the goal of the firm and, therefore, of all managers and employees? Discuss how one measures achievement of this goal.

1–8 For what three basic reasons is profit maximization inconsistent with wealth maximization?

---

1–9 What is risk? Why must risk as well as return be considered by the financial manager who is evaluating a decision alternative or action?

1–10 Describe the role of corporate ethics policies and guidelines, and discuss the relationship that is believed to exist between ethics and share price.

**focus on ETHICS**

**Will Google Live Up to Its Motto?**

Google offers an interesting case study on value maximization and corporate ethics. In 2004, Google’s founders provided “An Owner’s Manual” for shareholders, which stated that “Google is not a conventional company” and that the company’s ultimate goal “is to develop services that significantly improve the lives of as many people as possible.” The founders stressed that it was not enough for Google to run a successful business but that they want to use the company to make the world a better place. The “Owner’s Manual” also unveiled Google’s corporate motto, “Don’t Be Evil.” The motto is intended to convey Google’s willingness to do the right thing even when doing so requires the firm to sacrifice in the short run. Google’s approach does not appear to be limiting its ability to maximize value—the company’s share price increased from $100 to approximately $500 in 6 years.

Google’s business goal is “instantly delivering relevant information on any topic” to the world. However, when the company launched its search engine in China in early 2006, it agreed to the Chinese government’s request to censor search results. Some observers felt that the opportunity to gain access to the vast Chinese market led Google to compromise its principles.

In January 2010, Google announced that the Gmail accounts of Chinese human-rights activists and a number of technology, financial, and defense companies had been hacked. The company threatened to pull out of China unless an agreement on uncensored search results could be reached. Two months later, Google began routing Chinese web searches to their uncensored servers in Hong Kong, a move that was cheered by activists and human-rights groups, but criticized by the Chinese government. In the short term, Google’s shareholders suffered. During the first quarter of 2010, Google’s share price declined by 8.5 percent, compared to an increase of 45.2 percent for Google’s main rival in China, Baidu.com.

Google’s founders seemed to anticipate the current situation in the firm’s “Owner’s Manual.” According to the firm, “If opportunities arise that might cause us to sacrifice short-term results but are in the best long-term interest of our shareholders, we will take those opportunities. We have the fortitude to do this. We would request that our shareholders take the long-term view.”

It remains to be seen whether Google’s short-term sacrifice will benefit shareholders in the long run.

**Is the goal of maximization of shareholder wealth necessarily ethical or unethical?**

**How can Google justify its actions in the short run to its long-run investors?**


1.3 Managerial Finance Function

People in all areas of responsibility within the firm must interact with finance personnel and procedures to get their jobs done. For financial personnel to make useful forecasts and decisions, they must be willing and able to talk to individuals in other areas of the firm. For example, when considering a new product, the financial manager needs to obtain sales forecasts, pricing guidelines, and advertising and promotion budget estimates from marketing personnel. The managerial finance function can be broadly described by considering its role within the
organization, its relationship to economics and accounting, and the primary activities of the financial manager.

**ORGANIZATION OF THE FINANCE FUNCTION**

The size and importance of the managerial finance function depend on the size of the firm. In small firms, the finance function is generally performed by the accounting department. As a firm grows, the finance function typically evolves into a separate department linked directly to the company president or CEO through the chief financial officer (CFO). The lower portion of the organizational chart in Figure 1.1 on page 8 shows the structure of the finance function in a typical medium- to large-size firm.

Reporting to the CFO are the treasurer and the controller. The **treasurer** (the chief financial manager) typically manages the firm’s cash, investing surplus funds when available and securing outside financing when needed. The treasurer also oversees a firm’s pension plans and manages critical risks related to movements in foreign currency values, interest rates, and commodity prices. The **controller** (the chief accountant) typically handles the accounting activities, such as corporate accounting, tax management, financial accounting, and cost accounting. The treasurer’s focus tends to be more external, whereas the controller’s focus is more internal.

If international sales or purchases are important to a firm, it may well employ one or more finance professionals whose job is to monitor and manage the firm’s exposure to loss from currency fluctuations. A trained financial manager can “hedge,” or protect against such a loss, at a reasonable cost by using a variety of financial instruments. These **foreign exchange managers** typically report to the firm’s treasurer.

