

## Part One

# Introduction

- 1 The Role and Objective of Financial Management
- 2 The Domestic and International Financial Marketplace
- 3 Evaluation of Financial Performance

Part One provides an overview of the field of financial management. Chapter 1 discusses the role of financial management in the firm and the alternative forms of business organization and identifies the primary goal of the firm as the maximization of shareholder wealth. The foundation concepts of cash flow and net present value are introduced. The chapter also considers the organization of the financial management function, the relationship between finance and other business disciplines, and various careers that are available in finance. Chapter 2 presents key elements of the U.S. financial marketplace, including the structure of the U.S. financial system and the role of stock exchanges. Also included is an introduction to the various types of financial derivative securities. The last part of the chapter contains an introduction to international financial management, including multinational enterprises and the foreign currency markets and exchange rates. Chapter 3 deals with the tools of financial statement analysis used to evaluate a firm's financial performance.

## CHAPTER

## 1

# The Role and Objective of Financial Management

## Key Chapter Concepts

1. The most important forms of business organization are the
  - a. Sole proprietorship
  - b. Partnership—both limited and general
  - c. Corporation
2. Corporations have the advantages of limited liability for owners, potentially perpetual life, and the ability to raise large amounts of capital. Even though they account for only 20 percent of U.S. firms, corporations account for over 90 percent of U.S. business revenues.
3. *Shareholder wealth* is defined as the present value of the expected future returns to the owners of the firm. It is measured by the market value of the shareholders' common stock holdings.
4. The primary normative goal of the firm is to maximize shareholder wealth.
5. Achievement of the shareholder wealth maximization goal is often constrained by social responsibility concerns and problems arising out of agency relationships.
6. The market value of a firm's stock is determined by the magnitude, timing, and risk of the cash flows the firm is expected to generate. Managers can take a variety of actions to influence the magnitude, timing, and risk of the firm's cash flows. These actions are often classified as investment, financing, and dividend decisions.
7. Cash flow is a fundamental concept in finance and a focus of financial managers who are concerned with raising cash to invest in assets that will generate future cash flows for the firm and its owners.
8. The net present value rule is the primary decision-making rule used throughout the practice of financial management.
  - a. The net present value of an investment is equal to the present value of future returns minus the required initial outlay.
  - b. The net present value of an investment made by a firm represents the contribution of that investment to the value of the firm and, accordingly, to the wealth of shareholders.
9. Ethical standards of performance are an increasingly important dimension of the decision-making process of managers.
10. The finance function is usually headed by a vice president or chief financial officer.
  - a. Financial management responsibilities are often divided between the controller and treasurer.
  - b. The controller normally has responsibility for all activities related to accounting.
  - c. The treasurer is normally concerned with the acquisition, custody, and expenditure of funds.

## Financial Challenge

### Financial Management Questions



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- The terrorist acts of September 11, 2001 caused one of the most dramatic declines in the value of stocks traded in the world financial markets that has ever been witnessed. One month later, a large proportion of these initial losses had been recovered as stock prices returned toward their pre-September 11 levels. Why would the stock market respond so sharply to these events, and then recover so rapidly?
- In early October 2001, Xerox fired its auditor of 30 years, KPMG, over a dispute about the company's accounting practices. KPMG criticized the company's accounting practices because of "material weaknesses in the company's internal control systems" and a failure by Xerox's management to establish "the appropriate tone with respect to financial reporting." One week later the company warned that it would report larger-than-expected losses during the third quarter of the year. Do you believe there is any connection between the change in auditors and Xerox's deteriorating financial performance?
- During the fourth quarter of 2001 two icons of American industry, Polaroid and Bethlehem Steel, filed for bankruptcy protection under Chapter 11 of the Bankruptcy Act. As recently as 1997, Polaroid's stock traded for as much as \$60 per share. These shares traded for \$0.28 per share just prior to the bankruptcy filing. Bethlehem Steel joined four other domestic steel makers that have filed for bankruptcy since 1999. What factors led these two former giants of American industry to the depths of financial crisis?
- In 1989, Kohlberg Kravis Roberts & Co. (KKR) acquired RJR Nabisco, Inc. for \$109 per share, nearly twice the price that RJR's stock was selling for prior to the takeover. Why would KKR be willing to pay such a large premium to gain control of RJR Nabisco?
- At the end of fiscal year 1998, Ford Motor Company held cash and marketable securities of nearly \$24 billion. Why would a company such as Ford hold such large cash reserves? What factors led Ford to cut its dividend rate in half because of declining earnings and liquidity just three years later?
- In April 2000 the Krispy Kreme Corporation had an initial public offering of its common stock. The initial offering price for this Winston-Salem, North Carolina doughnut company was \$21 per share, or a multiple of about 19 times earnings. By October 2001, the stock was selling for \$150 per share (on a split-adjusted basis), or a multiple of nearly 80 times earnings—an incredible valuation for a mundane doughnut company. Why do you think the initial offering price of Krispy Kreme was so different from the valuation placed on the stock by the marketplace?
- Why do companies such as Eastman Kodak, AT&T, Motorola, Lucent Technologies, Coca-Cola, and others take large "one-time" restructuring charges? Eastman Kodak has taken nine "one-time" write-offs since 1990, totaling \$16.75 per share, or more than one-third of its stock value toward the end of 2001.
- How did Jeff Bezos, CEO of Amazon.com, lose \$10.8 billion in the stock market in a brief span of time? How did the cofounder and Chief Yahoo at Yahoo.com lose \$10.3 billion? How did Michael Saylor, chairman and CEO of MicroStrategy, lose \$13.53 billion?

- Why does Philip Morris pay a generous annual dividend while other companies, such as Microsoft, have never paid a dividend?

Each of these situations has implications for financial decision making. Financial management decisions made within enterprises—small or large, international or local, profit-seeking or not-for-profit—help to determine the kinds of products and services we consume and their prices, availability, and quality. Financial decisions can also affect the risk of a firm and the success of that firm in maximizing shareholder wealth. In short, financial decision making has effects that are felt daily throughout the entire economy.

The situations described above pose important questions for financial managers. The financial concepts and tools needed to deal with problems such as these and to make you a more effective decision maker are the subject matter of this book.

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## Introduction

Financial managers have the primary responsibility for acquiring funds (cash) needed by a firm and for directing those funds into projects that will maximize the value of the firm for its owners. The field of financial management<sup>1</sup> is an exciting and challenging one, with a wide range of rewarding career opportunities in the fields of corporate financial management, investment banking, investment analysis and management, portfolio management, commercial banking, real estate, insurance, wealth management, and the public sector—to name only a few broad areas.

Articles appear regularly in the major business periodicals, such as *The Wall Street Journal*, *Business Week*, *Fortune*, *Forbes*, and *Dunn's*, describing financial managers' involvement in important and challenging tasks. Consider, for example, the options facing General Motors' management in late 2001 when it was deciding whether to sell its Hughes Electronics unit to Charlie Ergen's EchoStar Corporation or Rupert Murdoch's News Corporation. EchoStar offered a substantial premium in the \$31.4 billion deal, but the EchoStar proposal was likely to face close antitrust scrutiny. Also, the financing for the EchoStar transaction was less certain than that for the News Corp. offer.

Think about the challenges facing airline executives in the aftermath of the September 11, 2001 terrorist attacks on New York and Washington. In the face of falling passenger load factors, should an airline cut service—as Delta, US Airways, United, American, and most other major airlines did—or should the airline view this as an opportunity to expand and gain market share—as the financially strong Southwest Airlines did?

Think of being the portfolio manager who bought a major stake in Krispy Kreme Corporation in April 2000 when the stock first went public at \$21 per share. One year later the stock was selling for more than \$100 per share. Is this the time to take profits for your clients, or is this the time to hold on to the stock, or even expand your holdings?

Any business has important financial concerns, and its success or failure depends in a large part on the quality of its financial decisions. Every key decision made by a firm's managers has important financial implications. Managers daily face questions like the following:

- Will a particular investment be successful?
- Where will the funds come from to finance the investment?
- Does the firm have adequate cash or access to cash—through bank borrowing agreements, for example—to meet its daily operating needs?

<sup>1</sup> The terms *financial management*, *managerial finance*, *corporate finance*, and *business finance* are virtually synonymous and are used interchangeably. Most financial managers, however, seem to prefer either *financial management* or *managerial finance*.

- Which customers should be offered credit, and how much should they be offered?
- How much inventory should be held?
- Is a merger or acquisition advisable?
- How should cash flows be used or distributed? That is, what is the optimal dividend policy?
- In trying to arrive at the best financial management decisions, how should risk and return be balanced?
- Are there “intangible” benefits (e.g., real option aspects) from an investment project that the firm is considering that will affect the accept/reject decision emerging from traditional quantitative analysis procedures?

This text presents an introduction to the theory, institutional background, and analytical tools essential for proper decision making in these and related areas. As a prospective manager, you will be introduced to the financial management process of typical firms. By learning how the financial management process works, you will establish one of the key building blocks for a successful management career.

## Forms of Business Organization

Most businesses are organized as either a sole proprietorship, a partnership, or a corporation.

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### Sole Proprietorship

A **sole proprietorship** is a business owned by one person. One of the major advantages of the sole proprietorship business form is that it is easy and inexpensive to establish. A major disadvantage of a sole proprietorship is that the owner of the firm has *unlimited personal liability* for all debts and other obligations incurred by the firm.

Sole proprietorships have another disadvantage in that their owners often have difficulty raising funds to finance growth. Thus, sole proprietorships are generally small. Although approximately 75 percent of all businesses in the United States are of this type, their revenue amounts to less than 6 percent of the total U.S. business revenue.<sup>2</sup> Sole proprietorships are especially important in the retail trade, service, construction, and agriculture industries.

### Partnership

A **partnership** is a business organization in which two or more co-owners form a business, normally with the intention of making a profit. Each partner agrees to provide a certain percentage of the funds necessary to run the business and/or agrees to do some portion of the necessary work. In return, the partners share in the profits (or losses) of the business.

Partnerships may be either general or limited. In a **general partnership**, each partner has unlimited liability for all of the obligations of the business. Thus, general partnerships have the same major disadvantage as sole proprietorships. Even so, approximately 90 percent of all partnerships in the United States are of this type.

A **limited partnership** usually involves one or more general partners and one or more limited partners. Although the limited partners may limit their liability, the extent of this liability can vary and is set forth in the partnership agreement. Limited partnerships are common in real estate ventures. During the 1980s some corporations, such as

<sup>2</sup> Internal Revenue Service, <http://www.irs.gov>, *Statistics of Income*.

