

PART I

The Foundation

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Chapter 1

Introduction to Financial Management

How do we want the firms in our economy to measure their own performance? How do we want them to determine what is better versus worse? Most economists would answer simply that managers have a criterion for evaluating performance and deciding between alternative courses of action, and that the criterion should be maximization of the long-term market value of the firm . . . This Value Maximization proposition has its roots in 200 years of research in economics and finance. (Michael C. Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function," *Journal of Applied Corporate Finance* 14, Fall 2001, p. 8.)

Overview

Business firms make decisions everyday. Virtually all business decisions have financial implications. Consequently, finance matters to everybody. We start our study of financial management by discussing the meaning of financial management and the role of the financial manager. We then turn to the corporate form of business organization and its advantages and disadvantages compared with other forms of business organization. To make effective business decisions, the financial manager should have a single-valued objective function. Thus, we advocate the maximization of shareholder wealth as the goal of financial management. Achieving this goal requires that the financial manager focus on economic profit, rather than accounting profit. Finally, we discuss potential agency problems involving the separation of ownership and management and mechanisms for aligning the interests of owners and managers.

Learning Objectives

After completing this chapter, you should be able to:

- understand the nature of financial management;
- describe the three major functions of the financial manager;
- discuss the advantages and disadvantages of corporations;
- identify the goal of financial management;
- differentiate between accounting profit and economic profit;
- explain the agency relationship and mechanisms for aligning the interests of owners and managers.

1.1 Financial Management and the Financial Manager

Financial management is an integrated decision-making process concerned with acquiring, financing, and managing assets to accomplish some overall goal within a business entity. Other names for financial management include managerial finance, corporate finance, and business finance. Making financial decisions is an integral part of all forms and sizes of business organizations from small privately held firms to large publicly traded corporations. Virtually every decision that a business makes has financial implications. Thus, financial decisions are not limited to the chief executive officer (CEO) and a handful of finance specialists. Managers involved in many areas within an organization such as production, marketing, engineering, and human resources among others make or participate in financial decisions at least occasionally.

The person associated with the financial management function is usually a top officer of the firm such as a vice president of finance or chief financial officer (CFO). This individual typically reports directly to the president or the CEO. In today's rapidly changing environment, the financial manager must have the flexibility to adapt to external factors such as economic uncertainty, global competition, technological change, volatility of interest and exchange rates, changes in laws and regulations, and ethical concerns. As the head of one of the major functional areas of the firm, the financial manager plays a pivotal leadership role in a company's overall efforts to achieve its goals.

The duties and responsibilities of the financial manager are far reaching. In broad terms, the two main functions of the financial manager concern acquiring and allocating funds among a firm's activities. This individual has policy-making duties regarding these functions. The financial manager also acts as a liaison between others in the finance department and management personnel from other departments.

In large firms, the financial manager often coordinates the activities of the treasurer and the controller. The treasurer is responsible for handling external financial matters, such as managing cash and credit, capital budgeting, raising funds, and financial analysis and planning. The controller's responsibilities mainly deal with internal matters which are accounting in nature. These activities involve cost accounting, taxes, payroll, and management information systems as well as preparing financial statements, budgets, and forecasts.

Practical Financial Tip 1.1

Understanding financial management is a key ingredient in the success of any business organization. Financial management focuses on business decisions that add value to the firm.

The objective of this book is to provide an introduction to the principles and techniques needed to make financial decisions that create value within profit-oriented business organizations, specifically corporations. Unlike a privately held corporation, a **publicly held corporation** is a corporation that sells shares outside of a closed group of investors. Many

of the principles and techniques that govern corporate finance also apply to nonprofit organizations. While the techniques of financial management change over time, the fundamentals remain remarkably constant.

Financial Management Decisions

Financial management involves three major types of decisions: (1) long-term investment decisions, (2) long-term financing decisions, and (3) working capital management decisions. These decisions concern the acquisition and allocation of resources among the firm's various activities. The first two decisions are long term in nature and the third is short term. Managers should not consider these decisions on a piecemeal basis but as an integrated whole because they are seldom independent of one another. Investment decisions typically affect financing decisions and vice versa. For example, a decision to build a new plant or to buy new equipment requires other decisions on how to obtain the funds needed to finance the project and to manage the asset once acquired.