**RELATIONSHIP TO ECONOMICS**

The field of finance is closely related to economics. Financial managers must understand the economic framework and be alert to the consequences of varying levels of economic activity and changes in economic policy. They must also be able to use economic theories as guidelines for efficient business operation. Examples include supply-and-demand analysis, profit-maximizing strategies, and price theory. The primary economic principle used in managerial finance is **marginal cost–benefit analysis**, the principle that financial decisions should be made and actions taken only when the added benefits exceed the added costs. Nearly all financial decisions ultimately come down to an assessment of their marginal benefits and marginal costs.

Jamie Teng is a financial manager for Nord Department Stores, a large chain of upscale department stores operating primarily in the western United States. She is currently trying to decide whether to replace one of the firm’s computer servers with a new, more sophisticated one that would both speed processing and handle a larger volume of transactions. The new computer would require a cash outlay of $8,000, and the old computer could be sold to net $2,000. The total benefits from the new server (measured in today’s dollars) would be $10,000. The benefits over a similar time period from the old computer (measured in today’s
dollars) would be $3,000. Applying marginal cost–benefit analysis, Jamie organ-
izes the data as follows:

<table>
<thead>
<tr>
<th>Benefits with new computer</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Benefits with old computer</td>
<td>$3,000</td>
</tr>
<tr>
<td>(1) Marginal (added) benefits</td>
<td>$7,000</td>
</tr>
<tr>
<td>Cost of new computer</td>
<td>$8,000</td>
</tr>
<tr>
<td>Less: Proceeds from sale of old computer</td>
<td>$2,000</td>
</tr>
<tr>
<td>(2) Marginal (added) costs</td>
<td>$6,000</td>
</tr>
<tr>
<td>Net benefit [(1) − (2)]</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Because the marginal (added) benefits of $7,000 exceed the marginal (added) costs of $6,000, Jamie recommends that the firm purchase the new computer to replace the old one. The firm will experience a net benefit of $1,000 as a result of this action.

**RELATIONSHIP TO ACCOUNTING**

The firm’s finance and accounting activities are closely related and generally overlap. In small firms accountants often carry out the finance function, and in large firms financial analysts often help compile accounting information. However, there are two basic differences between finance and accounting; one is related to the emphasis on cash flows and the other to decision making.

**Emphasis on Cash Flows**

The accountant's primary function is to develop and report data for measuring the performance of the firm, assess its financial position, comply with and file reports required by securities regulators, and file and pay taxes. Using generally accepted accounting principles, the accountant prepares financial statements that recognize revenue at the time of sale (whether payment has been received or not) and recognize expenses when they are incurred. This approach is referred to as the **accrual basis**.

The financial manager, on the other hand, places primary emphasis on **cash flows**, the intake and outgo of cash. He or she maintains the firm’s solvency by planning the cash flows necessary to satisfy its obligations and to acquire assets needed to achieve the firm’s goals. The financial manager uses this **cash basis** to recognize the revenues and expenses only with respect to actual inflows and outflows of cash. Whether a firm earns a profit or experiences a loss, it must have a sufficient flow of cash to meet its obligations as they come due.

**Example 1.3**

Nassau Corporation, a small yacht dealer, sold one yacht for $100,000 in the calendar year just ended. Nassau originally purchased the yacht for $80,000. Although the firm paid in full for the yacht during the year, at year-end it has yet to collect the $100,000 from the customer. The accounting view and the financial
view of the firm’s performance during the year are given by the following income
and cash flow statements, respectively.

<table>
<thead>
<tr>
<th>Accounting view (accrual basis)</th>
<th>Financial view (cash basis)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nassau Corporation income statement for the year ended 12/31</td>
<td>Nassau Corporation cash flow statement for the year ended 12/31</td>
</tr>
<tr>
<td>Sales revenue $100,000</td>
<td>Cash inflow $0</td>
</tr>
<tr>
<td>Less: Costs 80,000</td>
<td>Less: Cash outflow 80,000</td>
</tr>
<tr>
<td>Net profit $20,000</td>
<td>Net cash flow ($80,000)</td>
</tr>
</tbody>
</table>

In an accounting sense, Nassau Corporation is profitable, but in terms of actual cash flow it is a financial failure. Its lack of cash flow resulted from the uncollected accounts receivable of $100,000. Without adequate cash inflows to meet its obligations, the firm will not survive, regardless of its level of profits.