# http:

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Mesa Petroleum, restructured themselves as *master limited partnerships*, where the partnership units trade just like shares of stock.

The primary motivation for master limited partnerships was to avoid the double taxation of the firm's income that occurs in a corporation. Tax code changes in 1987 largely eliminated the tax motivation for master limited partnerships.<sup>3</sup>

Partnerships have been relatively important in the agriculture, mining, oil and gas, finance, insurance, real estate, and services industries. Overall, partnerships account for about 7 percent of all U.S. business firms and less than 5 percent of total business revenues.<sup>4</sup>

Partnerships are relatively easy to form, but they must be re-formed when there is a change in the makeup of the general partners. Partnerships have a greater capacity to raise capital than sole proprietorships, but they lack the tremendous capital attraction ability of corporations.

## Corporation

A **corporation** is a "legal person" composed of one or more actual individuals or legal entities. It is considered separate and distinct from those individuals or entities. Money contributed to start a corporation is called *capital stock* and is divided into *shares*; the owners of the corporation are called *stockholders* or *shareholders*.

Corporations account for less than 20 percent of all U.S. business firms but about 90 percent of U.S. business revenues and approximately 70 percent of U.S. business profits.<sup>5</sup>

The corporate form of business organization has four major advantages over both sole proprietorships and partnerships.

- **Limited liability** Once stockholders have paid for their shares, they are not liable for any obligations or debts the corporation may incur. They are liable only to the extent of their investment in the shares.
- **Permanency** The legal existence of a corporation is not affected by whether stockholders sell their shares, which makes it a more permanent form of business organization.
- **Flexibility** A change of ownership within a corporation is easily accomplished when one individual merely sells shares to another. Even when shares of stock are sold, the corporation continues to exist in its original form.
- **Ability to raise capital** Due to the limited liability of its owners and the easy marketability of its shares of ownership, a corporation is able to raise large amounts of capital, which makes large-scale growth possible.

However, the ability to raise capital comes with a cost. In the typical large corporation, ownership is separated from management. This gives rise to potential conflicts of goals and certain costs, called *agency costs*, which will be discussed later. However, the ability to raise large amounts of capital at relatively low cost is such a large advantage of the corporate form over sole proprietorships and partnerships that a certain level of agency costs is tolerated.

As a "legal person," a corporation can purchase and own assets, borrow money, sue, and be sued. Its officers are considered to be *agents* of the corporation and are authorized to act on the corporation's behalf. For example, only an officer, such as the treasurer, can sign an agreement to repay a bank loan for the corporation.

<sup>3</sup> Mesa converted back from a master limited partnership to a corporation at the end of 1991.

<sup>4</sup> Internal Revenue Service, *Statistics of Income*, <http://www.irs.gov>.

<sup>5</sup> Internal Revenue Service, *Statistics of Income*, <http://www.irs.gov>.

**Corporate Organization.** In most corporations, the stockholders elect a *board of directors*, which, in theory, is responsible for managing the corporation. In practice, however, the board of directors usually deals only with broad policy matters, leaving the day-to-day operations of the business to the *officers*, who are elected by the board. Corporate officers normally include a *chairman of the board*, *chief executive officer*, *chief operating officer*, *chief financial officer*, *president*, *vice president(s)*, *treasurer*, and *secretary*. In some corporations, one person holds more than one office; for instance, many small corporations have a person who serves as secretary-treasurer. In most corporations, the president and various other officers are also members of the board of directors. These officers are called “inside” board members, whereas other board members, such as the company’s attorney or banker, are called “outside” board members. A corporation’s board of directors usually contains at least three members.

**Corporate Securities.** In return for the use of their funds, investors in a corporation are issued certificates, or *securities*. Corporate securities represent claims against the assets and future earnings of the firm.

There are two types of corporate securities. Investors who lend money to the corporation are issued *debt securities*; these investors expect periodic interest payments, as well as the eventual return of their principal. Owners of the corporation are issued *equity securities*. Equity securities take the form of either *common stock* or *preferred stock*. Common stock is a residual form of ownership; that is, the claims of common stockholders on the firm’s earnings and assets are considered only after all other claims—such as those of the government, debt holders, and preferred stockholders—have been met. Common stockholders are considered to be true owners of the corporation. Common stockholders possess certain rights or claims, including dividend rights, asset rights, voting rights, and preemptive rights.<sup>6</sup> In Chapters 6 and 7 we illustrate how to obtain information about a company’s common stock and debt securities from such sources as *The Wall Street Journal*.

Preferred stockholders have priority over common stockholders with regard to the firm’s earnings and assets. They are paid cash dividends before common stockholders. In addition, if a corporation enters bankruptcy, is reorganized, or is dissolved, preferred stockholders have priority over common stockholders in the distribution of the corporation’s assets. However, preferred stockholders are second in line behind the firm’s creditors.

Because of the advantages of limited liability, permanency, and flexibility and because ownership shares in corporations tend to be more liquid (and hence relatively more valuable) than ownership interests in proprietorships and partnerships, it is easy to see why the majority of business conducted in the United States is done under the corporate form of organization.

# http:

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## Maximizing Shareholder Wealth as the Primary Goal

Effective financial decision making requires an understanding of the goal(s) of the firm. What objective(s) *should* guide business decision making—that is, what should management try to achieve for the owners of the firm? The most widely accepted objective of the firm is to maximize the value of the firm for its owners, that is, to *maximize shareholder wealth*. **Shareholder wealth** is represented by the market price of a firm’s common stock.

<sup>6</sup> Stockholder rights are discussed in greater detail in Chapter 7.



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Keyword: shareholder wealth

Warren Buffett, CEO of Berkshire Hathaway, an outspoken advocate of the shareholder wealth maximization objective and a premier “value investor,” says it this way:

Our long-term economic goal . . . is to maximize the average annual rate of gain in intrinsic business value on a per-share basis. We do not measure the economic significance or performance of Berkshire by its size; we measure by per-share progress.<sup>7</sup>

The shareholder wealth maximization goal states that management should seek to maximize the present value of the expected future returns to the owners (that is, shareholders) of the firm. These returns can take the form of periodic dividend payments or proceeds from the sale of the common stock. **Present value** is defined as the value today of some future payment or stream of payments, evaluated at an appropriate discount rate. The **discount rate** takes into account the returns that are available from alternative investment opportunities during a specific (future) time period. As we shall see in Chapter 4, the longer it takes to receive a benefit, such as a cash dividend or price appreciation of the firm’s stock, the lower the value investors place on that benefit. In addition, the greater the **risk** associated with receiving a future benefit, the lower the value investors place on that benefit. Stock prices, the measure of shareholder wealth, reflect the *magnitude*, *timing*, and *risk* associated with future benefits expected to be received by stockholders.

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

The objective of shareholder wealth maximization has a number of distinct advantages. First, this objective explicitly considers the timing and the risk of the benefits expected to be received from stock ownership. Similarly, managers must consider the elements of timing and risk as they make important financial decisions, such as capital expenditures. In this way, managers can make decisions that will contribute to increasing shareholder wealth.

Second, it is conceptually possible to determine whether a particular financial decision is consistent with this objective. If a decision made by a firm has the effect of increasing the market price of the firm’s stock, it is a good decision. If it appears that an action will not achieve this result, the action should not be taken (at least not voluntarily).

Third, shareholder wealth maximization is an impersonal objective. Stockholders who object to a firm’s policies are free to sell their shares *under more favorable terms* (that is, at a higher price) *than are available under any other strategy* and invest their funds elsewhere. If an investor has a consumption pattern or risk preference that is not accommodated by the investment, financing, and dividend decisions of that firm, the investor will be able to sell his or her shares in that firm at the best price, and purchase shares in companies that more closely meet the investor’s needs.

For these reasons, the shareholder wealth maximization objective is the primary goal in financial management. However, concerns for the social responsibilities of business, the existence of other objectives pursued by some managers, and problems that arise from agency relationships may cause some departures from pure wealth-maximizing behavior by owners and managers. (These problems are discussed later.) Nevertheless, the shareholder wealth maximization goal provides the standard against which actual decisions can be judged and, as such, is the objective assumed in financial management analysis.

<sup>7</sup> Berkshire Hathaway, Inc., *Annual Report* (2001).

### Social Responsibility Concerns

Most firms now recognize the importance of the interests of all their constituent groups, or **stakeholders**—customers, employees, suppliers, and the communities in which they operate—and not just the interests of stockholders. For example, Tucson Electric Power Company—the public utility providing electric service to the Tucson, Arizona, area—recognizes responsibilities to its various constituencies:<sup>8</sup>

- To sustain an optimum return on investment for *stockholders*
- To be perceived by *customers* as a provider of quality service
- To demonstrate that *employees* are our most valuable resource
- To provide corporate leadership to the *community*
- To operate compatibly with environmental standards and initiate programs that are sensitive to environmental issues [*community*]

Tucson Electric Power sees no conflict between being a good citizen and running a successful business.

A wide diversity of opinion exists as to what corporate social responsibility actually entails. The concept is somewhat subjective and is neither perceived nor applied uniformly by all firms. As yet, no satisfactory mechanism has been suggested that specifies how these social responsibility commitments can be balanced with the interests of the owners of the firm. However, in most instances, a manager who takes an appropriate long-term perspective in decision making, rather than focusing only on short-term accounting profits, will recognize responsibility to all of a firm's constituencies and will help lead the company to the maximization of value for shareholders.

### Divergent Objectives

The goal of shareholder wealth maximization specifies how financial decisions should be made. In practice, however, not all management decisions are consistent with this objective. For example, Joel Stern and Bennett Stewart have developed an index of managerial performance that measures the success of managers in achieving a goal of shareholder wealth maximization.<sup>9</sup> Their performance measure, called *Economic Value Added*, is the difference between a firm's annual after-tax operating profit and its total annual cost of capital. Many highly regarded major corporations, including Coca-Cola, AT&T, Quaker Oats, Briggs & Stratton, and CSX, have used the concept. The poor performances of other firms may be due, in part, to a lack of attention to stockholder interests and the pursuit of goals more in the interests of managers.

In other words, there often may be a divergence between the shareholder wealth maximization goal and the *actual* goals pursued by management. The primary reason for this divergence has been attributed to *separation of ownership and control* (management) in corporations.

