FINANCIAL MANAGEMENT

CONCEPTS AND APPLICATIONS

STEPHEN FOERSTER

Financial Management

Concepts and Applications

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Stephen Foerster

Western University

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To Linda for her love and support,

and to Jennifer, Christopher, Thomas, and Melanie

for absorbing unsolicited financial advice

and tolerating my attempts at humour

over the years

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About the Author

Stephen Foerster is a Professor of Finance at the Ivey Business School, Western University in Ontario, Canada. He currently teaches corporate finance to Executive MBA students. He received his M.A. and Ph.D. from the University of Pennsylvania (The Wharton School) and also obtained the Chartered Financial Analyst designation.

Professor Foerster is a member of the Editorial Board of *Financial Analysts Journal*. His research interests include capital markets and household finance. Major academic journals such as the *Journal of Finance* and *Journal of Financial Economics* have published his research, and he has written over 90 case studies. Professor Foerster has won numerous teaching and research awards. He has been a consultant and executive training course designer and facilitator in corporate finance, portfolio management, finance for nonfinancial executives, value-based management, risk management, and other investment areas. He also serves on a university pension board and a not-for-profit foundation board.

Born in Sudbury, Ontario, Professor Foerster is married with four children and enjoys golfing, hiking, and biking.

Brief Content

Contents

Preface

Welcome to the wonderful world of finance! What is the first thing that comes to your mind when someone mentions corporate finance or financial management? If you're like many students and nonfinancial managers, your initial response may be "It sounds like something I don't need to know" or "It sounds complex, and it deals with lots of numbers" or "It doesn't sound like the most exciting business subject I have studied." Yet my experience teaching business undergraduates, MBAs, and executives has led me to conclude that virtually *everyone* can overcome these initial feelings through an educational process that:

- Shows how finance integrates with other areas of business
- Shows the practical side of finance, rather than just the theoretical concepts
- Shows that finance is a dynamic, interesting, and topical area of study

Understanding finance is critical to understanding business in general, because finance is a key driver of a firm's activities. Familiarity with financial concepts also helps you fully understand many of the stories featured every day in the financial press.

Key Features

Financial Management: Concepts and Applications is made distinctive by incorporation of the following features:

- It introduces a unique financial management framework that serves as a unifying theme throughout the book. At the beginning of each chapter, we return to the framework and describe how the concepts in the chapter relate to the unifying theme. The benefit of this approach is that you won't get lost in the trees but will always have an eye on the greater forest.
- It emphasizes practical examples and applications of concepts. Throughout the book, we focus on Home Depot, Inc., the world's largest home improvement retailer. For example, after we discuss the topic of cost of capital, we'll look at how to estimate Home Depot's cost of capital. The book also includes examples of other firms and situations relevant to our discussions. Much of this information is conveyed visually via charts, exhibits, and tables.
- It integrates both the nonfinancial and financial areas of business. A unique feature for a finance textbook is the inclusion of a chapter that presents a nonfinancial perspective of financial management to help students identify opportunities and risks as well as to understand the corresponding financial implications.
- It highlights the relevance of the concepts for practicing managers. Whether you are a nonfinancial manager or an aspiring financial manager, you always want to know "so what?" Each chapter includes a summary section that describes the relevance of the concepts and ideas and the key take-aways for managers.
- It concludes with a comprehensive case study that summarizes the major concepts addressed throughout the book and presented in the unifying theme. The last chapter focuses on a well-known retail giant, Wal-Mart Stores, Inc. (Walmart), and

shows how we can apply all of the concepts introduced in the book to assess Walmart's performance and to identify ways that Walmart can create value for its shareholders.
- It is relatively short in length for a finance textbook, compared to many traditional finance texts with over 1,200 pages.

This text is aimed primarily at nonfinancial executives and managers, as well as current MBA and undergraduate students who are aspiring managers and want to be in a position to better communicate with financial managers, accountants, and controllers. The book is meant to be a practical guide to financial management, for those have never had direct exposure to the field of finance. The emphasis is on the application of tools to better understand a firm's financial situation.