As the example shows, accrual accounting data do not fully describe the circumstances of a firm. Thus the financial manager must look beyond financial statements to obtain insight into existing or developing problems. Of course, accountants are well aware of the importance of cash flows, and financial managers use and understand accrual-based financial statements. Nevertheless, the financial manager, by concentrating on cash flows, should be able to avoid insolvency and achieve the firm’s financial goals.

Individuals do not use accrual concepts. Rather, they rely solely on cash flows to measure their financial outcomes. Generally, individuals plan, monitor, and assess their financial activities using cash flows over a given period, typically a month or a year. Ann Bach projects her cash flows during October 2012 as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Inflow</td>
</tr>
<tr>
<td>Net pay received</td>
<td>$4,400</td>
</tr>
<tr>
<td>Rent</td>
<td>$1,200</td>
</tr>
<tr>
<td>Car payment</td>
<td>450</td>
</tr>
<tr>
<td>Utilities</td>
<td>300</td>
</tr>
<tr>
<td>Groceries</td>
<td>800</td>
</tr>
<tr>
<td>Clothes</td>
<td>750</td>
</tr>
<tr>
<td>Dining out</td>
<td>650</td>
</tr>
<tr>
<td>Gasoline</td>
<td>260</td>
</tr>
<tr>
<td>Interest income</td>
<td>220</td>
</tr>
<tr>
<td>Misc. expense</td>
<td>425</td>
</tr>
<tr>
<td>Totals</td>
<td>$4,620</td>
</tr>
</tbody>
</table>

Ann subtracts her total outflows of $4,835 from her total inflows of $4,620 and finds that her net cash flow for October will be −$215. To cover the $215
shortfall, Ann will have to either borrow $215 (putting it on a credit card is a form of borrowing) or withdraw $215 from her savings. Or she may decide to reduce her outflows in areas of discretionary spending—for example, clothing purchases, dining out, or areas that make up the $425 of miscellaneous expense.

**Decision Making**

The second major difference between finance and accounting has to do with decision making. Accountants devote most of their attention to the *collection and presentation of financial data*. Financial managers evaluate the accounting statements, develop additional data, and *make decisions* on the basis of their assessment of the associated returns and risks. Of course, this does not mean that accountants never make decisions or that financial managers never gather data but rather that the primary focuses of accounting and finance are distinctly different.

**PRIMARY ACTIVITIES OF THE FINANCIAL MANAGER**

In addition to ongoing involvement in financial analysis and planning, the financial manager’s primary activities are making investment and financing decisions. Investment decisions determine what types of assets the firm holds. Financing decisions determine how the firm raises money to pay for the assets in which it invests. One way to visualize the difference between a firm’s investment and financing decisions is to refer to the balance sheet shown in Figure 1.3. Investment decisions generally refer to the items that appear on the left-hand side of the balance sheet, and financing decisions relate to the items on the right-hand side. Keep in mind, though, that financial managers make these decisions based on their impact on the value of the firm, not on the accounting principles used to construct a balance sheet.

**REVIEW QUESTIONS**

1–11 In what financial activities does a corporate treasurer engage?
1–12 What is the primary economic principle used in managerial finance?
1–13 What are the major differences between accounting and finance with respect to emphasis on cash flows and decision making?
1–14 What are the two primary activities of the financial manager that are related to the firm’s balance sheet?
1.4 Governance and Agency

As noted earlier, the majority of owners of a corporation are normally distinct from its managers. Nevertheless, managers are entrusted to only take actions or make decisions that are in the best interests of the firm’s owners, its shareholders. In most cases, if managers fail to act on the behalf of the shareholders, they will also fail to achieve the goal of maximizing shareholder wealth. To help ensure that managers act in ways that are consistent with the interests of shareholders and mindful of obligations to other stakeholders, firms aim to establish sound corporate governance practices.