Separation of ownership and control has permitted managers to pursue goals more consistent with their own self-interests as long as they satisfy shareholders sufficiently to maintain control of the corporation. Instead of seeking to maximize some objective (such as shareholder wealth), managers “satisfice,” or seek acceptable levels of performance, while maximizing their own welfare.

Maximization of their own personal welfare (or utility) may lead managers to be concerned with long-run survival (job security). The concern for long-run survival may lead managers to minimize (or limit) the amount of risk incurred by the firm, since unfavorable outcomes can lead to their dismissal or possible bankruptcy for the firm. Likewise, the desire for job security is cited as one reason why management often opposes

<sup>8</sup> Tucson Electric Power Company, *Annual Report* (1992): 3.

<sup>9</sup> J. M. Stern, J. S. Shiely, I. Ross, *The EVA Challenge* (New York: Wiley, 2001).

takeover offers (mergers) by other companies. Giving senior managers “golden parachute” contracts to compensate them if they lose their positions as the result of a merger is one approach designed to ensure that they will act in the interests of shareholders in merger decisions, rather than in their own interests.

Other firms, such as Panhandle Eastern, International Multifoods, and Ford Motor Company, for example, expect top managers and directors to have a significant ownership stake in the firm. Panhandle Eastern’s president was paid entirely in the company’s common shares, 25,000 per quarter—no severance, no retirement plan, just stock and medical benefits.<sup>10</sup> Ford requires each of its top 80 officers to own common stock in the company at least equal to their annual salary. As the company’s chairman explained, “I want everyone thinking about the price of Ford stock when they go to work.”<sup>11</sup> Many other firms, including Disney, PepsiCo, Anheuser-Busch, and King Pharmaceuticals, provide key managers with significant stock options that increase in value with improvements in the firm’s performance, in an attempt to align their interests more closely with those of shareholders.

### Agency Problems

The existence of divergent objectives between owners and managers is one example of a class of problems arising from agency relationships. **Agency relationships** occur when one or more individuals (the **principals**) hire another individual (the **agent**) to perform a service on behalf of the principals.<sup>12</sup> In an agency relationship, principals often delegate decision-making authority to the agent. In the context of finance, two of the most important agency relationships are the relationship between stockholders (owners) and managers and the relationship between stockholders and creditors.

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

In October 2001 Enron Corporation took a \$1.01 billion charge related to losses on investments it had made that went bad. In 1991 the board of Enron permitted its CFO, Andrew Fastow, to set up and run partnerships that purchased assets from and helped to manage the risk of Enron. Fastow stood to make millions personally. This conflict-of-interest arrangement between the board and Enron’s CFO caused the losses cited above and helps to explain how the company’s stock could decline from a high of nearly \$85 in October 2000 to \$11 in October 2001. By late November, Enron’s stock traded below \$1 per share and in early December, Enron filed for Chapter 11 bankruptcy protection. In Enron’s case the agency conflict between owners and managers was handled poorly.

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



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Keyword: Enron

<sup>10</sup> “Panhandle Eastern Prospects by Hauling Others’ Fuel,” *Wall Street Journal* (February 2, 1993): B4.

<sup>11</sup> “Alex Trotman’s Goal: To Make Ford No. 1 in World Auto Sales,” *Wall Street Journal* (July 18, 1995): A1.

<sup>12</sup> See Amir Barnea, R. Haugen, and L. Senbet, *Agency Problems and Financial Contracting* (Englewood Cliffs, NJ: Prentice-Hall, 1985), for an overview of the agency problem issue. See also Michael Jensen and William Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure,” *Journal of Financial Economics* (October 1976): 305–360; and Eugene Fama, “Agency Problems and the Theory of the Firm,” *Journal of Political Economy* (April 1980): 288–307.

1. Expenditures to structure the organization in such a way as to minimize the incentives for management to take actions contrary to shareholder interests, such as providing a portion of management's compensation in the form of stock in the corporation
2. Expenditures to monitor management's actions, such as paying for audits of managerial performance and internal audits of the firm's expenditures
3. Bonding expenditures to protect the owners from managerial dishonesty
4. The opportunity cost of lost profits arising from complex organizational structures that prevent management from making timely responses to opportunities

Managerial motivations to act in the interests of stockholders include the structure of their compensation package, the threat of dismissal, and the threat of takeover by a new group of owners. Financial theory has shown that agency problems and their associated costs can be greatly reduced if the financial markets operate efficiently. Some agency problems can be reduced by the use of complex financial contracts. Remaining agency problems give rise to costs that show up as a reduction in the value of the firm's shares in the marketplace.

**Stockholders and Creditors.** Another potential agency conflict arises from the relationship between a company's owners and its creditors. Creditors have a fixed financial claim on the company's resources in the form of long-term debt, bank loans, commercial paper, leases, accounts payable, wages payable, taxes payable, and so on. Because the returns offered to creditors are fixed whereas the returns to stockholders are variable, conflicts may arise between creditors and owners. For example, owners may attempt to increase the riskiness of the company's investments in hopes of receiving greater returns. When this occurs, bondholders suffer because they do not have an opportunity to share in these higher returns. For example, when RJR Nabisco (RJR) was acquired by KKR, the debt of RJR increased from 38 percent of total capital to nearly 90 percent of total capital. This unexpected increase in financial risk caused the value of RJR's bonds to decline by nearly 20 percent. In response to this loss of value, Metropolitan Life Insurance Company and other large bondholders sued RJR for violating the bondholders' rights and protections under the bond covenants. In 1991, RJR and Metropolitan settled the suit to the benefit of Metropolitan. The issue of bondholder rights remains controversial, however.

In order to protect their interests, creditors often insist on certain protective covenants in a company's bond indentures.<sup>13</sup> These covenants take many forms, such as limitations on dividend payments, limitations on the type of investments (and divestitures) the company can undertake, poison puts,<sup>14</sup> and limitations on the issuance of new debt. The constraints on the owner-managers may reduce the potential market value of the firm. In addition to these constraints, bondholders may also demand a higher fixed return to compensate for risks not adequately covered by bond indenture restrictions.

## Maximization of Shareholder Wealth: Managerial Strategies

If the managers of a firm accept the goal of maximizing shareholder wealth, how should they achieve this objective? One might be tempted to argue that managers will maximize shareholder wealth if they maximize the profits of the firm. After all, profit maximization is the predominant objective that emerges from static microeconomic models

<sup>13</sup> Protective covenants are discussed in more detail in Chapters 6 and 18.

<sup>14</sup> A "poison put" is an option contained in a bond indenture that permits the bondholder to sell the bond back to the issuing company at face value under certain circumstances, such as a leveraged buy-out that raises the risk for existing debt holders.

of the firm. Unfortunately, the profit maximization objective has too many shortcomings to provide consistent guidance to the practicing manager.

Before discussing some of these shortcomings, it is useful to highlight one important managerial decision rule that emerges from the microeconomic profit maximization model. In order to maximize profits, we learned in microeconomics that a firm should expand output to the point where the marginal (additional) cost (MC) of the last unit produced and sold just equals the marginal revenue (MR) received. To move beyond that output level will result in greater additional costs than additional revenues and hence lower profits. To fail to produce up to the point where  $MC = MR$  results in a lower level of total profits than is possible by following the rule. This fundamental rule, that an economic action should be continued up to the point where the marginal revenue (benefit) just equals the marginal cost, offers excellent guidance for financial managers dealing with a wide range of problems. For example, we shall see that the basic capital expenditure analysis model is simply an adaptation of the  $MC = MR$  rule. Other applications appear in the working capital management and capital structure areas.

Despite the insights it offers financial managers, the profit maximization model is not useful as the central decision-making model for the firm for several reasons. First, the standard microeconomic model of profit maximization is *static*; that is, it lacks a time dimension. Profit maximization as a goal offers no explicit basis for comparing long-term and short-term profits. Major decisions made by financial managers *must* reflect the time dimension. For example, capital expenditure decisions, which are central to the finance function, have a long-term impact on the performance of the firm. Financial managers must make trade-offs between short-run and long-run returns in conjunction with capital investment decisions.

The second limitation of the profit maximization objective has to do with the definition of profit. Generally accepted accounting principles (as discussed in Chapter 3) result in literally hundreds of definitions of profit for a firm because of the latitude permitted in recognizing and accounting for costs and revenues. For example, in 1990, Carolina Power & Light Company (CPL) was forced to reduce its earnings by \$81.6 million because of an unfavorable regulatory treatment of its Harris nuclear plant. To offset this impact on the firm's earnings, CPL "changed its method of accounting for revenues to accrue unbilled revenues as of the date service is rendered, rather than when billed. The net effect of this accounting change for 1990 is an increase in net income of \$77 million, or \$0.92 per share."<sup>15</sup> This arbitrary accounting change has *no* impact on the cash flows or economic well-being of CPL and hence has no impact on its value.

Even if we could agree on the appropriate accounting definition of profit, it is not clear whether a firm should attempt to maximize total profit, the rate of profit, or earnings per share (EPS).

Consider Columbia Beverages, Inc., a firm with 10 million shares outstanding that currently earns a profit of \$10 million after tax. If the firm sells an additional 1 million shares of stock and invests the proceeds to earn \$100,000 per year, the total profit of the firm will increase from \$10 million to \$10.1 million. However, are shareholders better off? Prior to the stock sale, earnings per share are \$1 (\$10 million profit divided by 10 million shares of stock). After the stock sale, earnings per share decline to \$0.92 (\$10.1 million in earnings divided by 11 million shares). Although total profit has increased, earnings per share have declined. Stockholders are not better off as a result of this action.

This example might lead one to conclude that managers should seek to maximize earnings per share (for a given number of shares outstanding). This, too, can result in misleading actions. For example, consider a firm with total assets at the start of the year of \$10 million. The firm is financed entirely with stock (1 million shares out-



Click on this button at <http://finance.swcollege.com> for synopses of recent articles on The Goals and Environment of Financial Management.