Thus, the three major objectives of the book are as follows:

- To provide nonfinancial managers with insight into the various activities of a firm that affect cash flows
- To assist current and future managers in developing the analytical skills necessary for evaluating business problems and opportunities from a financial perspective
- To help nonfinancial managers better understand key concepts related to some of the major decisions facing financial managers

How This Book Is Organized

Financial Management: Concepts and Applications is divided into four parts. Part One, Assessing and Managing Performance, consists of Chapters 1 through 5. Chapter 1 provides an overview of finance and financial management. Chapters 2 through 5 focus on assessing a firm's current business from both the nonfinancial and financial perspectives. This assessment is critical to understanding the firm's financial health and managing its performance. To begin, Chapter 2 looks at sizing up a business by examining external factors, such as the economy and the industry in which the firm operates, as well as the firm's strengths and weaknesses in nonfinancial areas like marketing, operations, and human resources management. Chapters 3 and 4 explore assessing a business from a financial perspective. Chapter 3 presents key financial statements, whereas Chapter 4 examines historical ratios or measures of performance in order to determine the firm's liquidity, efficiency, capacity to take on more debt, and overall profitability. Finally, Chapter 5 focuses on day-to-day cash flow management, including management of accounts receivable, inventory, and accounts payable.

Part Two, Assessing Future Financial Needs, consists of Chapters 6 through 8. Chapter 6 focuses on projecting a firm's financial requirements through pro forma income statements, balance sheets, and cash budgets. The importance of spreadsheet analysis is also discussed. Chapter 7 summarizes time value of money concepts, which form the basis for bond and equity valuation. The investment decision process is examined in Chapter 8.

Part Three, Financing Long-Term Needs, consists of Chapters 9 through 12. First, Chapter 9 provides a bridge from short-term to long-term financing needs by presenting an overview of capital markets, as well as various debt and equity issues. Next, Chapter 10 focuses on assessing a firm's cost of capital by estimating the costs of debt and equity. The financing and payout decisions that a firm faces are examined in Chapter 11. Chapter 12 then looks at issues related to designing an optimal capital structure, including such trade-offs as cost, risk, and flexibility.

Part Four, Creating Value, consists of Chapters 13 and 14. Chapter 13 considers the measurement and creation of value. Traditional valuation techniques such as discounted cash flow analysis are presented. The chapter also looks at the concept of economic value added (EVA®), which is part of value-based management. Finally, Chapter 14 integrates all of the previous chapters by providing a comprehensive case study of Walmart.

Key terms are defined in the margins of each chapter, and a comprehensive glossary of key terms is presented following the last chapter. Each chapter contains self-study questions that summarize the key concepts covered in the chapter. The solutions to these questions are provided in MyFinanceLab.

Instructor Resources

Valuable instructor resources are available for this text and may be found on pearsonhighered.com.

- A PowerPoint® presentation created by author Stephen Foerster presents each chapter in a logical, visual progression and includes slides of example problems.
- A computerized Test Bank, created by Curtis Bacon of Southern Oregon University, is available in TestGen™ for Windows or Macintosh. Instructors can create tests or quizzes of varying lengths and difficulties using the questions included. The Test Bank for this title is also available in MyFinanceLab™.
- A Solutions Manual by author Stephen Foerster provides instructors with solutions to all end-of-chapter problems.

For Students

MyFinanceLab® is powered by a sophisticated adaptive learning engine that tailors learning material to meet the unique needs of each student. Videos, interactive quizzes, and other learning aids help students of various learning styles work with the material, and autograde functions help instructors focus on teaching.

Financial Management: Concepts and Applications will provide valuable insight to interested individuals and nonfinancial executives as part of an executive or university course in applied corporate finance, a case course in financial management, or as a supplement to financial theory courses.

This book assumes no prior knowledge of finance, but it provides a tremendous amount of value added—hopefully it is one of the best investments you will ever make!

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Overview of Financial Management

1

Welcome to the world of finance. This chapter provides an introduction to financial management, highlighting the important role of cash in a business. The chapter also describes key questions facing financial managers and fundamental concepts related to financial management. The relationship between financial management and accounting is examined, and different types of firm structures are described. Finally, the chapter presents a financial management framework that provides a unifying theme throughout the book. This framework shows that the primary goal of a firm is value creation, and that the creation of value is driven by two key factors: growth and risk.

LEARNING OBJECTIVES

OBJ 1.1
Explain the major cash-related activities of a firm and the cash flow cycle.

OBJ 1.2
Describe the major duties, tasks, and key questions facing financial managers.

OBJ 1.3
Describe fundamental concepts that nonfinancial managers need to understand.

OBJ 1.4
Describe the relationship between financial management and accounting, operations, marketing, information technology, and human resources.

OBJ 1.5
Explain the difference among sole proprietorships, general partnerships, limited liability companies, S corporations, and C corporations.

OBJ 1.6
Explain the components of the financial management framework.

