Foundations of Financial Management

FOURTEENTH EDITION

ANNOTATED INSTRUCTOR’S EDITION
 CHAPTER 1
The Goals and Functions of Financial Management

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Yvon Chouinard is a fascinating man who as a young boy had a dream of becoming a fur trapper and ended up being the owner and founder of Patagonia, Inc. This company is known not only for its clothing and gear equipment but also its environmentalism.

Mr. Chouinard was born in a little French-Canadian town in Maine, and as a seven-year-old boy moved with his family to Burbank, California. Not speaking English, Mr. Chouinard started attending school, but after three days decided it was not for him, and left school. At age 12 he became interested in falconry, which in the end led him to rock climbing. At age 18 he decided to teach himself how to create higher quality and more environmentally friendly climbing equipment. This reinforced his favorite motto: “You go to the mountains, but you don’t leave a trace of ever being there.” He developed reusable hard steel pitons for pounding into the rock face. Fellow climbers quickly noticed these even though they cost $1.50 each, at a time when European pitons were selling for just $.15. However, the investment was worth it, because unlike the others, Mr. Chouinard’s pitons could be used over and over again. His continuous improvements to climbing equipment and attire turned his lifestyle into a business.

By 1970, Chouinard Equipment had become the largest supplier of climbing hardware in the United States, and in 1972 the company introduced its first mail catalog. During those early years Mr. Chouinard’s mission was to make the best quality product possible. Even though his company was successful, it was not as sustainable as he would like. He considered closing his firm and quitting the business when he realized that the materials his company was using were damaging to the environment.

One example was the use of industrially grown cotton. Mr. Chouinard decided that within two years the company would no longer make products out of this product. The company created a new mission statement: Build the best product, cause no unnecessary harm, use business to inspire and implement solutions to the environmental crisis. True to its statement, Patagonia in the mid-1990s started using fibers that are sustainable, like recycled soda bottles and organic cotton for its famous fleeces, as well as organic dyes.

In 2001 Mr. Chouinard also costarted an alliance called 1% for the Planet®, which contributes at least 1 percent of its net annual sales to environmental causes. His devotion and determination have made Patagonia, Inc., one of the most environmentally aware companies in the world. It is involved in causes like: Voice Your Choice™, Conservacion Patagonica, The Conservation Alliance, and many other environmental programs, all of which help restore the state of our environment. (More information can be found on www.patagonia.com.)

While maintaining environmental integrity, Patagonia produces sales of over $240 million a year worldwide, allowing Mr. Chouinard to seriously leverage his concern for the natural settings he’s spent a lifetime enjoying. The life and story of Yvon Chouinard can be found in his book called: Let My People Go Surfing: The Education of a Reluctant Businessman.
The Goals and Functions of Financial Management

M is one of those companies that is more adept than others at creating products, marketing those products, and being financially astute. 3M is the world leader in optical films, industrial and office tapes, and nonwoven fabrics. Consumers may recognize 3M as the maker of Post-it notes, Scotch tape, and sponges, in addition to thousands of other diverse products such as overhead projectors and roofing granules. The company has always been known for its ability to create new products and markets and, at times, as much as 35 percent of their sales have been generated from products developed in the previous five years. In order to accomplish these goals, 3M’s research and development has to be financed, the design and production functions funded, and the products marketed and sold worldwide. This process involves all the functions of business.

Did you ever stop to think about the importance of the finance function for a $25 billion multinational company like 3M where 64 percent of sales are international? Someone has to manage the international cash flow, bank relationships, payroll, purchases of plant and equipment, and acquisition of capital. Financial decisions must be made concerning the feasibility and profitability of the continuous stream of new products developed through 3M’s very creative research and development efforts. The financial manager needs to keep his or her pulse on interest rates, exchange rates, and the tone of the money and capital markets.

In order to have a competitive multinational company, the financial manager must manage 3M’s global affairs and react quickly to changes in financial markets and exchange rate fluctuations. The board of directors and chief executive officer rely on the financial division to provide a precious resource—capital—and to manage it efficiently and profitably. If you would like to do some research on 3M, you can access its home page at www.3M.com. If you would like to understand more about how companies make financial decisions, keep reading.
Chapter 1  The Goals and Functions of Financial Management  

The field of finance is closely related to economics and accounting, and financial managers need to understand the relationships between these fields. Economics provides a structure for decision making in such areas as risk analysis, pricing theory through supply and demand relationships, comparative return analysis, and many other important areas. Economics also provides the broad picture of the economic environment in which corporations must continually make decisions. A financial manager must understand the institutional structure of the Federal Reserve System, the commercial banking system, and the interrelationships between the various sectors of the economy. Economic variables, such as gross domestic product, industrial production, disposable income, unemployment, inflation, interest rates, and taxes (to name a few), must fit into the financial manager’s decision model and be applied correctly. These terms will be presented throughout the text and integrated into the financial process.

Accounting is sometimes said to be the language of finance because it provides financial data through income statements, balance sheets, and the statement of cash flows. The financial manager must know how to interpret and use these statements in allocating the firm’s financial resources to generate the best return possible in the long run. Finance links economic theory with the numbers of accounting, and all corporate managers—whether in production, sales, research, marketing, management, or long-run strategic planning—must know what it means to assess the financial performance of the firm.

Many students approaching the field of finance for the first time might wonder what career opportunities exist. For those who develop the necessary skills and training, jobs include corporate financial officer, banker, stockbroker, financial analyst, portfolio manager, investment banker, financial consultant, or personal financial planner. As the student progresses through the text, he or she will become increasingly familiar with the important role of the various participants in the financial decision-making process. A financial manager addresses such varied issues as decisions on plant location, the raising of capital, or simply how to get the highest return on \[ \text{x million dollars} \] between 5 o’clock this afternoon and 8 o’clock tomorrow morning.