<sup>15</sup> Carolina Power & Light Company, "Letter to Members of the Financial Community," January 25, 1991.

standing) and has no debt. After-tax earnings are \$1 million, resulting in a return on stockholders' equity of 10 percent (\$1 million in earnings divided by \$10 million in stockholders' equity), and earnings per share are \$1. The company decides to retain one-half of this year's earnings (increasing assets and equity to \$10.5 million) and pay out the balance in stockholders' dividends. Next year the company's earnings total \$1.029 million, resulting in earnings per share of \$1.029. Are shareholders better off because of the decision by managers to reinvest \$500,000 in the firm? In this example, a strong argument can be made that the position of shareholders has deteriorated. Although earnings per share have increased from \$1 per share to \$1.029 per share, the realized return on stockholders' equity has actually declined, from 10 percent to 9.8 percent (\$1.029 million divided by \$10.5 million of stockholders' equity). In essence, the company's managers have reinvested \$500,000 of stockholders' money to earn a return of only 5.8 percent (\$0.029 million of additional earnings divided by \$0.5 million of additional investment). This type of investment is not likely to result in maximum shareholder wealth. Shareholders could do better by investing in risk-free government bonds yielding more than 5.8 percent.

The third major problem associated with the profit maximization objective is that it provides no direct way for financial managers to consider the risk associated with alternative decisions. For example, two projects generating identical future expected cash flows and requiring identical outlays may be vastly different with respect to the risk of the expected cash flows. Similarly, a firm can often increase its earnings per share by increasing the proportion of debt financing used in the firm's capital structure. However, leverage-induced increases in EPS come at the cost of increased financial risk. The financial marketplace will recognize the increased risk of financial distress that accompanies increases in debt financing and will value the resulting EPS accordingly.

### Determinants of Value

If the profit maximization objective does not provide the proper guidance to managers seeking to maximize shareholder wealth, what rules should these managers follow? First, it is important to recognize that the maximization of shareholder wealth is a market concept, not an accounting concept. Managers should attempt to maximize the **market value** of the company's shares, not the accounting or **book value** per share. The book value reflects the historic cost of assets, not the earning capacity of those assets. Also, the book value does not consider the risk associated with the assets.

Three major factors determine the market value of a company's shares of stock: *the amount of the cash flows expected to be generated for the benefit of stockholders; the timing of these cash flows; and the risk of the cash flows.*

**Cash Flow.** Throughout the book we stress the importance of cash flows in the practice of financial management. **Cash flow** relates to the actual cash generated or paid by the firm. Only cash can be used to acquire assets, and only cash can be used to make valuable distributions to investors. In contrast, the accounting system focuses primarily on a matching over time of the historic, cost-based revenues and expenses of a company, resulting in a bottom-line earnings figure. But accounting earnings are often misleading because they do not reflect the actual cash inflows and outflows of the firm. For example, an accountant records depreciation expense on an asset each period over the depreciable life of that asset. Depreciation is designed to reflect the decline in value of that asset over time. However, depreciation itself results in no cash outflow.<sup>16</sup> The entire cash outflow occurred when the asset was originally purchased.

<sup>16</sup> Because depreciation is used in computing a firm's tax liability, it can affect *after-tax* cash flows. This concept is discussed further in Chapters 3 and 8.

**Timing of Cash Flows.** The market value of a share of stock is influenced not only by the amount of the cash flows it is expected to produce but also by the timing of those cash flows. If faced with the alternatives of receiving \$100 today or \$100 three years from today, you would surely choose the \$100 today because you could invest that \$100 for three years and accumulate the interest. Thus, financial managers must consider both the magnitude of the cash flows they expect to generate and the timing of these cash flows because investors will reflect these dimensions of return in their valuation of the enterprise.

**Risk.** Finally, the market value of a share of stock is influenced by the perceived **risk** of the cash flows it is expected to generate. The relationship between risk and required return is an important concept in financial management and is discussed in detail in Chapter 5. In general, *the greater the perceived risk associated with an expected cash flow, the greater is the rate of return required by investors and managers.* Thus, financial managers must also consider the risk of the cash flows expected to be generated by the firm because investors will reflect this risk in their valuation of the enterprise.

### Managerial Actions to Influence Value

How can managers influence the magnitude, timing, and risk of the cash flows expected to be generated by the firm in order to maximize shareholder wealth? Many factors ultimately influence the magnitude, timing, and risk of a firm's cash flows and thus the price of the firm's stock. Some of these factors are related to the external economic environment and are largely outside the direct control of managers. Other factors can be directly manipulated by the managers. Figure 1.1 illustrates the factors affecting stock prices. The top panel enumerates some of the factors in the economic environment that have an impact on the strategic decisions managers can make. Even though economic environment factors are largely outside the direct control of managers, managers must be aware of how these factors affect the policy decisions under the control of management.

In this context, it is useful to consider a competitive strategy framework developed initially by Michael E. Porter and developed further by Alfred Rappaport.<sup>17, 18</sup> Porter and Rappaport recommend that managers formulate an overall competitive strategy analyzing five competitive forces that can influence an industry's structure and can thereby, in turn, ultimately affect the market prices of stocks of individual companies in a particular industry. The five competitive forces are

1. The threat of new entrants
2. The threat of substitute products
3. The bargaining power of buyers
4. The bargaining power of suppliers
5. The rivalry among current competitors

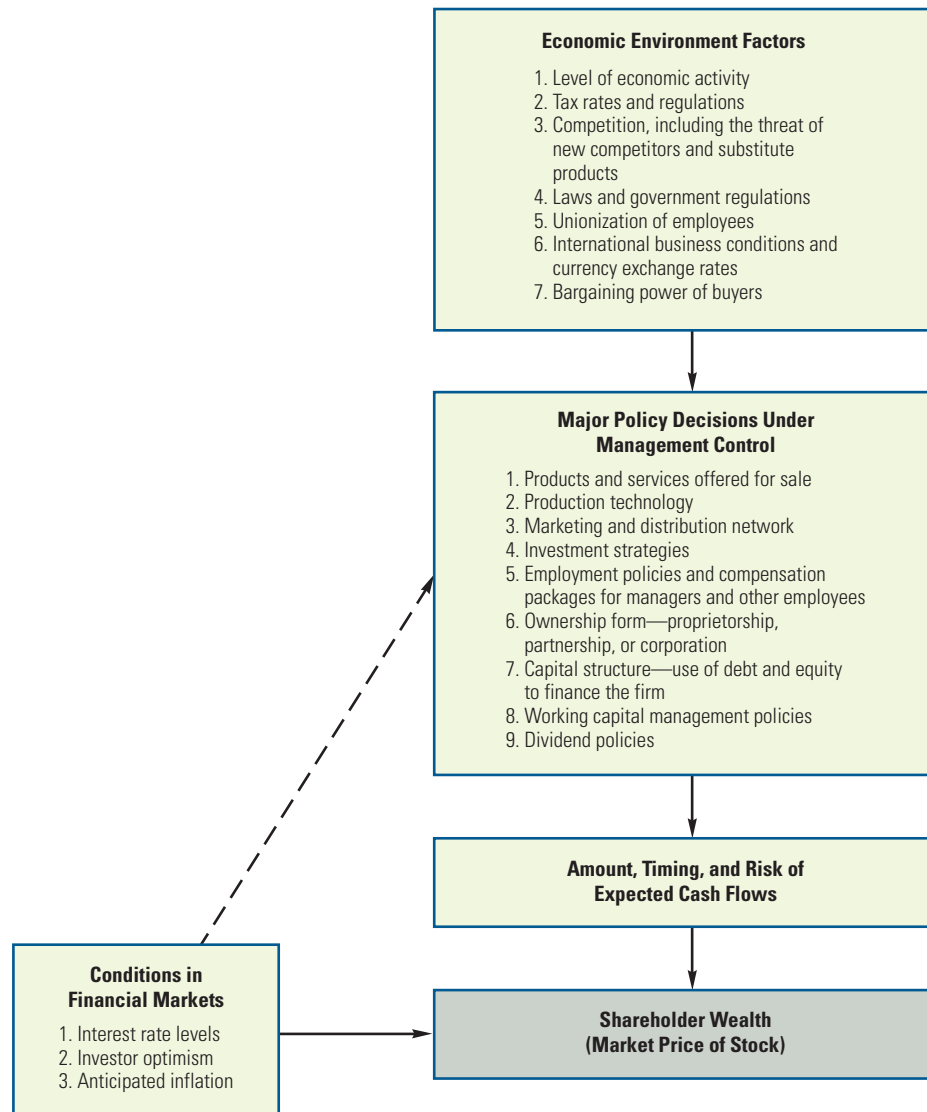
By making policy decisions using such a competitive framework, managers can be in a position to create value for shareholders.

Accordingly, the focus of this book is on making financial decisions that can improve the amount, timing, or risk profile of a firm's cash flow stream, thus leading to increases in shareholder wealth and value. Financial managers are not only responsible for *measuring* value, but also for *creating* value.

The next section defines the *cash flow concept* and establishes why cash flows are the relevant source of value in finance.

<sup>17</sup> Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), Chapter 1.

<sup>18</sup> Alfred Rappaport, *Creating Shareholder Value* (New York: Free Press, 1986), Chapter 4.



**Figure 1.1**  
Factors Affecting Stock Prices



## Cash Flow

The concept of *cash flow* is one of the central elements of financial analysis, planning, and resource allocation decisions. Cash flows are important because the financial health of a firm depends on its ability to generate sufficient amounts of cash to pay its creditors, employees, suppliers, and owners. Only cash can be spent. You cannot spend net income because net income does not reflect the actual cash inflows and outflows of the firm. For example, an accountant records depreciation expense in an attempt to recognize the decline in value of an asset over its life. However, depreciation expense requires no cash outlay, because the entire cash outflow occurred at the time the asset was purchased.

### The Cash Flow Generation Process

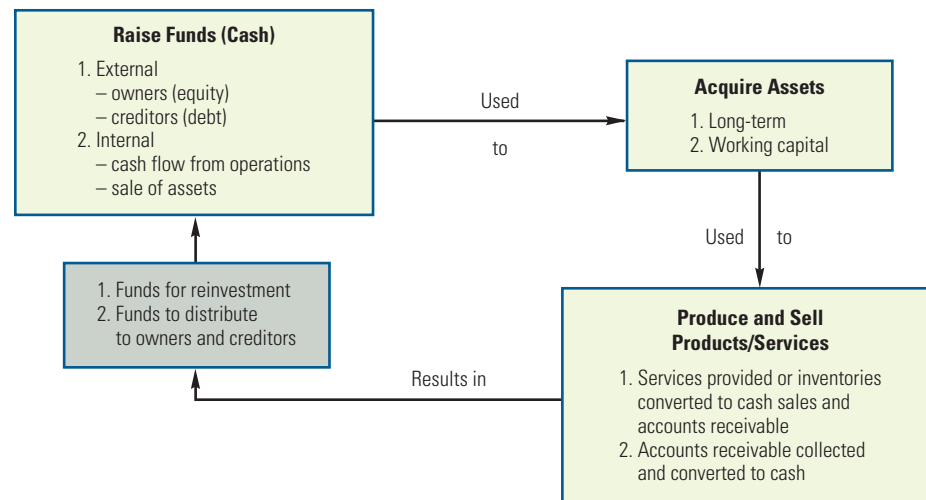
Financial managers are concerned primarily with raising funds (cash) for use by the firm and investing those funds in assets that can be converted into a stream of cash

flows accruing to the firm and its owners. If the value today of the stream of cash flows generated by the assets of a firm exceeds the cost of those assets, the investments undertaken by the firm add value to the firm. When financial managers perform this primary function of acquiring funds and directing the investment of those funds into value-maximizing projects, they must balance the risk (variability) and timing of the expected cash flow stream against the magnitude of the expected returns. The cash flow generation process for a firm is illustrated in Figure 1.2.