CORPORATE GOVERNANCE

Corporate governance refers to the rules, processes, and laws by which companies are operated, controlled, and regulated. It defines the rights and responsibilities of the corporate participants such as the shareholders, board of directors, officers and managers, and other stakeholders, as well as the rules and procedures for making corporate decisions. A well-defined corporate governance structure is intended to benefit all corporate stakeholders by ensuring that the firm is run in a lawful and ethical fashion, in accordance with best practices, and subject to all corporate regulations.

A firm’s corporate governance is influenced by both internal factors such as the shareholders, board of directors, and officers as well as external forces such as clients, creditors, suppliers, competitors, and government regulations. The corporate organization, depicted in Figure 1.1 on page 8, helps to shape a firm’s corporate governance structure. In particular, the stockholders elect a board of directors, who in turn hire officers or managers to operate the firm in a manner consistent with the goals, plans, and policies established and monitored by the board on behalf of the shareholders.

Individual versus Institutional Investors

To better understand the role that shareholders play in shaping a firm’s corporate governance, it is helpful to differentiate between the two broad classes of owners—individuals and institutions. Generally, individual investors own relatively small quantities of shares and as a result do not typically have sufficient means to directly influence a firm’s corporate governance. In order to influence the firm, individual investors often find it necessary to act as a group by voting collectively on corporate matters. The most important corporate matter individual investors vote on is the election of the firm’s board of directors. The corporate board’s first responsibility is to the shareholders. The board not only sets policies that specify ethical practices and provide for the protection of stakeholder interests, but it also monitors managerial decision making on behalf of investors.

Although they also benefit from the presence of the board of directors, institutional investors have advantages over individual investors when it comes to influencing the corporate governance of a firm. Institutional investors are investment professionals that are paid to manage and hold large quantities of securities on behalf of individuals, businesses, and governments. Institutional investors include banks, insurance companies, mutual funds, and pension funds. Unlike individual investors, institutional investors often monitor and directly influence a
firm’s corporate governance by exerting pressure on management to perform or communicating their concerns to the firm’s board. These large investors can also threaten to exercise their voting rights or liquidate their holdings if the board does not respond positively to their concerns. Because individual and institutional investors share the same goal, individual investors benefit from the shareholder activism of institutional investors.

**Government Regulation**

Unlike the impact that clients, creditors, suppliers, or competitors can have on a particular firm’s corporate governance, government regulation generally shapes the corporate governance of all firms. During the past decade, corporate governance has received increased attention due to several high-profile corporate scandals involving abuse of corporate power and, in some cases, alleged criminal activity by corporate officers. The misdeeds derived from two main types of issues: (1) false disclosures in financial reporting and other material information releases and (2) undisclosed conflicts of interest between corporations and their analysts, auditors, and attorneys and between corporate directors, officers, and shareholders. Asserting that an integral part of an effective corporate governance regime is provisions for civil or criminal prosecution of individuals who conduct unethical or illegal acts in the name of the firm, in July 2002 the U.S. Congress passed the **Sarbanes-Oxley Act of 2002** (commonly called **SOX**).

Sarbanes-Oxley is intended to eliminate many of the disclosure and conflict of interest problems that can arise when corporate managers are not held personally accountable for their firm’s financial decisions and disclosures. SOX accomplished the following: established an oversight board to monitor the accounting industry; tightened audit regulations and controls; toughened penalties against executives who commit corporate fraud; strengthened accounting disclosure requirements and ethical guidelines for corporate officers; established corporate board structure and membership guidelines; established guidelines with regard to analyst conflicts of interest; mandated instant disclosure of stock sales by corporate executives; and increased securities regulation authority and budgets for auditors and investigators.

