

Chapter 1

The Role of Managerial Finance



PRINCIPLES OF

MANAGERIAL FINANCE

13th Edition

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COURSE DESCRIPTION



Business Finance is an examination of the principles, theory and techniques of modern corporate financial management. Topics such as risk, return, valuation of securities and projects, long-term financing and the financial environment are explored.

COURSE MATERIALS



Textbooks

- Gitman, Lawrence J., Chad J. Zutter, (2012) *Principles of Managerial Finance* (13th ed.) Addison-Wesley, Reading MA.
- PearsonMyLab add-in

Supplemental Materials

- Notes and homework documents are accessed from www.tmcfinancenotes.weebly.com
 - Web Exercises are identified in word documents.
 - They are to be emailed to the instructor.
- Materials should be downloaded as necessary for the classes
- A laptop will be very beneficial in completing in class activities.

Computing / Software

- It is assumed that all students have a basic understanding of the use of Excel spreadsheet.
- There is an Excel spreadsheet to download from the Handout section of MYTMC.
- All individual homework and exams are completed via PearsonMyLab

GRADE COMPOSITION (TRADITIONAL)



Exams 55%

Individual Homework 35%

Attendance and Participation 10%

Grades are based on the total number of correct points achieved out of the total possible.

The above percentages represent an approximate distribution of the grading.

GRADE COMPOSITION (TAP)



Exams	50%
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Individual Homework	15%
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Group Homework	10%
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Individual Web Exercises	15%
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Attendance and Participation	10%
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Grades are based on the total number of correct points achieved out of the total possible.

The above percentages represent an approximate distribution of the grading.

Homework



Homework is due the week after the chapter is completely covered in class.

- There may be times when we do not get everything in the session covered. The chapter homework is only due after the chapter is completed.
- Chapter assignments are due before the next class. All individual homework will be completed on line.
- Group assignments are emailed to the instructor
 - Be sure to name the file correctly.
- Late assignments will receive a 10% penalty.

Exams



All exams are completed online.

You will be directed to the PearsonMyLab website for completion of homework and exam requirements.

You have approximately 3 minutes per question. (All multiple choice)

Chapters are examined after each is completed.

Once you start the exam the clock is running. You cannot stop and comeback.

- Give yourself plenty of time to complete the exam.

The exam must be completed by 8PM the day before the next class meeting.

- As soon as the exam is completed you will receive your score.
- Review of the questions cannot take place until after the deadline has passed.

Any technology challenges should be emailed ASAP.

What is Finance?



- **Finance** can be defined as the science and art of managing money.
- At the personal level, finance is concerned with individuals' decisions about how much of their earnings they spend, how much they save, and how they invest their savings.
- In a business context, finance involves the same types of decisions: how firms raise money from investors, how firms invest money in an attempt to earn a profit, and how they decide whether to reinvest profits in the business or distribute them back to investors.

Career Opportunities in Finance: Managerial Finance



- **Managerial finance** is concerned with the duties of the financial manager working in a business.
- **Financial managers** administer the financial affairs of all types of businesses—private and public, large and small, profit-seeking and not-for-profit.
 - Planning
 - Financing
 - Investing
 - Very involved with strategic planning and implementation

Managerial Finance (cont.)



- The recent global financial crisis and subsequent responses by governmental regulators,
 - increased global competition,
 - Increased rapid technological change
 - increased the importance and complexity of the financial manager's duties.
 - increased demand for financial experts who can
 - manage cash flows in different currencies
 - protect against the risks that naturally arise from international transactions.

Legal Forms of Business Organization



- A **sole proprietorship** is a business owned by one person and operated for his or her own profit.
- A **partnership** is a business owned by two or more people and operated for profit.
- A **corporation** is an entity created by law. Corporations have the legal powers of an individual in that it can sue and be sued, make and be party to contracts, and acquire property in its own name.
- Finance theories and techniques apply to all.

What is the Goal of the firm?



- Is there a benchmark that serves as an appropriate measure of whether an action should proceed or not?
 - Maximize profit
 - Minimize expenses
 - Maximize marketing share
 - Maximize share price
 - Maximize stakeholder wealth

Goal of the Firm: Maximize Profit?



Which Investment is Preferred?

Investment	Earnings per share (EPS)			
	Year 1	Year 2	Year 3	Total for years 1, 2, and 3
Rotor	\$1.40	\$1.00	\$0.40	\$2.80
Valve	0.60	1.00	1.40	3.00

Profit maximization may not lead to the highest possible share price for at least three reasons:

1. Timing is important—the receipt of funds sooner rather than later is preferred
2. Profits do not necessarily result in cash flows available to stockholders
3. Profit maximization fails to account for risk

Goal of the Firm: Maximize Shareholder Wealth!!!



Why?

Because maximizing shareholder wealth properly considers cash flows, the timing of these cash flows, and the risk of these cash flows.

- This is primarily what the owners want

This can be illustrated using the following simple stock valuation equation:

$$\text{Share Price} = \frac{\text{Future Dividends}}{\text{Required Return}}$$

**level & timing
of cash flows**

**risk of cash
flows**

Goal of the Firm: What About Stakeholders?



- **Stakeholders** are groups such as employees, customers, suppliers, creditors, owners, and others who have a direct economic link to the firm.
- A firm with a *stakeholder focus* consciously avoids actions that would prove detrimental to stakeholders. The goal is not to maximize stakeholder well-being but to preserve it.
- Such a view is considered to be "socially responsible."