A firm can raise funds by issuing different types of financial securities, including both debt and equity types.<sup>19</sup> Financing decisions such as these are summarized on the liabilities and owners' equity side of the balance sheet. In addition to selling securities, a firm can raise cash by borrowing from a lender such as a commercial bank. Funds can also be raised by generating cash flow internally. Internal cash flows include cash generated from operations and cash generated by the sale of assets.

Once cash is available, a decision must be made to invest it in one or more assets. The acquisition of the best long-term assets is crucial, because once acquired, long-term assets impact the firm for a long time. Long-term assets can be sold if necessary but sometimes only at a significant loss. Current assets, or working capital, such as cash, accounts receivable, and inventory, are held for operating purposes and generally offer little or no explicit return. If current asset balances are kept too high, shareholder wealth is sacrificed due to the opportunity cost of funds, that is, the returns that could be earned if these funds had been invested elsewhere. On the other hand, if current asset balances are too low, the risk of the firm increases because the firm may encounter difficulty in meeting its current financial obligations. In addition, low current asset balances (particularly inventories and accounts receivable) may prevent a firm from responding to the needs of prospective customers in a timely and profitable way.

Eventually, all assets are transformed into a cash flow. Plant and equipment generate a product or service. Inventory is gradually sold and generates cash sales or accounts receivable. Cash flow is generated as accounts receivable are collected. Then, the firm



**Figure 1.2**  
A Firm's Cash Flow Generation Process

<sup>19</sup> Chapter 6 discusses various types of debt securities, and Chapter 7 discusses various types of equity securities.

must decide how much of its cash flow to use to acquire additional assets, pay off creditors, and distribute to its owners.

### Importance of Cash Flows

The valuation of debt and equity securities is based upon the present value of the cash flows that these securities are expected to provide to investors.<sup>20</sup> Similarly, the value of a capital expenditure is equal to the present value of the cash flows that the asset is expected to produce for the firm. In addition, cash flows are central to the prosperity and survival of a firm. For example, rapidly expanding firms often grow faster than their ability to generate internally the cash flows needed to meet operating and financial commitments. As a result, these firms may be faced with difficult financial decisions regarding the external sources of funds needed to sustain rapid growth. On the one hand, increases in debt to support expansion result in an increase in the firm's financial risk. On the other hand, if new shares of stock are sold, ownership in the firm may be diluted more than is desired by the firm's controlling group of owners. Therefore, managers need to pay close attention to the projected cash flows associated with investment and firm expansion strategies.

As you learned in your accounting courses and as is discussed in Chapter 3, generally accepted accounting principles (GAAP) provide considerable latitude in the determination of the net income. As a consequence, GAAP concepts of net income do not provide a clear indication of the economic performance of a firm. Cash flow concepts are unambiguous and provide the necessary insight for managers making a wide range of financial resource allocation decisions. Investors also find that cash flow concepts provide a clear measure of performance. Accordingly, the concept of cash flow assumes great importance in the analysis of a firm's performance and the management of its resources.

### Cash Flows and Shareholder Wealth

In spite of the close tie between cash flow concepts and the objective of shareholder wealth maximization, many managers do not seem to place enough emphasis on this concept. Some managers focus on alternative performance measures, including accounting net income, accounting profit ratios (such as the return on equity or the return on assets), the sales growth rate, and market share. The focus on these accounting-based measures of performance may detract from the long-term performance of the company, because performance measures that are not based on cash flows are subject to short-term manipulation by managers.

By emphasizing cash flows rather than accounting-based measures of performance when making decisions, a manager is more likely to achieve the objective of shareholder wealth maximization. A firm that takes actions to maximize the present value of expected future cash flows *will* achieve a record of financial performance that will be reflected both in the company's financial statements and in the market value of its stock.



### Net Present Value Rule

To achieve the objective of shareholder wealth maximization, a set of appropriate decision rules must be specified. Earlier in this chapter we saw that the decision rule of setting *marginal cost equal to marginal revenue* ( $MC = MR$ ) provides a framework for making many important resource allocation decisions. The  $MC = MR$  rule is best suited for situations when the costs and benefits occur at approximately the same time. Many financial decisions, however, require that costs be incurred immediately but result in a stream of benefits over several future time periods. In these cases, the *net present value*

<sup>20</sup> The present value concept is discussed in detail in Chapter 4.

rule (NPV) provides appropriate guidance for decision makers. Indeed, the NPV rule is central to the practice of financial management. You will find this rule constantly applied throughout your study of finance.

The **net present value** of an investment is equal to the present value of the expected future cash flows generated by the investment minus the initial outlay of cash, or

$$(1.1) \quad \text{NPV} = \text{Present value of future cash flows} \textit{ minus Initial outlay}$$

For example, in 2001, Airbus was considering whether to launch a new superjumbo jet project in competition with Boeing's 747 family of jumbo jets. The development cost of the new plane was estimated to be \$12 billion. The success of the project would hinge on the final costs of development, the cost of production, the price per plane, and the number of planes expected to be sold. Each of these factors is a key determinant of the annual net cash flows from the project. Airbus ultimately concluded that the expected cash flows were sufficient to justify the investment. Boeing, in contrast, scrapped plans for an enlarged 747 model because they did not feel there would be sufficient demand for these monster planes.

*The net present value of an investment made by a firm represents the contribution of that investment to the value of the firm and, accordingly, to the wealth of shareholders.* For example, if Dell Computer expects a new line of servers to have a positive net present value of \$750 million, the value of Dell's common stock can be expected to increase by \$750 million at the time the investment is made, all other things being equal.

The net present value concept provides a framework for evaluating future *cash flows* from an investment or a firm. Thus, the net present value concept can be viewed as the bridge between cash flows and the goal of shareholder wealth maximization.

## Organization of the Financial Management Function

Many firms divide the decision-making responsibilities of management among several different officers, which often include those in manufacturing, marketing, finance, personnel, and engineering. A sample organization chart emphasizing the finance function is shown in Figure 1.3. The finance function is usually headed by a vice president of finance, or *chief financial officer* (CFO), who reports to the president. In some corporations the CFO may also be a member of the board of directors. In addition to overseeing the accounting, treasury, tax, and audit functions, today's CFO often has responsibility for strategic planning, monitoring and trading foreign currencies, managing the risk from volatile interest rates, and monitoring production and inventory levels. CFOs also must be able to communicate effectively with the investment community concerning the financial performance of the company.

The chief financial officer often distributes the financial management responsibilities between the *controller* and the *treasurer*. The controller normally has responsibility for all accounting-related activities. These include such functions as

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

## ETHICAL ISSUES

### *The Practice of Financial Management*

During the 1980s and 1990s, interest in the ethical dimensions of business practice exploded. Front-page stories of the stock trading scandals involving the use of insider information that led to the downfall of Dennis Levine and Ivan Boesky, the Treasury bond trading scandal at Salomon Brothers that severely damaged Salomon's reputation and resulted in its top managers being forced to resign, and the billions of dollars of questionable loans made by savings and loan executives that caused the collapse of much of the savings and loan industry, have focused attention on the ethical practices followed by business and financial managers.

*Webster's* defines ethics as "the discipline dealing with what is good or bad, right or wrong, or with moral duty and obligation."<sup>21</sup> John J. Casey defines ethics as follows: "At its best, business ethics is excellence in management applied with fairness and dispatch. It involves hard-headed thought, not a sentimental reaction. It also involves articulate, effective communication to all parties. . . ."<sup>22</sup> Casey identifies a number of techniques that managers can keep in mind when addressing the ethical dimensions of a business problem.

- Clarify the parameters of the problem.
- Involve the right team of participants at the outset.
- Collect all the facts bearing on the problem.
- Articulate the harm and benefit that may result from proposed actions.
- Weigh the consequences of alternatives.
- Seek equity for those who may be affected.

Other action guidelines that have been suggested for managers include to

- Ensure that personal interests do not conflict with business decisions being made.
- Respect the confidentiality of information entrusted to you.
- Make decisions based on rational, objective business analysis rather than on inappropriate factors, such as race, sex, or religion.

- Act fairly in dealing with customers while protecting the legitimate interests of the business.<sup>23</sup>

Ethical considerations impact all kinds of business and financial management decisions. Some financial decisions with important ethical dimensions, such as the loan administration policies apparent in many failed savings and loan institutions, command national attention. However, financial managers encounter day-to-day decisions that have important ethical dimensions. For example, as a new bank loan officer, should you recommend approval of a loan to a longtime friend, even though she does not quite meet the normal loan standards of the bank? As an account executive for a brokerage firm, should you recommend to your clients the securities of firms that have poor environmental management records or that deal in such products as alcohol and tobacco? Should you tell your father-in-law that your firm is likely to become a candidate for a takeover before this is publicly announced? As a division manager being evaluated in part on a return-on-assets calculation, should you lease assets to keep them out of the asset base for evaluation purposes and thereby enhance your apparent performance? Should your firm aggressively use allowable accounting practices to mask a fundamentally deteriorating level of performance? Should your firm move its plant from the Northeast to the Southeast in an attempt to break the union and save labor costs?

This brief sampling of the areas of business and financial-management decision making that possess important ethical dimensions provides a feel for the breadth of ethical issues facing financial managers. In most cases, the answers to these questions are not clear-cut. Actual decision making is very complex and involves many trade-offs among parties with competing interests. However, explicitly recognizing the costs and benefits associated with each of these decisions and making the decision in an atmosphere of balanced objectivity and fairness can help financial

managers avoid apparent or real breaches of their ethical trust.