OBJ 1.7
Explain why understanding financial management is relevant for managers.

1.1 Financial Management and the Cash Flow Cycle

You may have heard the expression "Cash is king!" This saying highlights the importance of a noble profession: financial management. At its heart, financial management involves managing cash, the bloodline of any corporation.

Cash is important because it is crucial to three activities that every business faces. First, a firm needs to *invest* in **real assets**,[1] or assets that produce goods or help provide services, in order to function as a business; it also needs to invest in **working capital**. These real assets may be tangible, such as plants and equipment, or they may be intangible, such as investments in research and patent development, whereas working capital investments represent money tied up in inventory and money owed by customers who buy on credit. Second, a firm must *finance* or pay for its real assets, meaning it must have cash on hand or be able to obtain cash from some external source, such as a bank or investor. The firm obtains cash from this source in exchange for taking on some obligation, such as agreeing to pay annual interest on a loan and to pay back the loan in a certain number of years. Third, a firm needs to generate cash from its *operations*.

As shown in **Figure 1.1**, the financial manager is at the center of cash-management activities in all three areas. In other words, although the financial manager is not directly involved in the operations of a business—that's left to

OBJECTIVE 1.1

Explain the major cash-related activities of a firm and the cash flow cycle.

[1] *Note:* All **bold** terms in blue are defined in the margins and in a glossary at the end of the book.

CASE STUDY

Advanced Micro Devices Inc.'s Cash Crunch

In the fall of 2012, Advanced Micro Devices Inc. (AMD) was facing a financial crisis. The company was a semiconductor designer and maker of PC processors, and thus a competitor of the much larger Intel Corp. On October 18, 2012, the firm issued its third-quarter results, which indicated a net loss of $157 million on revenue of $1.27 billion. The company's cash had declined from $1.8 billion to $1.5 billion over the quarter, and it was expected to drop to $600 million or lower in the next 12 months—significantly less than the $1.1 billion in reserves the company said it required. The quarterly operating expenses by AMD were around $450 million, and its debt was over $2 billion. In an attempt to control the crisis, the company announced a restructuring plan aimed at reducing operating expenses and improving its competitive position. How had AMD's finances come under such stress?

The simple reason for AMD's woes was less cash coming in to the firm and more cash going out, resulting in a cash crunch. On the cash inflow side, sales were being hurt because the global economy was weak and consumer tastes were changing. The company relied on the PC market for 85 percent of its sales, but the PC market was declining. In addition, AMD already faced one major competitor in Intel, and new entrants were threatening to enter the market. On the cash outflow side, AMD needed to spend money developing products for new markets, but analysts were concerned the firm would run out of funds before it was able to transform itself. The firm was trying to negotiate with a chip supplier to reduce purchase commitments and hence expenses. Credit rating agencies were considering downgrading AMD's debt, which would increase borrowing costs. The firm's stock and bond prices were falling, limiting access to new capital. As a result of all of these factors, AMD is experiencing a cash crunch, which highlights the importance of cash flow management. It is critical to anticipate cash flow needs and secure financing before a cash crunch occurs.

Sources: AMD news release "AMD Reports Third Quarter Results and Announces Restructuring," October 18, 2013; and Bloomberg Businessweek "AMD Faces Looming Cash Crunch Amid Quest for New Markets," Ian King, October 25 2012, http://www.businessweek.com/news/2012-10-25/amd-faces-looming-cash-crunch-amid-quest-for-new-markets-tech#p1 (accessed December 10, 2012).

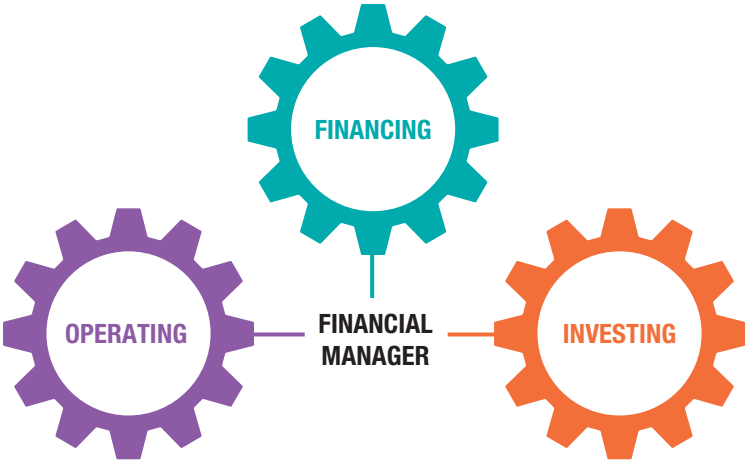

FIG 1.1
Cash-Related Activities and the Financial Manager

operating managers, marketing managers, human resource managers, and others—he or she plays an indirect role by ensuring there is enough cash to operate. The financial manager also ensures that any cash generated from operations is utilized effectively by investing in more real assets or paying back investors and lenders.