The following analogy illustrates the relationship among these decisions. Figure 1.1 shows a three-legged stool with each leg representing one of the firm's three major types of decision activities in financial management. Long-term investment decisions represent the most important leg on the stool because a firm's growth and profitability come largely from making appropriate investment decisions. The long-term financing and working capital management legs of the stool are also important because without them the stool (or the firm) will not function properly. Let's take a closer look at the three major types of financial management decisions.

Investment decisions

Long-term investment decisions involve determining the type and amount of assets that the firm wants to hold. That is, investing concerns allocating or using funds. The financial manager makes investment decisions about all types of assets – items on the left-hand side of the balance sheet. These decisions often involve buying, holding, reducing, replacing, selling,

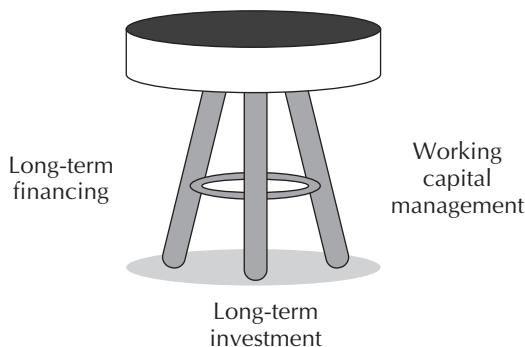


Figure 1.1 The three-legged stool analogy: Broad classification of decision activities in financial management

and managing assets. The process of planning and managing a firm's long-term investments is called **capital budgeting**. Common questions involving long-term investments include:

- In what lines of business should the firm engage?
- Should the firm acquire other companies?
- What sorts of property, plant, and equipment should the firm hold?
- Should the firm modernize or sell an old production facility?
- Should the firm introduce a more efficient distribution system than the current one?

As these examples show, investment decisions involve not only those that create revenues and profits, but also those that save money. The answers to these questions flow from the firm's long-term investment strategy.

Making investment decisions requires applying a key principle of financial management. The **investment principle** states that the firm should invest in assets and projects yielding a return greater than the minimum acceptable hurdle rate. A **hurdle rate** is the minimum acceptable rate of return for investing resources in a project. The financial manager should set the hurdle rate to reflect the riskiness of the project with higher hurdle rates for riskier projects.

Financing decisions

Long-term financing decisions involve the acquisition of funds needed to support long-term investments. Such decisions concern the firm's **capital structure**, which is the mix of long-term debt and equity the firm uses to finance its operations. These sources of financing are shown on the right-hand side of the balance sheet. Firms have much flexibility in choosing a capital structure.

Typical financing questions facing the financial manager include:

- Does the type of financing used make a difference?
- Is the existing capital structure the right one?
- How and where should the firm raise money?
- Should the firm use funds raised through its revenues?
- Should the firm raise money from outside the business?
- If the firm seeks external financing, should it bring in other owners or borrow the money?

The financial manager can obtain the needed funds for its investments and operations either internally or externally. Internally generated funds represent the amount of earnings that the firm decides to retain after paying a cash dividend, if any, to its stockholders. Dividend policy is intimately connected to a firm's investment and financing decisions because the dividend-payout ratio determines the amount of earnings that a firm can retain. According to the **dividend principle**, a firm should return cash to the owners if there are not enough investments that earn the hurdle rate. For publicly traded firms, a firm has the option of returning cash to owners either through dividends or stock repurchases. The form of return depends largely on the characteristics of the firm's stockholders.

If the firm decides to raise funds externally, the financial manager can do so by incurring debts, such as through bank loans or the sale of bonds, or by selling ownership interests

through a stock offering. The choice of financing method involves various tradeoffs. For example, a firm must repay debt with interest over a specific period without typically sharing control with the lender. By issuing common stock, the firm dilutes the control of current owners but does not have to repay the funds obtained from the stock sale.

When making financing decisions, managers should keep the financing principle in mind. The **financing principle** states that the financial manager should choose a financing mix that maximizes the value of the investments made and matches the financing to the assets being financed. Matching the cash inflows from the assets being financed with the cash outflows used to finance these assets reduces the potential risk.