An important concern for financial managers, who are entrusted with the resources of stockholders and are expected to maximize the value of these resources, is: How does a concern for ethics in the practice of financial management impact the goal of shareholder wealth maximization? Firms that expect employees to act according to a code of ethics in their business dealings can expect to have reduced litigation and damages expenses. A recent survey concluded that some 90 percent of the Fortune 500 companies have adopted a published code of conduct for their managers and other employees. High ethical standards are respected by customers and valued by investors. One could argue that ethi-

cal business dealings build long-term value for investors, whereas breaches of standards of business ethics may provide short-term gains at the expense of future returns. This can be seen clearly in the savings and loan industry, where often unscrupulous managers made decisions promising large short-term profits. In the long run, many of these institutions have failed, and their owners have lost everything.

Throughout the text, we will highlight ethical issues that confront financial managers as they make important financial decisions. Our objective is to raise your consciousness of these issues, rather than to make moral judgments about what is right or wrong in each case. Those judgments are best left to you as topics of lively discussions with your classmates.

<sup>21</sup> Webster's Third New International Dictionary (Chicago: Merriam Webster, 1981).

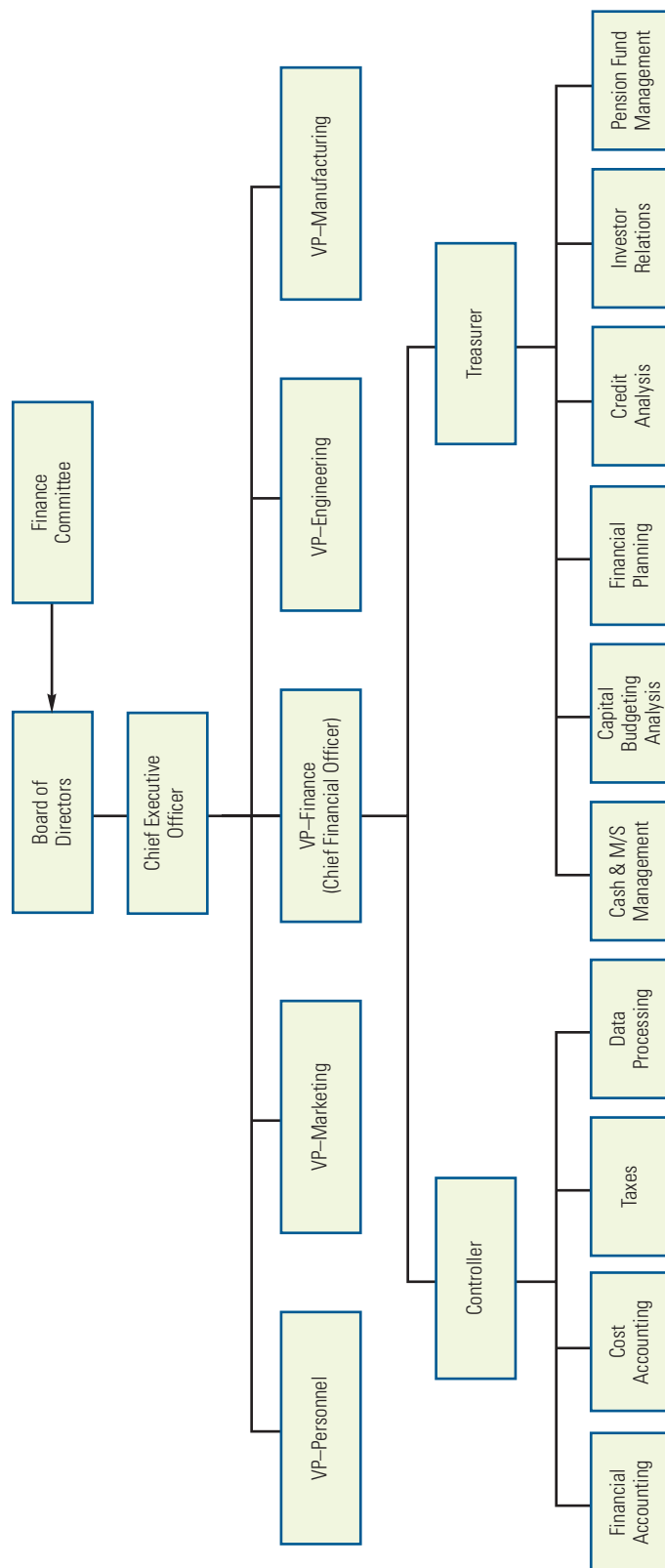
<sup>22</sup> John J. Casey, "The New Urgency for Ethics in Banking," *The Banker* magazine (March/April 1991): 44–50.

<sup>23</sup> *Ibid.*, 48–49.

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

- **Cash and Marketable Securities Management** This group monitors the firm's short-term finances—forecasting its cash needs, obtaining funds from bankers and other sources when needed, and investing any excess funds in short-term interest-earning securities.
- **Capital Budgeting Analysis** This department is responsible for analyzing capital expenditures—that is, the purchase of long-term assets, such as new facilities and equipment.
- **Financial Planning** This department is responsible for analyzing the alternative sources of long-term funds, such as the issuance of bonds or common stock, that the firm will need to maintain and expand its operations.
- **Credit Analysis** Most companies have a department that is responsible for determining the amount of credit that the firm will extend to each of its customers. Although this group is responsible for performing financial analysis, it may sometimes be located in the marketing area of the firm because of its close relationship to sales.
- **Investor Relations** Many large companies have a unit responsible for working with institutional investors (for example, mutual funds), bond rating agencies, stockholders, and the general financial community.
- **Pension Fund Management** The treasurer may also have responsibility for the investment of employee pension fund contributions. The investment analysis and portfolio management functions may be performed either within the firm or through outside investment advisors.

It should be emphasized that the specific functions of the controller and treasurer shown in Figure 1.3 are illustrative only and that the actual functions performed vary



**Figure 1.3**  
Sample Organization Chart

## ENTREPRENEURIAL ISSUES

### Shareholder Wealth Maximization

Entrepreneurial finance deals with the financial issues facing small businesses—an important sector of the U.S. economy. Small business firms may be organized as sole proprietorships, partnerships, or corporations. According to criteria used by the Small Business Administration, over 95 percent of all business firms are considered small. These firms account for the majority of private sector employment and nearly all of the recent net growth in new jobs.

It is difficult to arrive at a precise definition of a small, or entrepreneurial, business; however, the characteristics of small business firms can be identified. In general, small businesses are not the dominant firm in the industries in which they compete, and they tend to grow more rapidly than larger firms. Small firms have limited access to the financial markets, and they often do not have the depth of specialized managerial resources available to larger firms. Small firms also have a high failure rate.

In our discussion of the goals of the firm, we concluded that the predominant goal of financial managers is to maximize shareholder wealth, as measured by the price of the firm's stock. Many entrepreneurial corporations are closely held, and their stock trades infrequently, if ever. Other entrepreneurial firms are organized as sole proprietorships or partnerships. In these cases, there is no readily accessible external measure of performance. Consequently, these firms often rely more heavily on accounting-based measures of performance to track their progress. Accounting-based measures of performance are discussed in Chapter 3. In spite of the lack of an objective, readily available measure of performance, the fundamental decisions made by entrepreneurs are unaltered. That is, the firm should invest resources in projects expected to earn a rate of return *at least* equal to the required return on those projects, considering the project's risk.

However, because many entrepreneurs are poorly diversified with respect to their personal wealth (that is, they have a large proportion of their personal wealth tied up in the firm), these owners are often more concerned about avoiding risks that could lead to financial ruin than are managers of public corporations.

As discussed earlier, in the large modern corporation, there is a concern that a firm's managers may not always act in the interests of the owners (the agency problem). This problem is less severe in many entrepreneurial businesses because managers and owners are one and the same. An entrepreneur who consumes "excessive" perks is merely reducing his or her ability to withdraw profits from the firm. But to the extent that the manager is the owner, there is no owner-manager agency problem. Of course, the potential for agency-related conflicts between entrepreneurs and lenders still exists and may be greater in the closely held firm. As a consequence, many small firms find it difficult to acquire capital from lenders without also giving the lender an option on a part of the ownership in the firm or having the entrepreneur personally guarantee the loan.

Throughout this book we will identify situations where the entrepreneurial financial management of small businesses poses special challenges. In general, we find that small firms often lack the depth of managerial talent needed to apply sophisticated financial planning techniques. Also, because significant economies of scale are often associated with using sophisticated financial management techniques, these techniques are frequently not justified on a cost-benefit analysis basis in many entrepreneurial companies.

from company to company. For example, in some companies, the treasurer may have responsibility for tax matters. Also, as shown in Figure 1.3, the board of directors of the company may establish a finance committee, consisting of a number of directors and officers of the firm with substantial financial expertise, to make recommendations on broad financial policy issues.

## Financial Management and Other Disciplines

As you pursue your study of financial management, you should keep in mind that financial management is not a totally independent area in business administration. Instead, it draws heavily on related disciplines and fields of study. The most important of these are *accounting* and *economics*; in the latter discipline, both *macroeconomics* and *microeconomics* are significant. *Marketing*, *production*, *human resources management*, and the study of *quantitative methods* also have an impact on the financial management field. Each of these is discussed below.

### Accounting

Financial managers play the game of managing a firm's financial and real assets and securing the funding needed to support these assets. Accountants are the game's scorekeepers. Financial managers often turn to accounting data to assist them in making decisions. Generally a company's accountants are responsible for developing financial reports and measures that assist its managers in assessing the past performance and future direction of the firm and in meeting certain legal obligations, such as the payment of taxes. The accountant's role includes the development of financial statements, such as the *balance sheet*, the *income statement*, and the *statement of cash flows*.

Financial managers are primarily concerned with a firm's cash flows, because they often determine the feasibility of certain investment and financing decisions. The financial manager refers to accounting data when making future resource allocation decisions concerning long-term investments, when managing current investments in working capital, and when making a number of other financial decisions (for example, determining the most appropriate capital structure and identifying the best and most timely sources of funds needed to support the firm's investment programs).

In many small and medium-sized firms the accounting function and the financial management function may be handled by the same person or group of persons. In such cases, the distinctions just identified may become blurred.

# http:

The Web site maintained by The Economist magazine provides extensive background reading on many financial issues you will encounter in this course.

<http://www.economist.com>

Similarly, The Wall Street Journal's Web site is a rich source of information and examples of issues central to this course.