Let's take a closer look at the **cash flow cycle**—or where cash comes from and where it goes in a business—as depicted in **Figure 1.2**. In doing so, we'll work through an example that builds on the three main cash-related activities: financing, investing, and operating. We'll see the close relationship among how a firm is financed, how it invests, and how it operates. We'll also touch on some important finance terms that will be described in greater detail later in the book. As you read the example, keep two important points in mind. First, if a firm doesn't have cash, then it can't operate. Second, a firm's profits are *not* the same as its cash flow.

real assets: Assets used to produce goods and services

working capital: The difference between current assets and current liabilities on the balance sheet

cash flow cycle (cash conversion cycle): The pattern and timing of where cash comes from and where it goes in a firm

Let's start our example by focusing on financing activities. Say, for instance, that Ace Manufacturing Inc. is a start-up venture that needs to buy a new machine to manufacture electronic components. To facilitate the purchase, Ace identifies a number of individuals who are willing to supply cash now in exchange for something in the future, as defined in a simple contract (albeit a carefully worded and important contract). The contract that Ace provides to these suppliers of cash

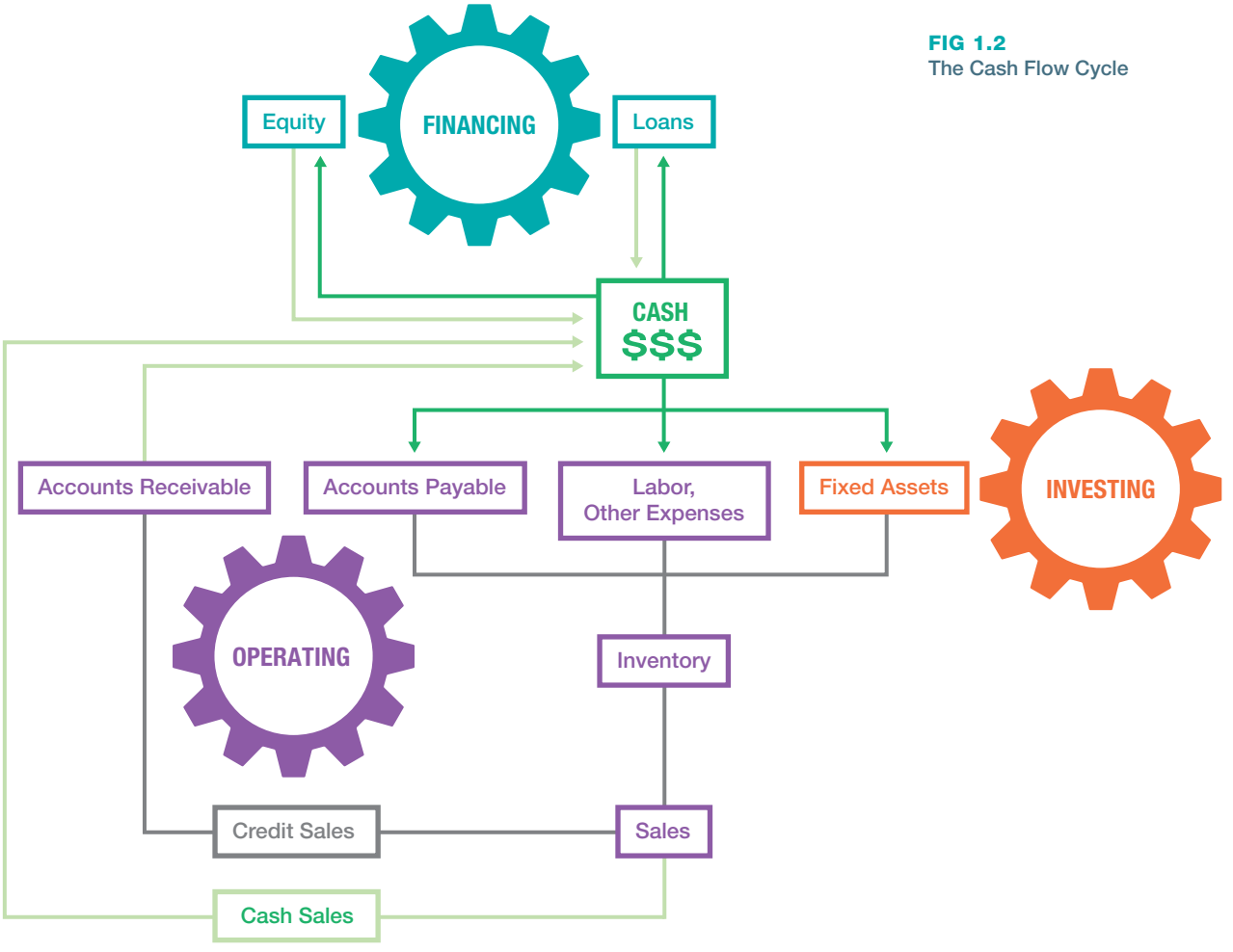

FIG 1.2
The Cash Flow Cycle

indicates the nature of their expected return, such as interest payments in the case of a loan, or perhaps a specified share of any future earnings Ace generates in the case of issuing equity. Contracts like these are known as **financial assets** or **financial instruments**.

Now, let's assume Ace decides to pay for its new machine by obtaining a loan from Solid Bank Ltd. So Ace agrees to a make a series of scheduled interest payments and principal payments to Solid Bank, much like a home mortgage, with the exact payment terms set out in the contract. If Ace is unable to make these payments, the contract specifies that Solid Bank can claim the machine and sell it in order to recoup the money it lent to Ace. This loan is also known as a **liability** to Ace, or an obligation the firm needs to pay. Liabilities may take forms besides loans, such as **bonds** (discussed in more detail in Chapters 7 and 9), which are another type of financial instrument that represents a long-term debt.