Working capital management decisions

So far we have focused on long-term investment and financing decisions. Now we turn to the day-to-day investment and financing decisions of a firm. Decisions involving a firm's short-term assets and liabilities refer to **working capital management**. **Net working capital** is defined as current assets minus current liabilities. The financial manager has varying degrees of operating responsibility over current assets and liabilities. Some key questions that the financial manager faces involving working capital management include:

- How much of a firm's total assets should the firm hold in each type of current asset such as cash, marketable securities, and inventory?
- How much credit should the firm grant to customers?
- How should the firm obtain needed short-term financing?

In summary, some of the more important concerns of financial management can be distilled into three questions:

- 1 What long-term investments should the firm undertake? (Investment decisions)
- 2 How should the firm raise money to fund these investments? (Financing decisions)
- 3 How should the firm manage its short-term assets and liabilities? (Working capital management decisions)

These decisions affect a firm's success and ultimately the overall economy. For example, misallocation of resources can affect a company's prospects of survival and growth and can be detrimental to the economy as a whole. Accordingly, we will examine each of these decision areas in the chapters ahead.

The financial manager's role is to help answer these and other important questions facing the firm. The balance-sheet model shown in Figure 1.2 is one way to graphically portray the three major types of decisions facing the financial manager and their effects on the firm.

As Figure 1.2 shows, the firm's long-term investment decisions concern the left-hand side of the balance sheet and result in fixed assets. Fixed assets last for a long time and can result in tangible fixed assets, such as buildings, machinery, and equipment, and intangible fixed assets, such as patents and trademarks. The firm's long-term financing decisions concern the right-hand side of the balance sheet. That is, the financial manager can obtain funds to pay for investments from creditors (long-term liabilities) or owners (stockholders' equity). Decisions involving short-lived assets and liabilities are working capital management decisions.

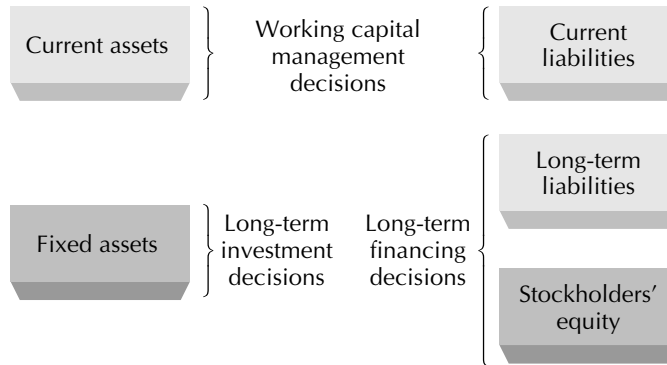


Figure 1.2 The balance-sheet model: Assets = Liabilities + Stockholders' Equity

Risk–Return Tradeoff

At the heart of most financial decisions is the concern about two specific factors: risk and return. An underlying assumption of finance is that investors should demand compensation for bearing risk. According to the concept of **risk aversion**, investors should expect a higher return for taking on higher levels of risk. Although considerable debate exists over the precise model for estimating risk and return, few contest the notion of a risk–return tradeoff. When making financial decisions, managers should assess the potential risk and rewards associated with these decisions. In fact, the foundation for maximizing shareholder wealth lies in understanding tradeoffs between risk and return.

Concept Check 1.1

- 1 What is financial management?
- 2 How do the roles of the firm's treasurer and controller differ?
- 3 What are three broad classifications of decisions within financial management? How are they related?
- 4 How does the notion of a risk–return tradeoff affect the behavior of financial managers?

1.2 Corporate Form of Business Organization

Although we focus on corporations in the chapters ahead, most principles and concepts underlying financial management apply across the three major forms of business organization.

- **Sole proprietorship:** a business owned and controlled by a single person.
- **Partnership:** a business owned by two or more individuals.
- **Corporation:** a legal entity separate and distinct from its owners.

Each of these legal forms of organizing firms has distinct advantages and disadvantages. As a firm grows in size, the advantages of the corporate form generally outweigh its disadvantages. In particular, the corporate form of business solves the problems associated with raising large amounts of cash. Not surprisingly, the corporation has emerged as the dominant force in today's global economy.

A sole proprietorship is the simplest, cheapest business to form, least regulated, and most common form of business organization. Despite these facts, corporations and their many variations around the world are the most important in terms of size and amount of business income generated. As a legal "person," a corporation has many of the rights, duties, and privileges of an actual person. For example, a corporation can enter into contractual agreements, own property, borrow money, sue others and be sued. Let's examine the major advantages and disadvantages of a corporation.