<http://public.wsj.com>

### Economics

There are two areas of economics with which the financial manager must be familiar: *microeconomics* and *macroeconomics*. Microeconomics deals with the economic decisions of individuals, households, and firms, whereas macroeconomics looks at the economy as a whole.

The typical firm is heavily influenced by the overall performance of the economy and is dependent upon the money and capital markets for investment funds. Thus, financial managers should recognize and understand how monetary policies affect the cost of funds and the availability of credit. Financial managers should also be versed in fiscal policy and how it affects the economy. What the economy can be expected to do in the future is a crucial factor in generating sales forecasts as well as other types of forecasts.

The financial manager uses microeconomics when developing decision models that are likely to lead to the most efficient and successful modes of operation within the firm. Specifically, financial managers use the microeconomic concept of setting marginal cost

equal to marginal revenue when making long-term investment decisions (*capital budgeting*) and when managing cash, inventories, and accounts receivable (*working capital management*).

## Job Outlook

Median annual earnings of financial managers were \$67,020 in 2000. The middle 50 percent earned between \$48,150 and \$91,580.

Source: *Occupational Outlook Handbook, 2002–03 Edition, U.S. Department of Labor*

# http:

Looking for a job? Soon to be looking for a job? Yahoo provides a web portal for hundreds of career opportunities and job search web sites.

<http://careers.yahoo.com>

## Marketing, Production, Quantitative Methods, and Human Resources Management

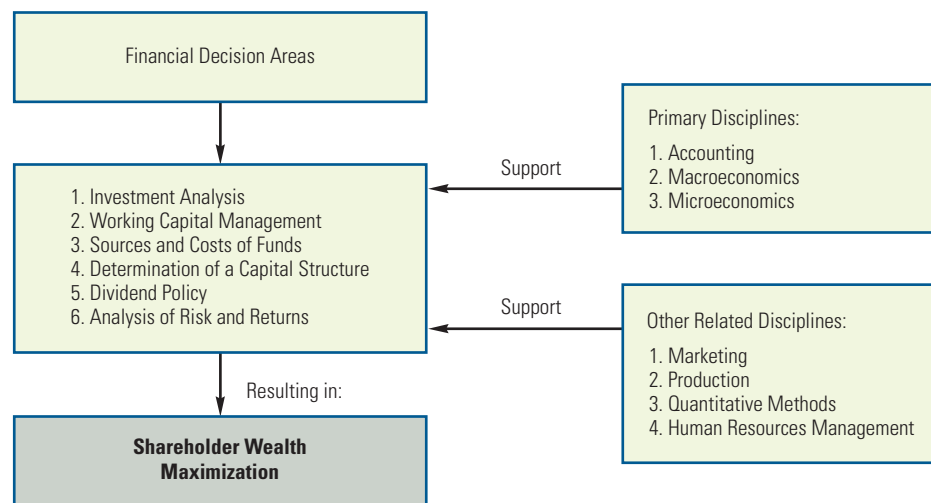
Figure 1.4 depicts the relationship between financial management and its primary supportive disciplines. Marketing, production, quantitative methods, and human resources management are indirectly related to the key day-to-day decisions made by financial managers.

For example, financial managers should consider the impact of new product development and promotion plans made in the marketing area because these plans will require capital outlays and have an impact on the firm's projected cash flows. Similarly, changes in the production process may necessitate capital expenditures, which the firm's financial managers must evaluate and then finance. The tools of analysis developed in the quantitative methods area are frequently helpful in analyzing complex financial management problems. Compensation policies may impact the extent of agency problems in a firm.

## Career Opportunities in Finance

The finance profession offers a number of exciting career opportunities. As illustrated in the organization chart in Figure 1.3, the corporate finance function encompasses a wide range of activities involved with acquisition and expenditure of the firm's resources. In addition to careers in corporate finance, opportunities are available in the financial services sector. The financial services sector includes such businesses as commercial banks, securities brokers, investment banks, mutual funds, pension funds, real estate companies, and insurance companies.

Detailed job responsibilities and duties are shown in Figure 1.5 for selected positions in the field of finance. These positions span the spectrum from entry-level jobs to leadership roles in corporate finance and financial services. One should keep in mind that organizational structures differ significantly among various companies and that the specific responsibilities and duties for a given position may vary considerably among companies.



**Figure 1.4**  
Impact of Other Disciplines on Financial Management

**Figure 1.5**

Job Responsibilities and Duties for Selected Positions in Finance

**Vice President of Finance**

**Basic Function:** Plan, direct, and execute the long-term financing required to fund corporate capital requirements at the lowest cost.

**Primary Responsibilities and Duties**

- Plan and execute the financings required to fund corporate capital requirements while maintaining a balanced capital structure
- Direct, support, and review the actions of the department in obtaining long-term financing and maintaining positive relations with lenders and rating agencies
- Provide a capital budgeting and financial projection system
- Integrate projections of capital requirements with the status of credit markets and the company's capital structure
- Coordinate the activities of underwriters, lawyers, and accountants in order to complete financings in a timely manner
- Maintain contact with all company lenders and keep them informed of the company's goals and progress
- Provide financial support for various contractual arrangements
- Monitor pension fund assets and various special projects

**Director—Investor Relations**

**Basic Function:** Primary work is in investor relations with additional responsibility for pension fund investments and corporate financings.

**Primary Responsibilities and Duties**

- Keep informed on business conditions of all company operating subsidiaries, strategic planning directions, and financial developments at the corporate level
- Stay abreast of industry matters to help explain external influences on the company as well as to keep up with the operating and financial results of the company and its competitors
- Communicate on a daily basis with the investment community in order to accurately portray company results and general expectations within the guidelines of SEC policy
- Arrange meeting times and places for senior management presentations around the country with investment analyst groups
- Act as host to analysts who visit company
- Establish plans and procedures when company hosts inspection trips or special seminars requiring special coordination among operating subsidiaries
- Select and set up personal meetings with institutional owners in order to develop greater support for our stock by the institution's portfolio managers
- Prepare monthly reports on investor relations matters, review policy and plans, and make recommendations for changes
- Monitor investment results of six investment managers

- Prepare monthly and quarterly reports on results and outlook
- Work with actuary and consultants on long-term strategy, including asset allocation and manager selection

**Assistant Treasurer—Cash Control and Risk Management**

**Basic Function:** Responsible for operations of the Treasury Department involving cash management operations with specific attention to the effective direction and control of corporate funds internally and through the company's various bank accounts.

**Primary Responsibilities and Duties**

- Manage, in conjunction with lock box banks retained by company, the processing of over 120,000 customer payments daily
- Disbursement of all company funds, including payrolls, pensions, and vendor payments
- Direct the management staff to assure compliance with our stated objectives and planning in order to assure the effectiveness of the organization
- Sign checks and review and approve various documents such as wire transfer confirmations and investment letters
- Meet with banks and their representatives
- Perform various assignments for senior management
- Also responsible for the risk management/insurance function

**Manager—Income Tax Compliance**

**Basic Function:** Supervise the income tax compliance activities of the company and its subsidiaries in a way that will meet the statutory requirements of all taxing jurisdictions and protect the company's interest against excessive taxation. The primary responsibility is to control tax costs and compliance costs. This involves developing ways of saving and/or deferring taxes wherever possible.

**Primary Responsibilities and Duties**

- Supervise the operation and filing of the consolidated Federal income tax and all state and local income tax returns of the company and its affiliates
- Review all returns and make decisions concerning the treatment of all transactions included in the returns
- Establish challenging work performance standards for staff members and develop their professional competence through instruction
- Maintain a good working knowledge of the Internal Revenue code and related regulations, rulings, and cases as well as state income tax laws, etc.
- Analyze various transactions and procedures in order to develop ways of saving or deferring taxes and to reduce or eliminate compliance costs
- Coordinate the efforts of various group, division, and subsidiary company controllers to assure proper administration of the income tax function

- Develop the information system necessary to assure proper and timely submission by subsidiaries and divisions of the financial data necessary for preparing tax returns
- Assist the company's independent accountants in their annual audits to ensure proper settlement and make recommendations for appeals or possible litigation
- Assist in the preparation of responses to questions from the Internal Revenue Service

#### Financial Analyst—Capital Budgets

**Basic Function:** Review capital expenditure and lease requests that require finance concurrence, coordinate and compile data for the annual capital budget, and compile actual and projected capital cash flows for reports.

##### Primary Responsibilities and Duties

- Check accuracy of financial and accounting treatment for capital and lease requests
- Check for compliance with corporate regulations
- Prepare executive summaries for major capital projects
- Travel to obtain further details on capital projects
- Provide analysis and control prior to authorization of project
- Coordinate and compile data for the annual capital budget
- Analyze all projects submitted for the budget
- Prepare executive summaries on projected authorizations, expenditures, and variances from historical data
- Compile actual and projected capital cash flows for quarterly report

#### Corporate Banking Officer

**Basic Function:** To maintain and expand existing relationships with clients by marketing all of the bank's services and to develop new client relationships.

##### Primary Responsibilities and Duties

- Call on Fortune 500 companies headquartered near the bank's offices
- Maintain existing clients in the face of product innovations, constant competition, and the fact that many products have specified terms
- Identify opportunities for all of the services offered by the bank, including credit, cash management, pension management, foreign exchange and interest rate exposure management, tax questions, and merger and acquisition activities
- Perform administrative follow-up on overdrawn deposit accounts, loan documents, rate information, memo writing for credit approvals, credit analysis, etc.

- Bring in the appropriate specialists to discuss technical products with clients
- Stay current with the technical aspects of new products
- Get to know customers better through personal calls
- Review files and annual reports

#### Account Executive (Securities Broker)

**Basic Function:** Provide advice and counsel to clients concerning potential investments; and execute purchase, sell, and other trade orders on behalf of clients.

##### Primary Responsibilities and Duties

- Make investment recommendations to clients
- Execute trades on behalf of clients
- Expand market through new contacts and clients
- Learn new investment products
- Serve as a liaison between bookkeeping and clients
- Review research to stay current with several markets

#### Mortgage Analyst—Production

**Basic Function:** Handle all matters related to the production, analysis, and negotiation of applications for the acquisition of conventional mortgage loans and real estate investments.