Like any discipline, the field of finance has developed and changed over time. At the turn of the century, finance emerged as a field separate from economics when large industrial corporations in oil, steel, chemicals, and railroads were created by early industrialists such as Rockefeller, Carnegie, and Du Pont. In these early days, a student of finance would spend time learning about the financial instruments that were essential to mergers and acquisitions. By the 1930s, the country was in its worst depression ever and financial practice revolved around such topics as the preservation of capital, maintenance of liquidity, reorganization of financially troubled corporations, and the bankruptcy process. By the mid-1950s finance moved away from its descriptive and definitional nature and became more analytical. One of the major advances was the decision-oriented process of allocating \textit{financial capital} (money) for the purchase of \textit{real capital} (long-term plant and equipment). The enthusiasm for more detailed analysis spread to other decision-making areas of the firm—such as cash and inventory...
management, capital structure theory, and dividend policy. The emphasis also shifted from that of the outsider looking in at the firm, to that of the financial manager making tough day-to-day decisions that would affect the firm’s performance.

**Modern Issues in Finance**

Modern financial management has focused on risk-return relationships and the maximization of return for a given level of risk. The award of the 1990 Nobel prize in economics to Professors Harry Markowitz and William Sharpe for their contributions to the financial theories of risk-return and portfolio management demonstrates the importance of these concepts. In addition, Professor Merton Miller received the Nobel prize in economics for his work in the area of capital structure theory (the study of the relative importance of debt and equity). These three scholars were the first professors of finance to win a Nobel prize in economics, and their work has been very influential in the field of finance over the last 50 years. Since then, others have followed.

Finance continues to become more analytical and mathematical. New financial products with a focus on hedging are being widely used by financial managers to reduce some of the risk caused by changing interest rates and foreign currency exchange rates.

While the increase of prices, or inflation, has always been a key variable in financial decisions, it was not very important from the 1930s to about 1965 when it averaged about 1 percent per year. However, after 1965 the annual rate of price increases began to accelerate and became quite significant in the 1970s when inflation reached double-digit levels during several years. Inflation remained relatively high until 1982 when the U.S. economy entered a phase of disinflation (a slowing down of price increases). The effects of inflation and disinflation on financial forecasting, the required rates of return for capital budgeting decisions, and the cost of capital are quite significant to financial managers and have become more important in their decision making.

The impact of the financial crisis and how it has affected the financial system will be covered throughout the book. In this brief introduction we want to emphasize risk management issues. Risk management will have a strong focus over the next decade as the result of the financial crisis that began with the housing bubble in the early part of the new millennium. The unwillingness to enforce risk management controls at most financial institutions allowed the extension of credit to borrowers who had high-risk profiles, and in too many cases, no chance of paying back their loans. In addition to the poor credit screening of borrowers, quantitative financial engineers created portfolios of mortgage-backed securities that included many of these risky loans. The rating agencies gave these products high credit ratings (AAA), and so investors, including sophisticated institutional investors, thought the assets were safe. As the economy went into a recession and borrowers stopped making their loan payments, these mortgage-backed securities fell dramatically in value and many financial institutions had huge losses on their balance sheets which they were forced to write off with mark-to-market accounting standards. In some cases the write-offs reduced bank capital to precarious levels or even below the minimum required level, causing the banks to raise more capital.
To make matters more complicated, new unregulated products called credit default swaps (CDS) were created as insurance against borrowers defaulting on their loans. These credit default swaps were backed by some of the same financial institutions who lacked enough capital to support the insurance that they guaranteed. Liquidity dried up, markets stopped working, and eventually the government stepped into the breach by forcing mergers and infusing capital into the financial institutions.

By fall 2008, Bear Sterns, the fifth largest investment bank, was forced to merge with JPMorgan Chase, a strong bank. By September 15, 2009, Lehman Brothers, the fourth largest investment bank, declared bankruptcy and even Merrill Lynch had to be saved by merging with Bank of America. The Federal Deposit Insurance Corporation seized Washington Mutual on September 25 and again JPMorgan Chase was called on to take over the operations of the biggest bank failure in U.S. history. As the markets continued to disintegrate, the Federal Reserve provided $540 billion to help money market funds meet their redemptions. The crisis continued into 2009 and by February 11 Congress agreed on a $789 billion stimulus package to help keep the economy afloat. Both Chrysler (in April) and General Motors (in June) filed for bankruptcy, and by September 2009 with the help of the Federal Reserve, money and capital markets became more stable and began to function properly.

This crisis created the longest recession since the Great Depression and forced financial institutions to pay more attention to their risk controls. Money became tight and hard to find unless a borrower had a very high credit rating. Chief executives who had previously ignored the warnings of their risk management teams now gave risk managers more control over financial transactions that might cause a repeat of the calamity, and Congress was working on new regulations for financial institutions and creating new oversight bodies. The future should be interesting.

**The Impact of the Internet**

The Internet craze of the 1990s created what was referred to as the “new economy.” The Internet has been around for a long time and only in the 1990s did it start to be applied to commercial ventures as companies tried to get a return on their previous technology investments. There never was a “new economy,” only an economy where companies were constantly moving through a technological transformation that continues to this day.

The rapid development of computer technology, both software and hardware, continued to turn the Internet into a dynamic force in the economy and has affected the way business is conducted. The rapid expansion of the Internet and its acceptance by the U.S. population has allowed the creation of many new business models and companies such as Amazon.com, eBay, and Google. It has also enabled the acceleration of e-commerce solutions for “old economy” companies. These e-commerce solutions include different ways to reach customers—the business to consumer model (B2C)—and more efficient ways to interact with suppliers—the business to business model (B2B).