Advantages of Corporations

The corporate form offers several distinct advantages over other forms of business.

- *Unlimited life.* As a distinct legal entity, the corporation has a perpetual life. That is, the corporation can continue to operate after the original owners have withdrawn.
- *Limited liability.* Because the owners, who are the stockholders or shareholders, are not liable for the debts of the corporation, they have limited liability. In fact, the most that stockholders can lose is their initial investment.
- *Ease of ownership transfer.* For publicly held corporations, stockholders can readily sell their stock in the open market.
- *Ability to raise funds.* The previous three advantages enhance the corporation's ability to raise large sums of money. That is, corporations can raise funds by selling additional shares of stock.
- *Proportional distribution of income.* Corporations distribute income, often by paying dividends, in proportion to ownership interest. This differs from a sole proprietor who receives all income from the business or partners who receive income based on the terms of the partnership agreement.

Disadvantages of Corporations

Despite its advantages, the corporate form also has drawbacks.

- *Cost and complexity to start.* A corporation is more difficult and costly to set up than are other forms of business organization. In the United States, a corporation is incorporated in a specific state. Forming a corporation requires preparing a charter and a set of bylaws.

Public corporations must incur the expense of preparing and disclosing information to their shareholders and various regulatory bodies.

- *Double taxation.* Unlike income from a sole proprietorship and general partnership, which is taxed once, income paid to owners is subject to double taxation. That is, the corporation pays taxes on taxable income and individual shareholders pay taxes on the income received.
- *Separation of ownership and management.* In many corporations, especially larger ones, managers and owners represent separate groups. In theory, managers should run the corporation's affairs in the best interests of its stockholders. In practice, the interests of managers and owners may not always be the same. For example, managers may place their own interests ahead of those of the shareholders. We discuss these agency conflicts later in this chapter.

Concept Check 1.2

- 1 What are the major advantages and disadvantages of corporations?
- 2 Why can the separation of ownership and management potentially lead to conflicts?

1.3 The Goal of Financial Management

So far we have seen that financial managers are primarily concerned with long-term investment and financing decisions as well as with working capital management decisions within a firm. To make effective decisions, the financial manager needs a clear objective or goal to serve as a standard for evaluating performance and deciding between alternative courses of actions. Without such a criterion, the financial manager would be unable to keep score – that is, to measure better from worse.

What should be the fundamental purpose of a business firm, specifically a corporation? More directly, what should be the goal of financial management? The number of potential goals is extensive. A few possibilities include maximizing revenues, profits, earnings per share, returns, market share, or social good; minimizing costs; maintaining steady earnings growth; avoiding financial distress and bankruptcy; and surviving. Each of these possibilities has serious defects as a corporate goal. For example, profit maximization focuses on accounting profits, lacks a time dimension, and ignores risk. Although much division of opinion exists on the goal of financial management, two leading contenders are stakeholder theory and value (wealth) maximization.

Stakeholder Theory

Stakeholder theory is the main contender to value maximization as the corporate goal. Stakeholder theory asserts that managers should make decisions that take into account the interests of all of a firm's stakeholders. Such stakeholders include not only financial

claimholders but also employees, managers, customers, suppliers, local communities, and the government. The major problem with stakeholder theory is that it involves multiple objectives. Telling the financial manager to maximize multiple objectives, some of which may be conflicting, would leave that manager with no way to make a reasoned decision. That is, corporate managers cannot effectively serve many masters. Purposeful behavior requires the existence of a single-valued objective function.

Value or Wealth Maximization

Most corporate financial theorists agree that the primary corporate goal is to maximize long-term firm value or wealth. Some dissention exists on whether the criterion should be maximization of the market value of the stockholders or the firm. Maximization of shareholder wealth focuses only on stockholders whereas maximization of firm value encompasses all financial claim holders including common stockholders, debt holders, and preferred stockholders.

Because common stockholders are the firm's most important stakeholders, the financial manager has a fiduciary responsibility to act in their best interests. From the stockholders' perspective, a good management decision would lead to an increase in the value of the stock. This is because investors generally prefer more wealth to less. Thus, the financial goal of the firm is *to maximize shareholder wealth as reflected in the market price of the stock*. The term **shareholders** refers to the firm's current owners or stockholders. For non-publicly traded firms, the objective in decision making is *to maximize firm value*.