The Role of Business Ethics



- **Business ethics** are the standards of conduct or moral judgment that apply to persons engaged in commerce.
- Violations of these standards in finance involve a variety of actions: “creative accounting,” earnings management, misleading financial forecasts, insider trading, fraud, excessive executive compensation, options backdating, bribery, and kickbacks.
- Negative publicity often leads to negative impacts on a firm

The Role of Business Ethics: Ethics and Share Price



Ethics programs seek to:

- reduce litigation and judgment costs
- maintain a positive corporate image
- build shareholder confidence
- gain the loyalty and respect of all stakeholders

The expected result of such programs is to positively affect the firm's share price.

Is there a place in business for the “Golden Rule”??

Managerial Finance Function: Relationship to Economics



- Financial managers must understand the economic framework and be alert to the consequences of varying levels of economic activity and changes in economic policy.
- They must also be able to use economic theories as guidelines for efficient business operation.
- **Marginal cost–benefit analysis** is the economic principle that states that financial decisions should be made and actions taken only when the added benefits exceed the added costs

Managerial Finance Function: Relationship to Accounting



- The firm's finance and accounting activities are closely-related and generally overlap.
- One major difference in perspective and emphasis between finance and accounting is that accountants generally use the accrual method while in finance, the focus is on cash flows.

Managerial Finance Function: Relationship to Accounting (cont.)



Sales	\$100,000 (1 yacht sold, 100% still uncollected)
Costs	\$ 80,000 (all paid in full under supplier terms)

Income Statement Summary

	<u>Accrual basis</u>	<u>Cash basis</u>
Sales	\$100,000	\$ 0
Less: Costs	<u>(80,000)</u>	<u>(80,000)</u>
Net Profit/(Loss)	\$ 20,000	\$(80,000)

Managerial Finance Function: Relationship to Accounting (cont.)



Finance and accounting also differ with respect to decision-making:

- Accountants devote most of their attention to the *collection and presentation of financial data*.
- Financial managers evaluate the accounting statements, develop additional data, and *make decisions* on the basis of their assessment of the associated returns and risks.

Governance and Agency: Corporate Governance



- **Corporate governance** refers to the rules, processes, and laws by which companies are operated, controlled, and regulated.
- It defines the rights and responsibilities of the corporate participants such as the shareholders, board of directors, officers and managers, and other stakeholders, as well as the rules and procedures for making corporate decisions.

Governance and Agency: Individual versus Institutional Investors



- **Individual investors** are investors who own relatively small quantities of shares so as to meet personal investment goals.
- **Institutional investors** are investment professionals, such as banks, insurance companies, mutual funds, and pension funds, that are paid to manage and hold large quantities of securities on behalf of others.
- Unlike individual investors, institutional investors often monitor and directly influence a firm's corporate governance by exerting pressure on management to perform or communicating their concerns to the firm's board.
 - Not historically the way the world worked. This has helped individual investors by giving some assurance as to confidence of management and their actions.

Governance and Agency: Government Regulation



The Sarbanes-Oxley Act of 2002:

- established an oversight board to monitor the accounting industry;
- tightened audit regulations and controls;
- **toughened penalties against executives who commit corporate fraud;**
- **strengthened accounting disclosure requirements and ethical guidelines for corporate officers;**
- **established corporate board structure and membership guidelines;**
- established guidelines with regard to analyst conflicts of interest;
- mandated instant disclosure of stock sales by corporate executives;
- increased securities regulation authority and budgets for auditors and investigators.

Governance and Agency: The Agency Issue



- A **principal-agent relationship** is an arrangement in which an agent acts on the behalf of a principal. For example, shareholders of a company (principals) elect management (agents) to act on their behalf.
- **Agency problems** arise when managers place personal goals ahead of the goals of shareholders.
- **Agency costs** arise from agency problems that are borne by shareholders and represent a loss of shareholder wealth.

The Agency Issue: The Agency Problem



Whenever a manager owns less than 100% of the firm's equity, a potential **agency problem** exists.

In theory, managers would agree with shareholder wealth maximization.

However, managers are also concerned with their personal wealth, job security, fringe benefits, and lifestyle.

This would cause managers to act in ways that might not always benefit the firm shareholders.

The Agency Issue:



- **How can we get managers to act in shareholder best interests?**
 - **Labor market for employment**
 - **Labor market for takeovers**
 - **Auditing the companies books**
 - **Compensation plans**
 - **Incentive plans** tie management compensation to share price; one example involves the granting of stock options.
 - **Performance plans** tie management compensation to measures such as EPS or growth in EPS.

Options



- **Option is the right to buy a stock at a certain price within a certain period of time.**
 - **Creates another place for people to acquire company stock.**

You have an option to buy a share of stock at \$50. The current price is \$35.

Where would you buy?

You have an option to buy a share of stock at \$50. After several years of good management the price has risen to \$65.

Where would you buy?

Matter of Fact—Forbes.com CEO Performance vs. Pay



Forbes.com CEO Performance vs. Pay

Efficiency ranking	Chief executive officer	Company	Compensation	Compensation rank
1st	Jeffery H. Boyd	Priceline.com	\$7.49 mil.	135th
2nd	Jeffrey P. Bezos	Amazon.com	\$1.28 mil.	463rd
3rd	Leonard Bell	Alexion Pharmaceuticals	\$4.26 mil.	286th
90th	H. Lawrence Culp Jr.	Danaher Corp.	\$141.36 mil.	1st
82nd	Lawrence J. Ellison	Oracle Corp.	\$130.23 mil.	2nd
163rd	Aubrey K. McClendon	Chesapeake Energy Corp.	\$114.29 mil.	3rd