**THE AGENCY ISSUE**

We know that the duty of the financial manager is to maximize the wealth of the firm’s owners. Shareholders give managers decision-making authority over the firm; thus managers can be viewed as the agents of the firm’s shareholders. Technically, any manager who owns less than 100 percent of the firm is an agent acting on behalf of other owners. This separation of owners and managers is shown by the dashed horizontal line in Figure 1.1 on page 8, and it is representative of the classic principal–agent relationship, where the shareholders are the principals. In general, a contract is used to specify the terms of a principal–agent relationship. This arrangement works well when the agent makes decisions that are in the principal’s best interest but doesn’t work well when the interests of the principal and agent differ.

In theory, most financial managers would agree with the goal of shareholder wealth maximization. In reality, however, managers are also concerned with their personal wealth, job security, and fringe benefits. Such concerns may cause managers to make decisions that are not consistent with shareholder
wealth maximization. For example, financial managers may be reluctant or unwilling to take more than moderate risk if they perceive that taking too much risk might jeopardize their job or reduce their personal wealth.

**The Agency Problem**

An important theme of corporate governance is to ensure the accountability of managers in an organization through mechanisms that try to reduce or eliminate the principal–agent problem; however, when these mechanisms fail agency problems arise. **Agency problems** arise when managers deviate from the goal of maximization of shareholder wealth by placing their personal goals ahead of the goals of shareholders. These problems in turn give rise to agency costs. **Agency costs** are costs borne by shareholders due to the presence or avoidance of agency problems, and in either case represent a loss of shareholder wealth. For example, shareholders incur agency costs when managers fail to make the best investment decision or when managers have to be monitored to ensure that the best investment decision is made, because either situation is likely to result in a lower stock price.

**Management Compensation Plans**

In addition to the roles played by corporate boards, institutional investors, and government regulations, corporate governance can be strengthened by ensuring that managers’ interests are aligned with those of shareholders. A common approach is to **structure management compensation** to correspond with firm performance. In addition to combating agency problems, the resulting performance-based compensation packages allow firms to compete for and hire the best managers available. The two key types of managerial compensation plans are incentive plans and performance plans.

**Incentive plans** tie management compensation to share price. One incentive plan grants **stock options** to management. If the firm’s stock price rises over time, managers will be rewarded by being able to purchase stock at the market price in effect at the time of the grant and then to resell the shares at the prevailing higher market price.

Many firms also offer **performance plans** that tie management compensation to performance measures such as earnings per share (EPS) or growth in EPS. **Performance shares** and/or **cash bonuses** are used as compensation under these plans.

**Performance shares** are shares of stock given to management for meeting stated performance goals, whereas **cash bonuses** are cash payments tied to the achievement of certain performance goals.

The execution of many compensation plans has been closely scrutinized in light of the past decade’s corporate scandals and financial woes. Both individual and institutional stockholders, as well as the Securities and Exchange Commission (SEC) and other government entities, continue to publicly question the appropriateness of the multimillion-dollar compensation packages that many corporate executives receive. The total compensation in 2009 for the chief executive officers of the 500 biggest U.S. companies is considerable. For example, the three highest-paid CEOs in 2009 were (1) H. Lawrence Culp Jr. of Danaher Corp., who earned $141.36 million; (2) Lawrence J. Ellison of Oracle Corp., who earned $130.23 million; and (3) Aubrey K. McClendon of Chesapeake Energy Corp., who earned...
Most studies have failed to find a strong relationship between the performance that companies achieve and the compensation that CEOs receive. During the past few years, publicity surrounding these large compensation packages (without corresponding performance) has driven down executive compensation. Contributing to this publicity is the SEC requirement that publicly traded companies disclose to shareholders and others the amount of compensation to their CEO, CFO, three other highest-paid executives, and directors; the method used to determine it; and a narrative discussion regarding the underlying compensation policies. At the same time, new compensation plans that better link managers’ performance to their compensation are being developed and implemented. As evidence of this trend, consider that the average total compensation for the top three CEOs in 2009 was down slightly more than 69 percent from the average for the top three CEOs in 2006. The average in 2006 was $421.13 million versus an average of $128.63 million in 2009.

The Threat of Takeover
When a firm’s internal corporate governance structure is unable to keep agency problems in check, it is likely that rival managers will try to gain control of the firm. Because agency problems represent a misuse of the firm’s resources and impose agency costs on the firm’s shareholders, the firm’s stock is generally depressed, making the firm an attractive takeover target. The threat of takeover by another firm that believes it can enhance the troubled firm’s value by restructuring its management, operations, and financing can provide a strong source of external corporate governance. The constant threat of a takeover tends to motivate management to act in the best interests of the firm’s owners.