In practice, this goal means that the financial manager can best serve business owners by identifying goods and services that add value to the firm because the marketplace desires and values the firm's offerings. This single-valued objective serves as a prerequisite for rational behavior within an organization. In fact, maximizing shareholder wealth has become the premier business mantra.

Why focus on maximizing share price? First, using stock price maximization as an objective function permits making definitive statements about the best way to allocate resources and to finance them. Second, stock prices are a highly observable measure that can be used to evaluate performance of publicly held corporations. No competing measure can provide as comprehensive a measure of a firm's standing. Stock price takes into account present and future earnings per share; the timing, duration, and risk of these earnings; the firm's dividend policy; and other factors affecting stock price. The market price of the firm's stock is a measure of the owners' economic well-being. Finally, stock prices reflect the long-run effects of decisions made by the firm.

Does a short-term increase or decrease in a firm's stock price mean that management is doing a good or poor job? Not necessarily. Many factors that influence stock prices are beyond management's control. Thus, management can only partially influence the stock price of the firm. Despite this difficulty, managers can still strive to maximize stockholder wealth in the context of the current economic and social environment.

Shareholder wealth maximization rests on several assumptions. The corporate objective function assumes that managers operate in the best interests of stockholders, not themselves, and do not attempt to expropriate wealth from lenders to benefit stockholders.

Shareholder wealth maximization also assumes that managers do not take actions to deceive financial markets in order to boost the price of the firm's stock. Another assumption is that managers act in a socially responsible manner and do not create unreasonable costs to society in pursuit of shareholder wealth maximization. This implies that the financial manager should not take illegal or unethical actions to increase the value of the equity owners. Given these assumptions, shareholder wealth maximization is consistent with the best interests of stakeholders and society in the long run.

Practical Financial Tip 1.2

The objective of decision making in financial management is *to maximize shareholder wealth as reflected in the market value of the stock*. This single-valued objective function is superior to alternatives because it provides managers with a rational basis for making financial decisions. Thus, when making a decision, rational managers should choose the alternative that most increases the wealth of the owners of the business.

Concept Check 1.3

- 1 How does value (wealth) maximization differ from stakeholder theory as a corporate goal?
- 2 What is the practical difficulty of using shareholder theory as the corporate goal?
- 3 What should be the financial goal of the firm? Why?
- 4 What are several assumptions underlying shareholder wealth maximization?

1.4 Accounting Profit versus Economic Profit

To achieve the corporate goal of maximizing shareholder wealth, should the financial manager focus on accounting profit or economic profit? As we will illustrate shortly, the answer is economic profit. Let's distinguish between accounting profit and economic profit.

Accounting profit is the difference between revenues and usually only explicit costs, recorded according to accounting principles. **Explicit costs** are measurable costs of doing business. Typical explicit costs include operating expenses such as cost of goods sold. Accounting costs generally do not include implicit costs, which are the returns the employed resource would have earned in its next best use. **Implicit costs** include opportunity costs associated with a firm's equity, costs of assets used in production, and owner-provided services. For example, the opportunity cost of equity capital is the implied rate of return that investors could earn by investing these funds elsewhere.

Economic profit is the difference between revenues and total costs (explicit and implicit costs, including the normal rate of return on capital). **Normal profit** is the minimum rate of return that investors are willing to accept for taking the risks of investment. By earning revenues in excess of its total costs, the firm has an economic profit. When revenues equal total

costs, economic profit is zero. This does not mean, however, that investors are receiving no returns. Instead, investors are getting a return that provides the appropriate compensation for bearing the risk of the investment. When accounting profit is zero, investors would be better off investing elsewhere because they are not recovering their full costs. Because accounting profit ignores implicit costs, accounting profit is generally higher than economic profit. By maximizing economic profit, the financial manager can maximize shareholder wealth.

Practical Financial Tip 1.3

Managers should understand the difference between accounting profit and economic profit. From the perspective of maximizing shareholder wealth, the relevant profit is economic profit.