Ralph S. Larsen, former chairman and CEO of Johnson & Johnson said, “The Internet is going to turn the way we do business upside down—and for the better. From the most straightforward administrative functions, to operations, to marketing and
sales, to supply chain relationships, to finance, to research and development, to customer relationships—no part of our business will remain untouched by this technological revolution."¹ So far he has been right.

For a financial manager, e-commerce impacts financial management because it affects the pattern and speed with which cash flows through the firm. In the B2C model, products are bought with credit cards and the credit checks are performed by Visa, MasterCard, American Express, or some other credit card company, and the selling firm gets the cash flow faster than it would using its own credit channels. In the B2B model, orders can be placed, inventory managed, and bids to supply product can be accepted, all online. The B2B model can help companies lower the cost of managing inventory, accounts receivable, and cash. Where applicable we have included Internet examples throughout the book to highlight the impact of e-commerce and the Internet on the finance function.

Having examined the field of finance and some of its more recent developments, let us turn our attention to the functions financial managers must perform. It is the responsibility of financial management to allocate funds to current and fixed assets, to obtain the best mix of financing alternatives, and to develop an appropriate dividend policy within the context of the firm’s objectives. These functions are performed on a day-to-day basis as well as through infrequent use of the capital markets to acquire new funds. The daily activities of financial management include credit management, inventory control, and the receipt and disbursement of funds. Less routine functions encompass the sale of stocks and bonds and the establishment of capital budgeting and dividend plans.

As indicated in Figure 1–1, all these functions are carried out while balancing the profitability and risk components of the firm.

The appropriate risk-return trade-off must be determined to maximize the market value of the firm for its shareholders. The risk-return decision will influence not only the operational side of the business (capital versus labor or Product A versus Product B) but also the financing mix (stocks versus bonds versus retained earnings).

Forms of Organization

The finance function may be carried out within a number of different forms of organizations. Of primary interest are the sole proprietorship, the partnership, and the corporation.

¹Johnson & Johnson 1999 Annual Report, p. 4.
Sole Proprietorship The **sole proprietorship** form of organization represents single-person ownership and offers the advantages of simplicity of decision making and low organizational and operating costs. Most small businesses with 1 to 10 employees are sole proprietorships. The major drawback of the sole proprietorship is that there is unlimited liability to the owner. In settlement of the firm’s debts, the owner can lose not only the capital that has been invested in the business, but also personal assets. This drawback can be serious, and the student should realize that few lenders are willing to advance funds to a small business without a personal liability commitment.

The profits or losses of a sole proprietorship are taxed as though they belong to the individual owner. Thus if a sole proprietorship makes $50,000, the owner will claim the profits on his or her tax return. (In the corporate form of organization, the corporation first pays a tax on profits, and then the owners of the corporation pay a tax on any distributed profits.) Approximately 72 percent of the 30 million business firms in this country are organized as sole proprietorships, and these produce approximately 4.2 percent of the total revenue and 10.0 percent of the total profits of the U.S. economy.

Partnership The second form of organization is the **partnership**, which is similar to a sole proprietorship except there are two or more owners. Multiple ownership makes it possible to raise more capital and to share ownership responsibilities. Most partnerships are formed through an agreement between the participants, known as the **articles of partnership**, which specifies the ownership interest, the methods for distributing profits, and the means for withdrawing from the partnership. For taxing purposes, partnership profits or losses are allocated directly to the partners, and there is no double taxation as there is in the corporate form.

Like the sole proprietorship, the partnership arrangement carries unlimited liability for the owners. While the partnership offers the advantage of sharing possible losses, it presents the problem of owners with unequal wealth having to absorb losses. If three people form a partnership with a $10,000 contribution each and the business loses $100,000, one wealthy partner may have to bear a disproportionate share of the losses if the other two partners do not have sufficient personal assets.

To circumvent this shared unlimited liability feature, a special form of partnership, called a **limited liability partnership**, can be utilized. Under this arrangement, one or more partners are designated general partners and have unlimited liability for the debts of the firm; other partners are designated limited partners and are liable only for their initial contribution. The limited partners are normally prohibited from being active in the management of the firm. You may have heard of limited partnerships in real estate syndications in which a number of limited partners are doctors, lawyers, and CPAs and there is one general partner who is a real estate professional. Not all financial institutions will extend funds to a limited partnership.

Corporation In terms of revenue and profits produced, the corporation is by far the most important type of economic unit. While only 20 percent of U.S. business firms are corporations, 83 percent of sales and 70 percent of profits can be attributed to the corporate form of organization. The **corporation** is unique—it is a legal entity unto itself. Thus the corporation may sue or be sued, engage in contracts, and acquire...
property. A corporation is formed through articles of incorporation, which specify the rights and limitations of the entity.

A corporation is owned by shareholders who enjoy the privilege of limited liability, meaning their liability exposure is generally no greater than their initial investment.\(^2\) A corporation also has a continual life and is not dependent on any one shareholder for maintaining its legal existence.

A key feature of the corporation is the easy divisibility of the ownership interest by issuing shares of stock. While it would be nearly impossible to have more than 10,000 or 20,000 partners in most businesses, a corporation may have several hundred thousand shareholders. For example, General Electric has 10.6 billion shares of common stock outstanding with 50.2 percent institutional ownership (pension funds, mutual funds, etc.), while Microsoft with 8.9 billion shares outstanding has 62.5 percent institutional ownership.

The shareholders’ interests are ultimately managed by the corporation’s board of directors. The directors may include key management personnel of the firm as well as directors from outside the firm. Directors serve in a fiduciary capacity for the shareholders and may be liable for the mismanagement of the firm. After the collapse of corporations such as Enron and WorldCom due to fraud, the role of outside directors became much more important and corporations were motivated to comply with more stringent corporate governance laws mandated by Congress. Outside directors may make from $5,000 per year for serving on the board of small companies to $75,000 to $150,000 per year for serving on the board of large companies such as General Electric. GE pays additional fees for outside directors who chair or are on the audit, the management development, and compensation committees.