$114.29 million. Tenth on the same list is Jen-Hsun Huang of NVIDIA Corp., who earned $31.40 million.

Matter of fact

A quick check of the most recent Forbes.com reporting of CEO performance versus pay for the top 500 U.S. companies reveals that the highest-paid CEOs are not necessarily the best-performing CEOs. In fact, the total compensation of the top three performing CEOs is less than 4 percent of the total compensation for the top-paid CEOs, all of whom have performances ranked 82nd or worse.

<table>
<thead>
<tr>
<th>Efficiency ranking</th>
<th>Chief executive officer</th>
<th>Company</th>
<th>Compensation</th>
<th>Compensation rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>Jeffery H. Boyd</td>
<td>Priceline.com</td>
<td>$7.49 mil.</td>
<td>135th</td>
</tr>
<tr>
<td>2nd</td>
<td>Jeffrey P. Bezos</td>
<td>Amazon.com</td>
<td>$1.28 mil.</td>
<td>463rd</td>
</tr>
<tr>
<td>3rd</td>
<td>Leonard Bell</td>
<td>Alexion Pharmaceuticals</td>
<td>$4.26 mil.</td>
<td>286th</td>
</tr>
<tr>
<td>90th</td>
<td>H. Lawrence Culp Jr.</td>
<td>Danaher Corp.</td>
<td>$41.36 mil.</td>
<td>1st</td>
</tr>
<tr>
<td>82nd</td>
<td>Lawrence J. Ellison</td>
<td>Oracle Corp.</td>
<td>$130.23 mil.</td>
<td>2nd</td>
</tr>
<tr>
<td>163rd</td>
<td>Aubrey K. McClendon</td>
<td>Chesapeake Energy Corp.</td>
<td>$114.29 mil.</td>
<td>3rd</td>
</tr>
</tbody>
</table>
Unconstrained, managers may have other goals in addition to share price maximization, but much of the evidence suggests that share price maximization—the focus of this book—is the primary goal of most firms.

**REVIEW QUESTIONS**


1–16 Define agency problems, and describe how they give rise to agency costs. Explain how a firm’s corporate governance structure can help avoid agency problems.

1–17 How can the firm structure management compensation to minimize agency problems? What is the current view with regard to the execution of many compensation plans?

1–18 How do market forces—both shareholder activism and the threat of takeover—act to prevent or minimize the agency problem? What role do institutional investors play in shareholder activism?

**FOCUS ON VALUE**

Chapter 1 established the primary goal of the firm—to maximize the wealth of the owners for whom the firm is being operated. For public companies, value at any time is reflected in the stock price. Therefore, management should act only on those opportunities that are expected to create value for owners by increasing the stock price. Doing this requires management to consider the returns (magnitude and timing of cash flows), the risk of each proposed action, and their combined effect on value.

**REVIEW OF LEARNING GOALS**

LG 1 Define finance and the managerial finance function. Finance is the science and art of managing money. It affects virtually all aspects of business. Managerial finance is concerned with the duties of the financial manager working in a business. Financial managers administer the financial affairs of all types of businesses—private and public, large and small, profit seeking and not for profit. They perform such varied tasks as developing a financial plan or budget, extending credit to customers, evaluating proposed large expenditures, and raising money to fund the firm’s operations.

LG 2 Describe the legal forms of business organization. The legal forms of business organization are the sole proprietorship, the partnership, and the corporation. The corporation is dominant in terms of business receipts, and its owners are its common and preferred stockholders. Stockholders expect to earn a return by receiving dividends or by realizing gains through increases in share price.
LG 3 Describe the goal of the firm, and explain why maximizing the value of the firm is an appropriate goal for a business. The goal of the firm is to maximize its value and therefore the wealth of its shareholders. Maximizing the value of the firm means running the business in the interest of those who own it—the shareholders. Because shareholders are paid after other stakeholders, it is generally necessary to satisfy the interests of other stakeholders to enrich shareholders.