On the other hand, instead of borrowing, Ace might issue **common equity** (also discussed in more detail in Chapters 7 and 9), which is a stake or share in the ownership of the firm in exchange for a cash investment. The **common shareholders**, or purchasers of these shares, provide an immediate source of cash to Ace and are known as *residual claimants.* The shareholders receive a "contract" known as a *stock certificate,* which indicates they will own a certain portion of whatever **profits** (or earnings after expenses) are left after other claimants, such as lenders like Solid Bank, have been satisfied. Thus, the shareholders are collectively the ultimate owners of the firm, and they entrust the company's managers—including its financial managers—to act in their best interest.

Now that our sample firm has some cash, let's turn to investing activities. Recall that Ace needs to buy a new machine to manufacture electronic components. We consider this activity an investment in fixed assets. Ace expects to be able to use this machine to manufacture electronic components for quite a number of years before it needs to be replaced. Thus, Ace will have a large cash outflow initially, but assuming it is successful in making products that are in demand, it will reap the rewards of profits in the future. Notice from Figure 1.2 that Ace has used its investment in fixed assets to create inventory.

financial instruments (financial assets): Securities such as bonds and stocks that represent claims on the assets of a firm

liabilities: Obligations to pay a specified amount or perform a particular service

bond: A financial instrument issued by a firm representing long-term debt

common equity (common stock): Securities representing the direct ownership of a firm, or the residual claims on the assets

common shareholders: Owners of common shares, or common equity

profits *(net earnings, net income, net profits)*: The difference between revenue and all associated expenses over a particular time period.

dividends: A share of the profits of the firm distributed to shareholders

Next, let's examine Ace's operating activities. To create electronic components, Ace needs to order parts from suppliers. We'll examine the cash flow implications of dealing with suppliers (and customers) in much more detail in Chapter 5; for now, simply note that it's customary for suppliers to provide supplies immediately, with an expectation of repayment in some specified period, such as 30 days—this is referred to in Figure 1.2 as *accounts payable.* Ace therefore needs to ensure it is on good terms with its suppliers. Ace also has cash outlays for labor as well as other operating-relating expenses. Later, once Ace has built up an inventory of electronic components, it can generate sales to its customers, who are computer manufacturers. Like most companies, Ace will make its sales on credit, with its customers promising to pay in, say, 30 days—just like Ace's relationship with its suppliers. So, from a cash flow management perspective, Ace needs to ensure its customers submit payment in a timely manner. We have also included in Figure 1.2 the possibility that some customers may pay in cash.