Example 1.1 Accounting Profit versus Economic Profit

Suppose an entrepreneur has \$100,000 in cash and also owns a small building. This individual uses the cash to start a new venture and the building as a place of business. During the next year, the business generates \$200,000 in sales revenues and incurs \$150,000 in operating expenditures. The entrepreneur does not take any salary. Instead of opening the business, the entrepreneur's next best opportunities were to invest the cash elsewhere and earn \$10,000, lease the building for \$15,000, and take a job paying \$50,000 for the year. Has this entrepreneur made a profit?

Solution: The answer depends on the type of profit under consideration. From an accounting standpoint, the entrepreneur earned a profit because revenues exceed costs by \$50,000. After factoring in less obvious costs such as opportunity costs, the entrepreneur actually experienced an economic loss.

Revenue	\$200,000
Expenditures	<u>-150,000</u>
Accounting profit	\$50,000
Interest forgone	-10,000
Lease payment forgone	-15,000
Salary forgone	<u>-50,000</u>
Economic loss	<u><u>-\$25,000</u></u>

Concept Check 1.4

- 1 How do explicit costs differ from implicit costs? Give several examples of each.
- 2 What is the difference between accounting profit and economic profit?
- 3 Is accounting profit or economic profit more relevant to achieving the financial goal of maximizing shareholder wealth? Why?

1.5 The Agency Relationship

So far we have seen that the financial manager should act in the best interest of shareholders by taking actions that maximize the stock price. We also have seen that a separation of ownership and management exists within modern corporations. As a consequence of this separation, might the interests of management and shareholders differ? The answer to this question is definitely yes. The possibility of conflicts of interest between the stockholders and management of a firm is called an **agency problem**. Let's examine how agency problems may occur.

Stockholders delegate decision-making authority to managers to run the business. An **agent** is a person who is authorized to act for another person or group called a **principal**. The relationship between the agent and the principal is called an **agency relationship**. An agency relationship exists between stockholders and management.

Several agency problems may exist with this agency relationship. One problem is that managers may abuse the use of benefits called **perquisites** or "perks" such as expensive offices as well as access to private jets and company cars. The abuse of perquisites imposes costs on the firm and ultimately its owners. Another problem is that managers may act in their own self-interest rather than those of the stockholders. For example, in the case of Tyco International, shareholders alleged that certain Tyco executives enriched themselves and others with company funds, falsified financial reports, and inflated pre-tax profits. These actions greatly depressed the company's stock price.

Firms incur costs, called **agency costs**, to reduce the potential for conflict between the interests of principals and agents. These costs can be direct or indirect. Direct agency costs often result from corporate expenditures that benefit management but involve a cost to the stockholders. Incentives such as bonuses, stock options, and perquisites are examples of such costs. **Monitoring costs**, which are costs borne by stockholders to monitor or limit the actions of the managers, are another type of direct agency cost. One example is paying outside auditors to determine the accuracy of accounting information. Another example is the cost of having a board of directors whose job is to make sure that decisions are made in the best interests of shareholders. An indirect agency cost could result from management's failure to make a profitable investment because of its aversion to risk.

Several mechanisms are available to help align the interests of managers and shareholders.

- *Managerial compensation.* The firm can use incentive compensation systems to align managers' and shareholders' interests. That is, a firm can structure salaries, bonuses, performance shares, and stock options to reward superior performance and penalize poor performance. **Performance shares** are shares of stock given to managers based on their performance as measured by such criteria as earnings per share. The notion behind having managers become substantial owners of company stock is to lessen their likelihood of behaving in a manner inconsistent with maximizing shareholder wealth. For example, managers are often given options to buy stock at a bargain price. As the stock rises, the value of the option also increases.

- *Direct shareholder intervention.* Investors, especially institutions holding a large number of shares, can intervene in corporate issues through their voting power and by nominating and electing members to the board of directors to represent their interests.
- *Threat of dismissal.* Stockholders elect the board of directors. One of the responsibilities of the board is to hire and fire top management. Thus, the board can fire managers who do not meet performance expectations.
- *Threat of acquisition.* Compared with well-managed firms, poorly managed firms are more likely to be acquisition targets because such firms have not provided sufficient value to stockholders and have greater turnaround potential. After the takeover, managers exhibiting poor performance are often fired.

Concept Check 1.5

- 1 What is an agency relationship?
- 2 Why do agency problems exist in large corporations?
- 3 What is the difference between direct and indirect agency costs? Give an example of each.
- 4 Describe four mechanisms available for aligning the interests of managers and stockholders.