LG 4 Describe how the managerial finance function is related to economics and accounting. All areas of responsibility within a firm interact with finance personnel and procedures. The financial manager must understand the economic environment and rely heavily on the economic principle of marginal cost–benefit analysis to make financial decisions. Financial managers use accounting but concentrate on cash flows and decision making.

LG 5 Identify the primary activities of the financial manager. The primary activities of the financial manager, in addition to ongoing involvement in financial analysis and planning, are making investment decisions and making financing decisions.

LG 6 Describe the nature of the principal–agent relationship between the owners and managers of a corporation, and explain how various corporate governance mechanisms attempt to manage agency problems. This separation of owners and managers of the typical firm is representative of the classic principal–agent relationship, where the shareholders are the principals and managers are the agents. This arrangement works well when the agent makes decisions that are in the principal’s best interest but can lead to agency problems when the interests of the principal and agent differ. A firm’s corporate governance structure is intended to help ensure that managers act in the best interests of the firm’s shareholders, and other stakeholders, and it is usually influenced by both internal and external factors.

Opener-in-Review

In the chapter opener you read about Facebook and its founder’s reluctance to go public. If Zuckerberg is expected to remain the CEO of Facebook after the IPO, why would he be worried about going public?

Self-Test Problem (Solution in Appendix)

LG 4 ST1-1 Emphasis on Cash Flows Worldwide Rugs is a rug importer located in the United States that resells its import products to local retailers. Last year Worldwide Rugs imported $2.5 million worth of rugs from around the world, all of which were paid
for prior to shipping. On receipt of the rugs, the importer immediately resold them to local retailers for $3 million. To allow its retail clients time to resell the rugs, Worldwide Rugs sells to retailers on credit. Prior to the end of its business year, Worldwide Rugs collected 85% of its outstanding accounts receivable.

a. What is the accounting profit that Worldwide Rugs generated for the year?
b. Did Worldwide Rugs have a successful year from an accounting perspective?
c. What is the financial cash flow that Worldwide Rugs generated for the year?
d. Did Worldwide Rugs have a successful year from a financial perspective?
e. If the current pattern persists, what is your expectation for the future success of Worldwide Rugs?
Recently, some branches of Donut Shop, Inc., have dropped the practice of allowing employees to accept tips. Customers who once said, “Keep the change,” now have to get used to waiting for their nickels. Management even instituted a policy of requiring that the change be thrown out if a customer drives off without it. As a frequent customer who gets coffee and doughnuts for the office, you notice that the lines are longer and that more mistakes are being made in your order.

Explain why tips could be viewed as similar to stock options and why the delays and incorrect orders could represent a case of agency costs. If tips are gone forever, how could Donut Shop reduce these agency costs?

## Problems

### P1–1 Liability comparisons
Merideth Harper has invested $25,000 in Southwest Development Company. The firm has recently declared bankruptcy and has $60,000 in unpaid debts. Explain the nature of payments, if any, by Ms. Harper in each of the following situations.

a. Southwest Development Company is a *sole proprietorship* owned by Ms. Harper.

b. Southwest Development Company is a 50–50 *partnership* of Ms. Harper and Christopher Black.

c. Southwest Development Company is a *corporation*.

### P1–2 Accrual income versus cash flow for a period
Thomas Book Sales, Inc., supplies textbooks to college and university bookstores. The books are shipped with a proviso that they must be paid for within 30 days but can be returned for a full refund credit within 90 days. In 2009, Thomas shipped and billed book titles totaling $760,000. Collections, net of return credits, during the year totaled $690,000. The company spent $300,000 acquiring the books that it shipped.

a. Using accrual accounting and the preceding values, show the firm’s net profit for the past year.

b. Using cash accounting and the preceding values, show the firm’s net cash flow for the past year.

c. Which of these statements is more useful to the financial manager? Why?