Because the corporation is a separate legal entity, it reports and pays taxes on its own income. As previously mentioned, any remaining income that is paid to the shareholders in the form of dividends will require the payment of a second tax by the shareholders. One of the key disadvantages to the corporate form of organization is this potential double taxation of earnings. In 2003, Congress diminished part of this impact by lowering the maximum tax rate on dividends from 38.6 percent to 15 percent. However, this 15 percent rate is likely to increase in the future.

There is, however, one way to completely circumvent the double taxation of a normal corporation and that is through formation of a Subchapter S corporation. With a Subchapter S corporation,\(^3\) the income is taxed as direct income to the stockholders and thus is taxed only once as normal income, similar to a partnership. Nevertheless, the shareholders receive all the organizational benefits of a corporation, including limited liability. The Subchapter S designation can apply to corporations with up to 75 stockholders.\(^3\)

While the proprietorship, traditional partnership, and various forms of limited partnerships are all important, the corporation is given primary emphasis in this text. Because of the all-pervasive impact of the corporation on our economy, and because

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\(^2\) An exception to this rule is made if shareholders buy their stock at less than par value. Then they would be liable for up to the par value.

\(^3\) If there are more than 75 investors, a master limited partnership can be formed in which there is limited liability and single taxation of owners.
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most growing businesses eventually become corporations, the effects of most deci-
sions in this text are often considered from the corporate viewpoint.

As we learned in the previous section, the corporation is governed by the board of
directors, led by the chairman of the board. In many companies the chairman of the
board is also the CEO or Chief Executive Officer of the company. During the three-
year stock market collapse of 2000–2002, many companies went bankrupt due to mis-
management or in some cases, financial statements that did not accurately reflect the
financial condition of the firm because of deception as well as outright fraud. Com-
panies such as WorldCom reported over $9 billion of incorrect or fraudulent financial
entries on their income statements. Many of the errors were found after the company
filed for bankruptcy, and new management came in to try and save the company.

Enron also declared bankruptcy after it became known that their accountants kept
many financing transactions “off the books.” The company had more debt than most
of their investors and lenders knew about. Many of these accounting manipulations
were too sophisticated for the average analyst, banker, or board member to under-
stand. In the Enron case, the U.S. government indicted its auditor, Arthur Andersen,
and because of the indictment, the Andersen firm was dissolved. Other bankruptcies
involving WorldCom, Global Crossing, and Adelphia also exhibited fraudulent finan-
cial statements. Because of these accounting scandals, there was a public outcry for
corporate accountability, ethics reform, and a demand to know why the corporate gov-
erance system had failed.

Again, in the financial crisis in 2007–2009 it seems that boards of directors didn’t
understand the risk that their management had taken in extending mortgages to high
credit risks. Even senior management didn’t understand the risk embodied in some of
the mortgage-backed securities that their organizations had bought for investments.
This total lack of risk management oversight continued to put a focus on corporate
governance issues. With the Internet bubble and financial crisis coming so close
together, many questioned the ability of large companies and financial institutions to
regulate themselves. Why didn’t the boards of directors know what was going on and
stop it? Why didn’t they fire members of management and clean house? Why did they
allow such huge bonuses and executive compensation when companies were perform-
ing so poorly? One result of the financial crisis is that we can expect more government
regulation of financial institutions and more careful examination of corporations by
outside financial analysts.

The issues of corporate governance are really agency problems. Agency theory
examines the relationship between the owners and the managers of the firm. In pri-
vately owned firms, management and owners are usually the same people. Manage-
ment operates the firm to satisfy its own goals, needs, financial requirements, and the
like. However, as a company moves from private to public ownership, management
now represents all the owners. This places management in the agency position of mak-
ing decisions that will be in the best interests of all shareholders. Because of diversi-
fied ownership interests, conflicts between managers and shareholders can arise that
impact the financial decisions of the firm. When the chairman of the board is also the
chief executive of the firm, stockholders recognize that the executive may act in his or her own best interests rather than those of the stockholders of the firm. In the prior bankruptcy examples, that is exactly what happened. Management filled their own pockets and left the stockholders with little or no value in the company’s stock. In the WorldCom case, a share of common stock fell from the $60 range to $.15 per share and eventually ended up being worthless. Because of these potential conflicts of interest, many hold the view that the chairman of the board of directors should be from outside a company rather than an executive of the firm.

Because institutional investors such as pension funds and mutual funds own a large percentage of stock in major U.S. companies, these investors are having more to say about the way publicly owned corporations are managed. As a group they have the ability to vote large blocks of shares for the election of a board of directors. The threat of their being able to replace poorly performing boards of directors makes institutional investors quite influential. Since pension funds and mutual funds represent individual workers and investors, they have a responsibility to see that firms are managed in an efficient and ethical way.

**Sarbanes-Oxley Act**

Because corporate fraud during the Internet bubble had taken place at some very large and high-profile companies, Congress decided that it needed to do something to control corrupt corporate behavior. There were problems that needed correcting. The major accounting firms had failed to detect fraud in their accounting audits, and outside directors were often not provided with the kind of information that would allow them to detect fraud and mismanagement. Because many outside directors were friends of management and had been nominated by management, there was a question about their willingness to act independently in carrying out their fiduciary responsibility to shareholders. Congress has often created laws that have unintended consequences, so there is still disagreement on the effectiveness of the Sarbanes-Oxley Act that Congress passed in 2002.