1.6 Organization of the Book

Now that we have completed an introduction to financial management, we can take a closer look at the organization of this book. We focus on the fundamentals of financial management for profit-oriented businesses, especially corporations. Since we believe that the best way to learn finance is by applying its models, theories, and techniques, we provide numerous examples throughout the book.

Understanding Financial Management: A Practical Guide consists of 12 chapters in four parts. Part I, “The Foundation,” contains five chapters providing the underpinnings of financial management. In Chapter 1 we define financial management, discuss major types of financial decisions, and advocate shareholder wealth maximization as the financial goal of the firm. Our next aim is to provide certain background materials and tools needed to make sound financial decisions that create value. Therefore, in Chapters 2 and 3 we discuss interpreting financial statements and conducting financial statement analysis primarily using ratios. In Chapters 4 and 5 we explore the topics of the time value of money and valuation. We develop basic procedures for valuing future cash flows with particular emphasis on stocks and bonds.

In Part II we focus on working capital management decisions. In Chapter 6 we examine various approaches to managing working capital including cash, accounts receivable, inventory, and payables. We also discuss short-term financing. In the past, the management of working

capital consumed much of a financial manager's time. Today, long-term investment and financing decisions have assumed an increasingly important role in financial management.

In Part III we examine long-term investment decisions. Chapter 7 provides an overview of capital investment decisions and focuses on estimating project cash flows. We give a comprehensive example of estimating cash flows for an expansion and a replacement project. In Chapter 8 we consider capital budgeting, which results in the acquisition of fixed assets. In Chapter 9 we examine common ways to describe, assess, and adjust for risk associated with capital investments.

The final part, Part IV, focuses on long-term financing decisions. In Chapter 10 we discuss how business firms raise external capital and how investors trade securities. We examine how to determine the cost of three capital components: debt, preferred stock, and common equity. We also discuss how to calculate the weighted average cost of capital and the appropriate weights to use in this process. Finally, we examine how to calculate the marginal cost of capital and to determine the firm's optimal capital budget.

Chapter 11 investigates the financing mix for a firm. We illustrate how a firm may use financial leverage to increase the expected returns to shareholders while increasing risk for the shareholders. We show how taxes and certain market frictions may make a firm's capital structure decision relevant in the real world.

Finally, in Chapter 12, we focus on dividends and share repurchases because they are the principal mechanisms by which corporations disburse cash to their shareholders. We also discuss other related matters such as dividend reinvestment plans, stock dividends, stock splits, and reverse stock splits. We conclude that dividends can matter by affecting shareholder wealth because of various market imperfections and other factors.

In this book, we focus on core topics and leave the discussion of special topics such as mergers and acquisitions, risk management, leasing, financial distress, and international aspects of corporate finance to other sources. At the core of financial management are three interrelated decision areas: long-term investment, long-term financing, and working capital management (short-term) decisions. Taken together, these decisions determine the value of the firm to its shareholders. Creating value within a firm requires an understanding of financial management.

Summary

This chapter provides an introduction to some of the basic concepts underlying financial management. In this chapter, we stressed the following points:

- 1 Financial management is concerned with acquiring, financing, and managing assets to achieve a desired goal.
- 2 The financial management process involves three broad decision areas: (1) long-term investment decisions, (2) long-term financing decisions, and (3) working capital management decisions.
- 3 Financial decisions involve a risk–return tradeoff in which higher expected returns are accompanied by higher risk. The financial manager determines the appropriate risk–return tradeoff to maximize the value of the firm's stock.

- 4 Corporations offer several advantages over other forms of business organization including unlimited life, limited liability, ease of transferring ownership, and ability to raise funds. Corporations also have shortcomings including cost and complexity, double taxation, and separation of ownership and management.
- 5 The primary financial goal of the firm is to maximize the wealth of its shareholders. Shareholder wealth maximization is achieved in a public corporation by maximizing the market price of the firm's stock.
- 6 Maximizing shareholder wealth results from focusing on economic profit, not accounting profit.
- 7 Agency problems result when the interests of owners (principals) differ from the interests of managers (agents). Mechanisms available to align the interests of these parties include management compensation, direct shareholder intervention, threat of dismissal, and threat of takeovers.

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