We've now come full circle in our cash flow cycle. When Ace receives payment from its customers, it can use the cash to pay interest on its loan or even repay part or the entire loan. It might also pay **dividends**—making cash payments—to its common shareholders. As the cycle continues, Ace may invest in more assets and buy more supplies to create more inventory to replace the depleted inventory from earlier sales.

1.2 The Role of Financial Managers

OBJECTIVE 1.2

Describe the major duties, tasks, and key questions facing financial managers.

Let's examine the role of the financial manager throughout this cash flow cycle. Financial management represents the bridge between a firm's real assets and its financial commitments—in other words, between the assets in which the firm has invested (and which are expected to generate cash) and the commitments the firm has made to its suppliers of cash. Accordingly, financial managers have four main duties: assessing the current business, assessing future financing needs, developing long-term financing strategies, and assessing future investments. To elaborate, financial managers are concerned with the following tasks:

- Understanding the firm's present business situation and measuring its current performance.
- Assessing the firm's future financial needs in the short and medium term (say, over the next one to five years).
- Determining the best way to obtain cash to pay for real assets (known simply as **financing**) and assessing other financing decisions, including how best to manage money generated by the operations of the business. For example, financial managers must decide whether earnings available after expenses and taxes should be paid directly to the firm's shareholders in the form of dividends or reinvested back into the firm in the form of **retained earnings**.
- Investing money in the various operations of the business (known simply as **capital budgeting** or **investing**) and seeking ways to maximize the value of the firm by growing cash flows while mitigating risk.

Financial managers are concerned with both short-term and medium-term/long-term decisions. Short-term decisions focus on day-to-day cash flow and **working capital management**, which is the relationship between the firm's short-term **assets** (what the firm owns) and liabilities (what the firm owes). Medium-term/long-term decisions affect the firm's overall **capital structure**, or mix of debt and equity. The ultimate task of the financial manager is to ensure the firm is maximizing value for its key stakeholders: its shareholders. Value is created by increasing cash flows and providing returns commensurate with the risk involved in the growth activities. Of course, a firm has other important stakeholders as well—including lenders, employees, customers, and the communities in which the firm operates—but the common shareholders are the key stakeholders, because they are essentially the owners of the business.

Figure 1.3 summarizes several key questions that highlight the ultimate task facing financial managers. Later, we'll see how these questions relate to the focal point of our financial management framework.

financing: The process of obtaining funds to pay for real assets

retained earnings: The cumulative amount of earnings retained or reinvested in the firm and not paid out as dividends

capital budgeting: The process of selecting investment projects

investing: The process of committing funds for the purpose of obtaining a return over a particular period of time

working capital management: The process of managing short-term decisions pertaining to current assets and current liabilities

assets: Tangible or intangible items of value to a firm

capital structure: The mix of debt and equity that a firm uses to finance its operations

Q: How can my financial decisions help create value for the firm's shareholders?

To Create Value:

What amount of financing does the firm require?

How should the firm raise the required financing?

What investments should the firm make?

FIG 1.3
Key Questions Facing Financial Managers

IN-DEPTH

Maximizing Shareholder Value: An Ethical Responsibility?

Finance professors often get criticized by ethics professors because they tell their students that the goal of the firm is to maximize shareholder value. Financial scandals such as Enron, Tyco and others are regularly blamed on the excessive focus on shareholder value maximisation.

Theo Vermaelen, Professor of Finance at INSEAD, says this critique is misplaced and reflects a lack of understanding of what we teach in finance courses.

"Shareholder value is defined as the present value of free cash flows from now until infinity, discounted at a rate that reflects the risks of these cash flows. So, maximizing shareholder value is not the same thing as maximizing short-term profits, earnings per share or manipulating stock prices through accounting fraud. The Enron disaster, in which all shareholders lost their money, has nothing to do with excessive focus on shareholder value," he says.

Another misunderstanding is that because anyone who evaluates decisions on the basis of consequences for shareholder value, does not care about other stakeholders.

"In a discounted cash flow spreadsheet, shareholder value is calculated by taking revenues and then subtracting labor costs, executive compensation, interest, and taxes. This residual cash flow incorporates the interests of all stakeholders, not simply the shareholder. What we don't do is 'balance' the interest of stakeholders as you can justify any decision by stakeholder maximization theory. For example maximizing stakeholder value could mean that I pay workers above-competitive salaries at the expense of shareholders. The problem is that if you do this in a competitive market, in the long run you will be driven out of business, as recently illustrated by the collapse of General Motors. Of course, in the short run a firm may make abnormal profits, but this will attract competitors, so that in the long run also shareholders will earn a competitive rate of return".