The act set up a five-member Public Company Accounting Oversight Board with the responsibility for establishing auditing standards within companies, controlling the quality of audits, and setting rules and standards for the independence of the auditors. It also puts great responsibility on the internal audit committee of each publicly traded company to enforce compliance with the act. The major focus of the act is to make sure that publicly traded corporations accurately present their assets, liabilities, and equity and income on their financial statements.

**GOALS OF FINANCIAL MANAGEMENT**

Let us look at several alternative goals for the financial manager as well as the other managers of the firm. One may suggest that the most important goal for financial management is to “earn the highest possible profit for the firm.” Under this criterion, each decision would be evaluated on the basis of its overall contribution to the firm’s earnings. While this seems to be a desirable approach, there are some serious drawbacks to profit maximization as the primary goal of the firm.
First, a change in profit may also represent a change in risk. A conservative firm that earned $1.25 per share may be a less desirable investment if its earnings per share increase to $1.50, but the risk inherent in the operation increases even more.

A second possible drawback to the goal of maximizing profit is that it fails to consider the timing of the benefits. For example, if we could choose between the following two alternatives, we might be indifferent if our emphasis were solely on maximizing earnings.

<table>
<thead>
<tr>
<th>Earnings per Share</th>
<th>Period One</th>
<th>Period Two</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alternative A</td>
<td>$1.50</td>
<td>$2.00</td>
<td>$3.50</td>
</tr>
<tr>
<td>Alternative B</td>
<td>2.00</td>
<td>1.50</td>
<td>3.50</td>
</tr>
</tbody>
</table>

Both investments would provide $3.50 in total earnings, but Alternative B is clearly superior because the larger benefits occur earlier. We could reinvest the difference in earnings for Alternative B one period sooner.

Finally, the goal of maximizing profit suffers from the almost impossible task of accurately measuring the key variable in this case, namely, “profit.” As you will observe throughout the text, there are many different economic and accounting definitions of profit, each open to its own set of interpretations. Furthermore, problems related to inflation and international currency transactions complicate the issue. Constantly improving methods of financial reporting offer some hope in this regard, but many problems remain.

**A Valuation Approach**

While there is no question that profits are important, the key issue is how to use them in setting a goal for the firm. The ultimate measure of performance is not what the firm earns, but how the earnings are valued by the investor. In analyzing the firm, the investor will also consider the risk inherent in the firm’s operation, the time pattern over which the firm’s earnings increase or decrease, the quality and reliability of reported earnings, and many other factors. The financial manager, in turn, must be sensitive to all of these considerations. He or she must question the impact of each decision on the firm’s overall valuation. If a decision maintains or increases the firm’s overall value, it is acceptable from a financial viewpoint; otherwise, it should be rejected. This principle is demonstrated throughout the text.

**Maximizing Shareholder Wealth**

The broad goal of the firm can be brought into focus if we say the financial manager should attempt to maximize the wealth of the firm’s shareholders through achieving the highest possible value for the firm. Shareholder wealth maximization is not a simple task, since the financial manager cannot directly control the firm’s stock price, but can only act in a way that is consistent with the desires of the shareholders. Since stock prices are affected by expectations of the future as well as by the current economic environment, much of what affects stock prices is beyond management’s direct
control. Even firms with good earnings and favorable financial trends do not always perform well in a declining stock market over the short term.

The concern is not so much with daily fluctuations in stock value as with long-term wealth maximization. This can be difficult in light of changing investor expectations. In the 1950s and 1960s, the investor emphasis was on maintaining rapid rates of earnings growth. In the 1970s and 1980s, investors became more conservative, putting a premium on lower risk and, at times, high current dividend payments.

In the early and mid-1990s, investors emphasized lean, efficient, well-capitalized companies able to compete effectively in the global environment. But by the late 1990s, there were hundreds of high-tech Internet companies raising capital through initial public offerings of their common stock. Many of these companies had dreams, but very little revenue and no earnings, yet their stock sold at extremely high prices. Some in the financial community said that the old valuation models were dead, didn’t work, and were out of date; earnings and cash flow didn’t matter anymore. Alan Greenspan, then chairman of the Federal Reserve Board, made the now famous remark that the high-priced stock market was suffering from “irrational exuberance.” By late 2000, many of these companies turned out to be short-term wonders. A few years later, hundreds were out of business. The same scenario played out with the housing bubble of 2001–2006, which collapsed in 2007.

Management and Stockholder Wealth

Does modern corporate management always follow the goal of maximizing shareholder wealth? Under certain circumstances, management may be more interested in maintaining its own tenure and protecting “private spheres of influence” than in maximizing stockholder wealth. For example, suppose the management of a corporation receives a tender offer to merge the corporation into a second firm; while this offer might be attractive to shareholders, it might be quite unpleasant to present management. Historically, management may have been willing to maintain the status quo rather than to maximize stockholder wealth.

As mentioned earlier, this is now changing. First, in most cases “enlightened management” is aware that the only way to maintain its position over the long run is to be sensitive to shareholder concerns. Poor stock price performance relative to other companies often leads to undesirable takeovers and proxy fights for control. Second, management often has sufficient stock option incentives that will motivate it to achieve market value maximization for its own benefit. Third, powerful institutional investors are making management more responsive to shareholders.

Social Responsibility and Ethical Behavior

Is our goal of shareholder wealth maximization consistent with a concern for social responsibility for the firm? In most instances the answer is yes. By adopting policies that maximize values in the market, the firm can attract capital, provide employment, and offer benefits to its community. This is the basic strength of the private enterprise system.

Nevertheless, certain socially desirable actions such as pollution control, equitable hiring practices, and fair pricing standards may at times be inconsistent with earning
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the highest possible profit or achieving maximum valuation in the market. For example, pollution control projects frequently offer a negative return. Does this mean firms should not exercise social responsibility in regard to pollution control? The answer is no—but certain cost-increasing activities may have to be mandatory rather than voluntary, at least initially, to ensure that the burden falls equally over all business firms. However, there is evidence that socially responsible behavior can be profitable. For example 3M estimates that its Pollution Prevention Pays (3P) program has had financial benefits as well as social benefits. This program has been in place for over 32 years and during this time has prevented the release of more than 2.6 billion pounds of pollutants and saved over $1 billion. See the box on page 16 for more about how 3M is a socially responsible citizen.