### P1–3 Cash flows
It is typical for Jane to plan, monitor, and assess her financial position using cash flows over a given period, typically a month. Jane has a savings account, and her bank loans money at 6% per year while it offers short-term investment rates of 5%. Jane’s cash flows during August were as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Cash inflow</th>
<th>Cash outflow</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clothes</td>
<td></td>
<td>$1,000</td>
</tr>
<tr>
<td>Interest received</td>
<td>$450</td>
<td></td>
</tr>
<tr>
<td>Dining out</td>
<td></td>
<td>500</td>
</tr>
<tr>
<td>Groceries</td>
<td></td>
<td>800</td>
</tr>
<tr>
<td>Salary</td>
<td>$4,500</td>
<td></td>
</tr>
<tr>
<td>Auto payment</td>
<td></td>
<td>355</td>
</tr>
<tr>
<td>Utilities</td>
<td></td>
<td>280</td>
</tr>
<tr>
<td>Mortgage</td>
<td></td>
<td>1,200</td>
</tr>
<tr>
<td>Gas</td>
<td></td>
<td>222</td>
</tr>
</tbody>
</table>
a. Determine Jane’s total cash inflows and cash outflows.
b. Determine the net cash flow for the month of August.
c. If there is a shortage, what are a few options open to Jane?
d. If there is a surplus, what would be a prudent strategy for her to follow?

P1–4 Marginal cost–benefit analysis and the goal of the firm Ken Allen, capital budgeting analyst for Bally Gears, Inc., has been asked to evaluate a proposal. The manager of the automotive division believes that replacing the robotics used on the heavy truck gear line will produce total benefits of $560,000 (in today’s dollars) over the next 5 years. The existing robotics would produce benefits of $400,000 (also in today’s dollars) over that same time period. An initial cash investment of $220,000 would be required to install the new equipment. The manager estimates that the existing robotics can be sold for $70,000. Show how Ken will apply marginal cost–benefit analysis techniques to determine the following:
   a. The marginal (added) benefits of the proposed new robotics.
   b. The marginal (added) cost of the proposed new robotics.
   c. The net benefit of the proposed new robotics.
   d. What should Ken Allen recommend that the company do? Why?
   e. What factors besides the costs and benefits should be considered before the final decision is made?

P1–5 Identifying agency problems, costs, and resolutions Explain why each of the following situations is an agency problem and what costs to the firm might result from it. Suggest how the problem might be dealt with short of firing the individual(s) involved.
   a. The front desk receptionist routinely takes an extra 20 minutes of lunch time to run personal errands.
   b. Division managers are padding cost estimates so as to show short-term efficiency gains when the costs come in lower than the estimates.
   c. The firm’s chief executive officer has had secret talks with a competitor about the possibility of a merger in which she would become the CEO of the combined firms.
   d. A branch manager lays off experienced full-time employees and staffs customer service positions with part-time or temporary workers to lower employment costs and raise this year’s branch profit. The manager’s bonus is based on profitability.

P1–6 ETHICS PROBLEM What does it mean to say that managers should maximize shareholder wealth “subject to ethical constraints”? What ethical considerations might enter into decisions that result in cash flow and stock price effects that are less than they might otherwise have been?
Assume that Monsanto Corporation is considering the renovation and/or replacement of some of its older and outdated carpet-manufacturing equipment. Its objective is to improve the efficiency of operations in terms of both speed and reduction in the number of defects. The company’s finance department has compiled pertinent data that will allow it to conduct a marginal cost–benefit analysis for the proposed equipment replacement.

The cash outlay for new equipment would be approximately $600,000. The net book value of the old equipment and its potential net selling price add up to $250,000. The total benefits from the new equipment (measured in today’s dollars) would be $900,000. The benefits of the old equipment over a similar period of time (measured in today’s dollars) would be $300,000.

**TO DO**

Create a spreadsheet to conduct a marginal cost–benefit analysis for Monsanto Corporation, and determine the following:

a. The marginal (added) benefits of the proposed new equipment.

b. The marginal (added) cost of the proposed new equipment.

c. The net benefit of the proposed new equipment.

d. What would you recommend that the firm do? Why?

Visit [www.myfinancelab.com](http://www.myfinancelab.com) for Chapter Case: *Assessing the Goal of Sports Products, Inc.*, Group Exercises, and numerous online resources.