While economists typically justify maximizing shareholder value on the basis of economic efficiency arguments, Vermaelen wants to give an ethical twist to this. He proposes a new definition of ethical behavior in business that is less tied to highly personal values: respect for implicit contracts. Once we embrace this definition, maximizing shareholder value may well be an ethical responsibility.

Vermaelen adopts the view that a company should be considered as a nexus of contracts between various stakeholders. All contracts have explicit and implicit characteristics. For example, the debt contract has a large number of explicit terms such as maturity, interest rate, seniority, covenants, and so on. However, shareholders have a largely implicit contract. Apart from voting rights, which are relatively meaningless for small stockholders, shareholders have no explicit rights. Shareholders are not entitled to any dividends or can't get their money back. As a company needs shareholders, the survival of a corporation with widely dispersed ownership depends on the survival of this implicit contract.

"In a capitalist economy it is reasonable to assume that shareholders have an implicit contract that the management will maximize their interests," Vermaelen says. "So, I believe that respect for such implicit contracts is an ethical responsibility. Hence, policies that are deliberately aimed at destroying shareholder value are unethical. Unless, of course, the company makes it clear in advance that it will pursue a different objective. For example, a company that raises equity and states that it will start a corporate social responsibility policy that distributes five per cent of its profits to the poor behaves ethically because investors can incorporate the lower profits in the issue price of the stock. But implementing such policies when they were not announced in advance is, in my view, unethical."

Proponents of CSR argue that many of these policies actually do create shareholder value. For example, giving money to the poor may create sympathy for the company, increase revenues and/or lower labor costs and may ultimately be value maximizing.

"Obviously if CSR policies are simply PR or marketing exercises than obviously they are not inconsistent with value maximization or unethical," Vermaelen says. "But it is up to the company to prove that this marketing strategy works."

The fact that managers may not maximize shareholder value is generally described as an agency problem. Traditionally economists try to deal with this by designing compensation schemes that align the interest of stockholders and managers. Or, alternatively, appoint a board of directors that has the fiduciary duty to make sure managers maximize shareholder value.

"The problem is that it is difficult, if not impossible to solve the problem this way, as the current credit crisis indicates," Vermaelen says. "Bonuses based on short-term profits led bankers to take risks that produced short-term profits and short-term stock price increases without creating long-term shareholder value. So besides designing better incentive schemes to align managerial and shareholder interests, there is a need to promote the ethical view that the right thing to do is to maximize shareholder value"

1.3 A Nonfinancial Perspective of Financial Management

OBJECTIVE 1.3

Describe fundamental concepts that nonfinancial managers need to understand.

Perhaps unfortunately, not everyone will be able to enjoy the challenges and rewards that come with a career in financial management. So now let's consider financial management from a number of *nonfinancial* managers' perspectives. In the final chapter of this book, Chapter 14, we'll examine Wal-Mart Stores Inc. (Walmart) as a comprehensive case study. For now, let's consider a variety of nonfinancial managers who would be interested in Walmart's financial performance.

- Suppose you worked for Walmart in an operations capacity and wanted to consider how you could have a positive financial impact on Walmart;
- Suppose you were considering investing in Walmart's common shares and wanted to understand whether it was a good time to invest;
- Suppose you were an analyst assigned to recommend stock investments in Walmart;
- Suppose you worked at a credit rating agency assigned to assess the creditworthiness of Walmart's bonds; or
- Suppose you were a major competitor of Walmart and wanted to understand the threats you faced.

From each of these perspectives you would need to examine Walmart's financial health. You would want to gather information, such as Walmart's financial statements, analyze the information, and assess Walmart's financial strengths and weaknesses.

Keeping in mind these various perspectives, **Figure 1.4** summarizes some fundamental concepts that nonfinancial managers need to understand. These concepts will be further developed in later chapters.

FIG 1.4
Fundamental Concepts Related to Financial Management

Assessment of the Current Business

- Business size-up (economic conditions, industry key success factors, opportunities and risks, strengths and weaknesses)
- Performance measurement (financial statement analysis)
- Day-to-day cash management

Assessment of Future Financing Requirements

- Financial statement projections
- Understanding investment decisions

Issues Related to Long-Term Financing Decisions

- Understanding capital markets
- Determining the cost of capital
- Raising long-term capital

Issues Related to Investments

- Measuring value
- Creating value

IN THE NEWS

Walmart's Financial Challenges

In the spring of 2012, Walmart had just released its most recent quarterly results covering the busy 2011 holiday season, through January 31. The economic recovery from recession was slow but Walmart wanted to encourage spending. As such, and wanting to reverse a decline in same-store revenues year-over-year, Walmart had guaranteed holiday shoppers that they would receive the lowest price on merchandise. Walmart refocused on offering low prices throughout the store instead of temporarily slashing prices selectively. While Walmart was able to reverse its declining trend in revenues, its overall gross margin (profits after cost of sales as a percentage of sales) declined.