Unethical and illegal financial practices on Wall Street by corporate financial “deal-makers” have made news headlines from the late 1980s until the present. For example, Bernie Madoff and his Ponzi scheme made headlines in the latter part of the decade. Insider trading has been one of the most widely publicized issues in recent years. **Insider trading** occurs when someone has information that is not available to the public and then uses this information to profit from trading in a company’s publicly traded securities. This practice is illegal and protected against by the Securities and Exchange Commission (SEC). Sometimes the insider is a company manager; other times it is the company’s lawyer, investment banker, or even the printer of the company’s financial statements. Anyone who has knowledge before public dissemination of that information stands to benefit from either good news or bad news. Trading on private information serves no beneficial economic or financial purpose to the public. It could be argued that insider trading has a negative impact on the average shareholder’s interests because it destroys confidence in the securities markets by making the playing field uneven for investors. If participants feel the markets are unfair, it could destroy firms’ ability to maximize shareholder value.

The penalties for insider trading can be severe—there is a long history of insider traders who have gone to prison. In the 1980s, Ivan Boesky, Dennis Levine, and Michael Milken were all sent to jail for their insider trading. More recently, Roger Blackwell, a professor and marketing consultant, was convicted in 2005 of tipping off his family and friends about a forthcoming Kellogg purchase of Worthington Foods. Jeffrey Skilling, former CEO of Enron, was convicted of insider trading and was sentenced to 24 years in prison. Samuel Waksal, the founder of ImClone, a pharmaceutical company, was jailed for family sales of ImClone stock in 2000 before a negative review of a promising drug was made public by the Food and Drug Administration. In cases like Waksal’s his shares were sold before the bad news was announced and the selling investors were able to avoid large losses. This same incident also sent Martha Stewart, the homemaking expert, to prison.

Ethics and social responsibility can take many different forms. Ethical behavior for a person or company should be important to everyone because it creates an invaluable reputation. However, once that reputation is lost because of unethical behavior, it is very difficult to get back. Some companies are more visible than others in their pursuit of these ethical goals and most companies that do a good job in this area are profitable, save money, and are good citizens in the communities where they operate.
You may wonder how a financial manager knows whether he or she is maximizing shareholder value and how ethical (or unethical) behavior may affect the value of the company. This information is provided daily to financial managers through price changes determined in the financial markets. But what are the financial markets?

Financial markets are the meeting place for people, corporations, and institutions that either need money or have money to lend or invest. In a broad context, the financial markets exist as a vast global network of individuals and financial institutions that may be lenders, borrowers, or owners of public companies worldwide. Participants in the financial markets also include national, state, and local governments that are primarily borrowers of funds for highways, education, welfare, and other public activities; their markets are referred to as public financial markets. Corporations such as Coca-Cola, Nike, and Ford, on the other hand, raise funds in the corporate financial markets.

Structure and Functions of the Financial Markets

Financial markets can be broken into many distinct parts. Some divisions such as domestic and international markets, or corporate and government markets, are
self-explanatory. Others such as money and capital markets need some explanation. **Money markets** refer to those markets dealing with short-term securities that have a life of one year or less. Securities in these markets can include commercial paper sold by corporations to finance their daily operations, or certificates of deposit with maturities of less than one year sold by banks. Examples of money market securities are presented more fully in Chapter 7.

The **capital markets** are generally defined as those markets where securities have a life of more than one year. While capital markets are long-term markets, as opposed to short-term money markets, it is often common to break down the capital markets into intermediate markets (1 to 10 years) and long-term markets (greater than 10 years). The capital markets include securities such as common stock, preferred stock, and corporate and government bonds. Capital markets are fully presented in Chapter 14. Now that you have a very basic understanding of the makeup of the financial markets, you need to understand how these markets affect corporate managers.

**Allocation of Capital**

A corporation relies on the financial markets to provide funds for short-term operations and for new plant and equipment. A firm may go to the markets and raise financial capital either by borrowing money through a debt offering of corporate bonds or short-term notes, or by selling ownership in the company through an issue of common stock. When a corporation uses the financial markets to raise new funds, called an initial public offering or IPO, the sale of securities is said to be made in the **primary market** by way of a new issue. After the securities are sold to the public (institutions and individuals), they are traded in the **secondary market** between investors. It is in the secondary market that prices are continually changing as investors buy and sell securities based on their expectations of a corporation’s prospects. It is also in the secondary market that financial managers are given feedback about their firms’ performance.

How does the market allocate capital to the thousands of firms that are continually in need of money? Let us assume that you graduate from college as a finance major and are hired to manage money for a wealthy family like the Rockefellers. You are given $250 million to manage and you can choose to invest the money anywhere in the world. For example, you could buy common stock in Microsoft, the American software company, or in Nestlé, the Swiss food company, or in Cemex, the Mexican cement company; you could choose to lend money to the U.S. or Japanese governments by purchasing their bonds; or you could lend money to ExxonMobil or British Petroleum. Of course these are only some of the endless choices you would have.

How do you decide to allocate the $250 million so that you will maximize your return and minimize your risk? Some investors will choose a risk level that meets their objective and maximize return for that given level of risk. By seeking this risk-return objective, you will bid up the prices of securities that seem underpriced and have potential for high returns and you will avoid securities of equal risk that, in your judgment, seem overpriced. Since all market participants play the same risk-return game, the financial markets become the playing field, and price movements become the winning or losing score. Let us look at only the corporate sector of the market and
100 companies of equal risk. Those companies with expectations for high return will have higher relative common stock prices than those companies with poor expectations. Since the securities’ prices in the market reflect the combined judgment of all the players, price movements provide feedback to corporate managers and let them know whether the market thinks they are winning or losing against the competition.