##### Primary Responsibilities and Duties

- Negotiate terms, conditions, interest rates, etc., to obtain a flow of acceptable applications for conventional loans and opportunities to purchase real estate
- Analyze client's financial status and past performance, type of property, nature of offer, property location, facilities and access, and competition
- Inspect property under consideration
- Prepare detailed analyses of proposed loan or purchase and recommend action on offerings
- Prepare mortgage committee memoranda in conjunction with supervisor and present recommendations to the officer in charge of the mortgage committee
- Prepare commitment letters on those investments which have been approved by the committee
- Assist in the negotiation of the final commitment terms and conditions
- Work with clients to help resolve problems which may jeopardize company's rights under a mortgage
- Prepare correspondence under own signature or for signature by supervisor on all aspects of application processing

Source: Jack S. Rader, *Careers in Finance* (Tampa, FL: Financial Management Association International, College of Business Administration, University of South Florida, 813-9743-2084, 1995). Reprinted with permission.

## Professional Finance Affiliations

There are several professional organizations for practicing financial managers. These include the Financial Executives Institute, the Institute of Chartered Financial Analysts, and the Financial Management Association. These organizations provide an opportunity for professional interaction and lifelong learning.



FinanceLinks Online

Click on this button at  
**<http://finance.swcollege.com>** for links to professional organizations.

The Financial Management Association (FMA) has a goal of serving as a bridge between the academic study of finance and the application of financial principles by financial managers. This goal is achieved through the publication of a quarterly journal, *Financial Management*. The FMA sponsors student chapters at many universities and sponsors the National Honor Society, the only national honorary organization for students of finance. The FMA also holds an annual meeting featuring the presentation of financial research, panel discussions led by leading academic and financial practitioners, and tutorials on new developments in finance. Additional membership information can be obtained from the Financial Management Association, College of Business Administration, University of South Florida, Tampa, Florida 33620, <http://www.fma.org>.

## Organization of the Text

This text provides an introduction to both analytical tools and descriptive materials that are useful in financial management. Because this is an introductory-level text, however, it does *not* attempt to make the reader an expert in every aspect of financial decision making. Instead, it is intended to do the following:

- Acquaint the reader with the types of decisions faced by financial managers.
- Develop a framework for analyzing these decisions in a systematic manner.
- Provide the reader with the background necessary to pursue more advanced readings and courses in financial management.

Although the subject matter in this text is divided into distinct parts, in reality and practice, the various types of financial decisions are interrelated and should not be considered in isolation from one another.

Each chapter begins with a summary preview of the key concepts from the chapter. This is followed by a financial challenge faced by a real firm(s) and related to the material in the chapter. At the end of each chapter is a point-by-point summary of the chapter and extensive sets of discussion questions and problems, including “Self-Test Problems” with detailed solutions, which you can use to test your understanding of the text material. A glossary of key terms is provided at the end of the book. Some chapters also have more complex, integrative case problems. Where appropriate, special *International Financial Management Issues* and *Entrepreneurial Finance Issues* are discussed. The book also has a large number of *Ethical Issues* sections integrated throughout. “Check” answers to selected problems appear at the end of the book. You will find an overview of the CFM Excel *templates* that are available for solving many of the complex chapter problems and cases at the book’s Web site (<http://moyer.swcollege.com>).

## Parts of the Text

**Part One, Introduction.** Chapter 2 reviews the major elements of the U.S. and international financial marketplace. It includes a discussion of the structure of the U.S. financial system and the role of stock exchanges. Also included are introductions to various types of derivative securities and international financial management. Chapter 3 considers the financial statements and ratios that can be used to evaluate the financial performance of a firm.

**Part Two, Determinants of Valuation.** Valuation is a central theme of the book. Chapter 4 develops the concept of the time value of money. This concept is used in the valuation of securities and the evaluation of investment projects expected to provide benefits over a number of years. Chapter 5 provides a comprehensive introduction to the concept of risk in finance and the relationship between risk, required return, and the shareholder wealth maximization goal of the firm. Chapter 6 applies the basic

valuation model to fixed income securities, such as bonds and preferred stock. Chapter 7 deals with the valuation of common stock and the role of investment bankers.

**Part Three, The Capital Investment Decision.** This portion of the text focuses on capital expenditures—that is, investments in long-term assets. Chapters 8 and 9 present the fundamentals of capital budgeting, namely, the process of investing in long-term assets. Chapter 8 deals with the measurement of the cash flows (benefits and costs) associated with long-term investment projects. Chapter 9 considers various decision-making criteria that can be used when choosing projects that will maximize the value of the firm. Chapter 10 extends the concepts developed in Chapter 9 by considering some of the decision-making techniques that attempt to deal with the problem of the risk associated with a specific project's cash flow.

**Part Four, The Cost of Capital, Capital Structure, and Dividend Policy.** Chapter 11 illustrates the principles of measuring a firm's cost of capital. The cost of funds to a firm is an important input in the capital budgeting process. Chapters 12 and 13 address the relationship of the cost of capital to the firm's capital structure. Chapter 14 discusses the factors that influence the choice of a dividend policy and the impact of various dividend policies on the value of a firm.

**Part Five, Working Capital Management and Financial Forecasting.** Chapters 15 through 18 examine the management of a firm's current asset and liability accounts—that is, net working capital. Chapter 15 provides an overview of working capital management, with emphasis on the risk-return trade-offs involved in working capital decision making. Chapter 15 also covers financial forecasting. Chapter 16 deals with the management of cash and marketable securities, and Chapter 17 focuses on the management of accounts receivable and inventories. Finally, Chapter 18 discusses the management of secured and unsecured short-term and intermediate-term credit.

**Part Six, Selected Topics in Contemporary Financial Management.** Chapter 19 deals with lease financing. Chapter 20 focuses on option-related funding alternatives, including convertible securities, and warrants. Chapter 21 discusses the factors that affect exchange rates and foreign exchange risk. Chapter 22 examines corporate restructuring decisions, including mergers and acquisitions, bankruptcy, and reorganization.

## Summary

- The three primary forms of business organization are the *sole proprietorship*, the *partnership*, and the *corporation*. Corporations have certain advantages over the other two forms of business organization, especially for large businesses.
- A corporation is defined as a “legal person” composed of one or more actual individuals or legal entities. The owners of a corporation are called *stockholders* or *shareholders*. The stockholders elect a *board of directors* that usually deals with broad policy matters, whereas the day-to-day operations are supervised by the corporate *officers*.
- Corporations issue *debt securities* to investors who lend money to the corporation and *equity securities* to investors who become owners.
- The optimal form of organization for a business enterprise is influenced by such factors as cost, complexity, owner liability, business continuity, need for raising capital, the owners' desire to maintain decision-making authority, and tax considerations.
- The primary normative goal of financial management decision making is the *maximization of shareholder wealth* as measured by the price of the firm's stock.

- *Agency relationships*, such as the relationship between stockholders and managers and the relationship between owners and lenders, give rise to certain agency problems and costs that can have an important impact on firm performance.
- The amount, timing, and risk of the cash flows generated by a firm are, in large part, determined by key financial management decisions, including investment decisions, dividend decisions, financing decisions, and ownership structure decisions. These decisions must be made in the context of factors in the broader economic environment.
- The cash flow concept is a fundamental concept in finance. Financial managers focus on raising cash to invest in assets that will, in turn, generate future cash flows for the firm and its owners.
- The net present value (NPV) rule is central to financial analysis. The net present value of an investment is equal to the present value of future returns minus the initial outlay. Future outlays are discounted back to the present at a required rate of return that reflects the perceived risk of the investment.
- The net present value of an investment made by a firm represents the contribution of the investment to the value of the firm and, accordingly, to the wealth of shareholders.
- The finance function is usually headed by a vice president or *chief financial officer*. The financial management responsibilities are often divided between the *controller* and the *treasurer*. The controller normally has responsibility for all accounting-related activities. The treasurer is normally concerned with the acquisition, custody, and expenditure of funds.
- Financial management is closely related to other areas of business decision making, particularly accounting and economics.
- The finance profession offers a number of exciting career opportunities both within the corporate finance function and in the financial services sector.

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## Questions and Topics for Discussion

1. Define *shareholder wealth*. Explain how it is measured.
2. What are the differences between shareholder wealth maximization and profit maximization? If a firm chooses to pursue the objective of shareholder wealth maximization, does this preclude the use of profit maximization decision-making rules? Explain.
3. Which type of corporation is more likely to be a shareholder wealth maximizer—one with wide ownership and no owners directly involved in the firm's management or one that is closely held?
4. Is the shareholder wealth maximization goal a short- or long-term goal? Explain your answer.
5. It has been argued that shareholder wealth maximization is not a realistic normative goal for the firm, given the social responsibility activities that the firm is "expected" to engage in (such as contributing to the arts, education, etc.). Explain why these social responsibility activities are not necessarily inconsistent with shareholder wealth maximization.
6. Explain why management may tend to pursue goals other than shareholder wealth maximization.
7. Explain what is meant by *agency relationships* and *agency costs*.
8. Give some examples of agency costs incurred by shareholders in the agency relationship between the shareholders (owners) and management of a firm.

9. What is the source of potential agency conflicts between owners and bondholders? Who is the agent and who is the principal in this relationship?
10. Explain the differences in the responsibilities of the treasurer and the controller in a large corporation.
11. Explain the relationship between financial management and (a) microeconomics and (b) macroeconomics.
12. Why is earnings per share not a consistently good measure of a firm's performance?
13. Metropolitan Life Insurance Company, Swiss Bank Corporation, and several other holders of RJR Nabisco bonds filed suit against the company to prevent it from completing the leveraged buyout acquisition from Kohlberg Kravis Roberts. Why do you think the bondholders wanted to block this transaction? What arguments can you make for and against the bondholders' case?
14. What are the major factors that determine the value of a firm's stock?
15. What is the relationship between the concepts of net present value and shareholder wealth maximization?
16. Under pressure from outside investors, including corporate raider Carl Icahn, USX Corporation, the parent corporation for U.S. Steel and Marathon Oil, announced a plan to split its stock into separate steel and energy issues. The market response to this action was immediately positive, with the stock price of USX increasing \$2.37 to close at \$31.25 on the day of the announcement. Why do you think this action by USX was so well received by the stock market?
17. In 2001, Polaroid Corporation declared bankruptcy. How can you reconcile a bankruptcy declaration with a management pledged to maximize shareholder wealth?
18. How can the adherence to high standards of ethical business practice contribute to the goal of shareholder wealth maximization?
19. Compare the potential for agency problems in sole proprietorships, partnerships, and corporations. In light of your analysis, why is the corporate form of organization so popular?