"They're working extremely hard just to see improving sales," said Brian Sozzi, chief equities analyst at NBG, an independent research firm. "But it's coming at the expense of profits on each sale."

Going forward, Walmart officials said the company would keep looking for ways to cut prices. "You can expect us to invest even more in lower prices," [Mike] Duke, Walmart's CEO, said.

During a recent media call with reporters, Charles Holley, chief financial officer, said that January has the best performance in the quarter [November through January], reflecting the sales momentum the discounter is enjoying. "I do think there's a new normal with customers. The markets are more volatile. Gas prices are more volatile. Customers are looking for new ways to save money because they don't know [what is] around the corner."

Source: "Sales Up, Quarterly Profits Down, at Wal-Mart," by Anne D'Innocenzio, Associated Press reporter, February 21, 2012, http://www.theledger.com/article/20120221/NEWS/120229897?p=1&tc=pg (accessed December 11, 2012).

1.4 Financial Management's Relationship with Accounting and Other Disciplines

OBJECTIVE 1.4

Describe the relationship between financial management and accounting, operations, marketing, information technology, and human resources.

Many newcomers to the area of finance have a mistaken impression that a firm's finance and accounting functions are essentially the same. (Try not to express this view in the presence of either finance professors or accounting professors!) In reality, these two functions are distinct, although a firm's finance department relies heavily on data supplied by the firm's accounting department.

Let's take a closer look at the relationship between financial management and accounting. To make capital budgeting and financing decisions, a financial manager requires key financial data, such as information about the firm's cash inflows and outflows. The financial manager relies on the firm's accountant to provide this information in a systematic and organized fashion. In this role, known as *financial accounting,* the accountant supports the financial manager by identifying relevant data related to the activities of the firm, then presenting the data in an agreed-on and standardized manner, known as *generally accepted accounting practices.* The accountant communicates this information not only internally to managers but also externally to shareholders, lenders, analysts, and other interested parties.

To communicate financial data, accountants provide *scorecards* that summarize the firm's relevant economic activity. These scorecards take several forms. For example, the **balance sheet** provides a snapshot of the firm's assets, as well as the financing of those assets, at a specific moment in time. The **income statement** provides a measure of the firm's profitability over a particular period, such as a year. Similarly, the **cash flow statement** provides a summary of the firm's cash inflows and outflows over a particular length of time, categorized into cash related to operating, investing, and financing—the three main areas that are highlighted in Figure 1.1.

Beyond financial accounting, accountants carry out a second important role known as *cost accounting.* Here, they determine the proper allocation of costs associated with the creation of products and assist in creating budgets useful for financial planning. They also provide information that can help managers evaluate decisions, such as whether to acquire a new asset. For example, accounting information would indicate a firm's ability to generate a certain level of operating profits relative to the amount of assets employed to generate those profits. This information would assist in cost-benefit analysis of a potential new investment. Therefore, financial and nonfinancial managers alike are highly dependent on the types of information accountants provide.

Financial managers also interact with managers from functional areas other than accounting, including operations, marketing, technology, and human resources. Managers in all of these functional areas require funding for their activities, which necessitates their interaction with financial managers. For instance, the operations function allows for development of the products or services a firm will sell. Operations managers require funds for both small capital expenditures (such as equipment purchases) and large capital expenditures (such as plant expansions). In addition, most firms not strictly in service-related industries need to invest in inventory. Furthermore, how a firm deals with suppliers and what repayment terms it may be able to negotiate has important financial implications.

Marketing plays a crucial role in generating revenue for the business. Marketing managers require funds for marketing and selling activities, as well as for entering new markets both domestically and globally. In addition, marketing-related policies such as credit terms provided to customers have important financial implications as they result in investments in accounts receivable.

balance sheet: A financial statement reflecting the value of a firm's assets, liabilities, and net worth at a particular time

income statement: A financial statement indicating a firm's revenues, expenses, and resulting income over a period of time

cash flow statement: A financial statement reflecting a firm's cash inflows and outflows categorized into cash related to operating, investing, and financing