Those companies that perform well and are rewarded by the market with high-priced securities have an easier time raising new funds in the money and capital markets than their competitors. They are also able to raise funds at a lower cost. Go back to that $250 million you are managing. If ExxonMobil wants to borrow money from you at 9 percent and Chevron is willing to pay 8 percent but also is riskier, to which company will you lend money? If you chose ExxonMobil you are on your way to understanding finance. The competition between the two firms for your funds will eventually cause Chevron to offer higher returns than ExxonMobil, or they will have to go without funds. In this way the money and capital markets allocate funds to the highest quality companies at the lowest cost and to the lowest quality companies at the highest cost. In other words, firms pay a penalty for failing to perform competitively.

**Institutional Pressure on Public Companies to Restructure**

Sometimes an additional penalty for poor performance is a forced restructuring by institutional investors seeking to maximize a firm’s shareholder value. As mentioned earlier, institutional investors have begun to flex their combined power, and their influence with corporate boards of directors has become very visible. Nowhere has this power been more evident than in the area of corporate restructuring. Restructuring can result in changes in the capital structure (liabilities and equity on the balance sheet). It can also result in the selling of low-profit-margin divisions with the proceeds of the sale reinvested in better investment opportunities. Sometimes restructuring results in the removal of the current management team or large reductions in the workforce. Restructuring also has included mergers and acquisitions of gigantic proportions unheard of in earlier decades. Rather than seeking risk reduction through diversification, firms are now acquiring greater market shares, brand name products (i.e., British Petroleum acquiring Amoco), hidden assets values, or technology—or they are simply looking for size to help them compete in an international arena.

The restructuring and management changes at Hewlett-Packard, IBM, American Express, Sears, and Eastman Kodak during the last decade were a direct result of institutional investors affecting change by influencing the boards of directors to exercise control over all facets of the companies’ activities. Quite a few boards of directors were viewed as rubber stamps for management before this time. Large institutional investors have changed this perception. Without their attempt to maximize the value of their investments, many of the above mentioned restructuring deals would not have taken place. And without the financial markets placing a value on publicly held companies, the restructuring would have been much more difficult to achieve.

**Internationalization of the Financial Markets**

International trade is a growing trend that is likely to continue. Global companies are becoming more common and international brand names like Sony, Coca-Cola, Nestlé, and Mercedes Benz are known the world over. McDonald’s hamburgers are
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Revised Pages

The growth of the global company has led to the growth of global fund raising as companies search for low-priced sources of funds. In a recent annual report, Coca-Cola stated that it conducted business in 59 different currencies and borrowed money in yen, euros, and other international currencies. This discussion demonstrates that the allocation of capital and the search for low-cost sources of financing are now an international game for multinational companies. As an exclamation point consider all the non-U.S. companies who want to raise money in the United States. More and more foreign companies have listed their shares on the New York Stock Exchange, and there are hundreds of foreign companies whose stock is traded in the United States through American Depository Receipts (ADRs).

We live in a world where international events impact economies of all industrial countries and where capital moves from country to country faster than was ever thought possible. Computers interact in a vast international financial network and markets are more vulnerable to the emotions of investors than they have been in the past. The corporate financial manager has an increasing number of external impacts to consider. Future financial managers will need to have the sophistication to understand international capital flows, computerized electronic funds transfer systems, foreign currency hedging strategies, and many other functions.

The Internet and Changes in the Capital Markets

Technology has had a significant impact on the capital markets. The biggest impact has been in the area of cost reduction for trading securities. Those firms and exchanges that are at the front of the technology curve are creating tremendous competitive cost pressures on those firms and exchanges that cannot compete on a cost basis. This has caused consolidations among major stock markets and the merger of brokerage firms with domestic as well as international partners.

In the late 1990s and early 2000s, advances in computer technology stimulated the creation of electronic communications networks (ECNs). These electronic markets had speed and cost advantages over traditional markets and took market share away from the New York Stock Exchange. If you can’t beat them, join them, so the New York Stock Exchange merged with Archipelago, the second largest ECN. The NASDAQ stock market which was already an electronic market bought Instinet, the largest ECN, from Reuters and merged their technology platforms.

Additionally, the cost pressures and the need for capital caused the major markets to become for-profit publicly traded companies. The first to go public was the Chicago Mercantile Exchange, followed by NASDAQ, the NYSE, and the Chicago Board of Trade. Once these exchanges became publicly traded they were able to use their shares for mergers and acquisitions. In 2007, the New York Stock Exchange merged with EuroNext, a large European exchange, and became a global market, and NASDAQ bought a 30 percent stake in the London Stock Exchange—only to dispose of it in the fall of 2007 at a large profit. Later NASDAQ merged with the OMX, a Nordic stock exchange operating eight stock exchanges in the Nordic and Baltic countries. Because the OMX is considered a leader in trading technology, it has over 35 stock exchanges worldwide using its technology. In 2007 the Chicago Board of Trade and the Chicago Mercantile Exchange merged, and so the trend to bigger and more global markets with
low-cost structures continues. The future will likely bring an increased emphasis on globalization of markets through technology.

Another area where the Internet has played its role is in the area of retail stock trading. Firms like Charles Schwab, E*TRADE, TD Ameritrade, and other discount brokerage firms allow customers to trade using the Internet and have created a competitive problem for full-service brokers such as Merrill Lynch and Morgan Stanley. These discount firms have forced the full-service retail brokers to offer Internet trading to their customers, even though Internet trading is not as profitable for them as trading through their brokers.

Another change that has squeezed profits for market makers is the change to price quotes in decimals rather than the traditional 1/16, 1/8, 1/4, and 1/2 price quotes. The trend is to a lower cost environment for the customers and a profit squeeze on markets and brokers. These issues and others will be developed more fully in the capital market section of the text.

The material in this text is covered under six major headings. The student progresses from the development of basic analytical skills in accounting and finance to the utilization of decision-making techniques in working capital management, capital budgeting, long-term financing, and other related areas. A total length of 21 chapters should make the text appropriate for one-semester coverage.

The student is given a thorough grounding in financial theory in a highly palatable and comprehensive fashion—with careful attention to definitions, symbols, and formulas. The intent is that the student will develop a thorough understanding of the basic concepts in finance.

**Parts**

1. **Introduction**  This section examines the goals and objectives of financial management. The emphasis on decision making and risk management is stressed, with an update of significant events influencing the study of finance.

2. **Financial Analysis and Planning**  The student first has the opportunity to review the basic principles of accounting as they relate to finance (financial statements and funds flow are emphasized). Understanding the material in Chapter 2 is a requirement for understanding the topics of working capital management, capital structure, cost of capital, and capital budgeting.

   Additional material in this part includes a thorough study of ratio analysis, budget construction techniques, and development of comprehensive pro forma statements. The effect of heavy fixed commitments, in the form of either debt or plant and equipment, is examined in a discussion of leverage.

3. **Working Capital Management**  The techniques for managing the short-term assets of the firm and the associated liabilities are examined. The material is introduced in the context of risk-return analysis. The financial manager must constantly choose between liquid, low-return assets (perhaps marketable securities) and more profitable, less liquid assets (such as inventory). Sources of short-term financing are also considered.
4. The Capital Budgeting Process  The decision on capital outlays is among the most significant a firm will have to make. In terms of study procedure, we attempt to carefully lock down “time value of money” calculations, then proceed to the valuation of bonds and stocks, emphasizing present value techniques. The valuation chapter develops the traditional dividend valuation model and examines bond price sensitivity in response to discount rates and inflation. An appendix presents the supernormal dividend growth model, or what is sometimes called the “two-stage” dividend model. After careful grounding in valuation practice and theory, we examine the cost of capital and capital structure. The text then moves to the actual capital budgeting decision, making generous use of previously learned material and employing the concept of marginal analysis. The concluding chapter in this part covers risk-return analysis in capital budgeting, with a brief exposure to portfolio theory and a consideration of market value maximization.

5. Long-Term Financing  The student is introduced to U.S. financial markets as they relate to corporate financial management. The student considers the sources and uses of funds in the capital markets—with warrants and convertibles covered, as well as the more conventional methods of financing. The guiding role of the investment banker in the distribution of securities is also analyzed. Furthermore, the student is encouraged to think of leasing as a form of debt.

6. Expanding the Perspective of Corporate Finance  A chapter on corporate mergers considers external growth strategy and serves as an integrative tool to bring together such topics as profit management, capital budgeting, portfolio considerations, and valuation concepts. A second chapter on international financial management describes the growth of the international financial markets, the rise of multinational business, and the related effects on corporate financial management. The issues discussed in these two chapters highlight corporate diversification and risk-reduction attempts prevalent in the new century.

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Part 1 Introduction

DISCUSSION QUESTIONS

1. How did the recession of 2007–2009 compare with other recessions since the Great Depression in terms of length? (LO3).
2. What effect did the recession of 2007–2009 have on government regulation? (LO3).
3. What advantages does a sole proprietorship offer? What is a major drawback of this type of organization? (LO2)
4. What form of partnership allows some of the investors to limit their liability? Explain briefly. (LO2)
5. In a corporation, what group has the ultimate responsibility for protecting and managing the stockholders’ interests? (LO2)
6. What document is necessary to form a corporation? (LO2)
7. What issue does agency theory examine? Why is it important in a public corporation rather than in a private corporation? (LO4)
8. Why are institutional investors important in today’s business world? (LO4)
9. Why is profit maximization, by itself, an inappropriate goal? What is meant by the goal of maximization of shareholder wealth? (LO4)
10. When does insider trading occur? What government agency is responsible for protecting against the unethical practice of insider trading? (LO1)
11. In terms of the life of the securities offered, what is the difference between money and capital markets? (LO5)
12. What is the difference between a primary and a secondary market? (LO5)
13. Assume you are looking at many companies with equal risk; which ones will have the highest stock prices? (LO3)
14. What changes can take place under restructuring? In recent times, what group of investors has often forced restructuring to take place? (LO5)

WEB EXERCISE

1. Ralph Larsen, former chairman and CEO of Johnson & Johnson, was quoted in this chapter concerning the use of the Internet. Johnson & Johnson has been one of America’s premier companies for decades and has exhibited a high level of social responsibility around the world. Go to the Johnson & Johnson Web site at www.jnj.com.

2. Click on “Our Caring.” Scroll down and click on “Our Credo Values.” Read the first two paragraphs and write a brief summary of the credo. Return to the home page and click on “Investors.” Then scroll down and click on the most recent Annual Report. (“Annual Report and Proxy Statements”).

3. Scroll way down the Annual Report until you see “Consolidated Statement of Earnings” for the last few years. This is on page 000.
4. Compute the percentage change between the last two years for the following (numbers are in millions of dollars):
   a. Sales to Customers
   b. Net Earnings
   c. Earnings per Share

5. Generally speaking, is Johnson & Johnson growing by more or less than 10 percent per year?

*Note:* Occasionally a topic we have listed may have been deleted, updated, or moved into a different location on a Web site. If you click on the site map or site index, you will be introduced to a table of contents that should aid you in finding the topic you are looking for.