CHAPTER 1

An Introduction to the Foundations of Financial Management

CHAPTER ORIENTATION

This chapter lays a foundation for what will follow. First, it focuses on the goal of the firm, followed by the five principles that form the foundations of financial management and the role of finance in business. The chapter then reviews the legal forms of business organization and discusses the tax implications relating to financial decisions. Finally, the chapter discusses the multinational firm and its role in finance.

CHAPTER OUTLINE

I. The Goal of the Firm

A. In this book, we will designate maximization of shareholder wealth to be the goal of the firm, by which we mean maximization of the total market value of the firm's common stock.

B. We have chosen the goal of shareholder wealth maximization because the effects of all financial decisions are included in this goal.

C. In order to employ this goal, we need not consider every price change to be a market interpretation of the worth of our decisions. What we do focus on is the effect that our decision *should* have on the stock price if everything were held constant.

II. Five Principles That Form the Foundations of Finance

A. **Principle 1: Cash Flow Is What Matters.** In measuring value, we will use cash flows rather than accounting profits because it is only cash flows that the firm receives and is able to reinvest. In addition, in making business decisions, we will concern ourselves with only what happens as a result of that decision.

B. **Principle 2: Money Has a Time Value.** Almost all financial decisions involve comparing money in different periods, perhaps investing today and receiving returns later, or borrowing money today and paying it off later. A dollar received today is worth more than a dollar received in the future because of the time value of money.

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C. **Principle 3: Risk Requires a Reward.** There is a risk-return trade-off in finance—typical risk-averse investors won't take additional risk unless they expect to be compensated with additional return. Almost all financial decisions involve some sort of risk-return trade-off.

D. **Principle 4: Market Prices Are Generally Right.** In general, financial markets are quick to impound new information into stock prices, and the prices tend to be correct.

E. **Principle 5: Conflicts of Interest Cause Agency Problems.** Self-interested managers will not work for the owners' best interest unless it is in the managers' best interest as well. The corporate agency problem is a result of the separation of ownership from the decision makers of the firm. As a result, managers may make decisions that are not in line with the goal of maximization of shareholder wealth.

F. **The Global Financial Crisis.**

G. **Avoiding Financial Crisis—Back to the Principles.** Many of the financial problems of the past can be traced back to ignoring the basic principles of finance.

H. **The Essential Elements of Ethics and Trust.** Ethical behavior is doing the right thing, and ethical dilemmas are everywhere in finance. Ethical behavior is important in financial management, just as it is important in everything we do. Businesses cannot interact unless they trust each other. Unfortunately, precisely how we define what is and is not ethical behavior is sometimes difficult. Nevertheless, we should not give up the quest.

III. The Role of Finance in Business

A. Three basic types of issues are addressed by the study of finance.

1. What long-term investments should the firm undertake? This area of finance is generally referred to as capital budgeting.

2. How should the firm raise money to fund these investments? The firm's funding choices are generally referred to as capital structure decisions.

3. How can the firm best manage its cash flows as they arise in its day-to-day operations? This area of finance is generally referred to as working capital management.

B. Why Study Finance? Every area of business involves making choices that relate to the management of money over time. A basic knowledge of finance is necessary even for nonfinance majors. An understanding of finance is also important for management of personal finances.

C. The Role of the Financial Manager. Firms have many different organizational structures. Financial officers may fill any of the following roles: vice-president for finance, chief financial officer (CFO), treasurer, or controller.

IV. The Legal Forms of Business Organization

A. Sole Proprietorships

1. **Sole proprietorship:** A business owned by a single individual, which has a minimum amount of legal structure.

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2. The predominant form of business organization in the United States in total numbers is the sole proprietorship.
3. There are several advantages of sole proprietorships.
   a. They are easily established with few complications.
   b. There are minimal organizational costs.
   c. The owner does not have to share profits or control with others.
4. There are some disadvantages of sole proprietorships.
   a. There is unlimited liability for the owner.
   b. The owner must absorb all losses.
   c. Equity capital is limited to the owner's personal investment.
   d. The business terminates immediately upon owner's death.

B. Partnerships

1. **Partnership:** An association of two or more individuals coming together as co-owners to operate a business for profit.
2. Partnerships come in two types.
   a. General partnership: This is a partnership in which all partners are fully liable for the indebtedness incurred by the partnership. The relationship between partners is dictated by the partnership agreement.
      (l) General partnerships have some advantages.
         (a) The organizational requirements are minimal.
         (b) The government regulations are negligible.
      (2) General partnerships have some disadvantages.
         (a) All partners have unlimited liability.
         (b) It can be difficult to raise large amounts of capital.
         (c) The partnership is dissolved by the death or withdrawal of the general partner.
   b. Limited partnership: This is a partnership in which one or more of the partners has limited liability, restricted to the amount of capital he or she invests in the partnership.
      (l) Limited partnerships have some advantages.
         (a) For the limited partners, liability is limited to the amount of capital invested in the company.
         (b) The withdrawal or death of a limited partner does not affect the continuity of the business.

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(c) Limited partners have a stronger incentive to invest, improving the partnership's ability to raise capital.

(2) Limited partnerships have some disadvantages .

(a) At least one general partner must have unlimited liability in the partnership.

(b) The names of the limited partners may not appear in the name of the firm.

(c) The limited partners may not participate in the management of the business.

(d) It is more expensive to organize than a general partnership, as a written agreement is mandatory.

C. Corporations

1. **Corporation:** An "impersonal" legal entity having the power to purchase, sell, and own assets and to incur liabilities while existing separately and apart from its owners.
2. Ownership of a corporation is evidenced by shares of stock.
3. The corporate form of organization has several advantages .
   a. The owners have limited liability.
   b. Transferability of ownership is relatively easy through the sale of one's shares of stock.
   c. The death of an owner does not result in the discontinuance of the firm.
   d. The ability to raise large amounts of capital is increased.
4. The corporate form of organization has some disadvantages.
   a. It is the most difficult and expensive form of business to establish.
   b. Control of the corporation is not guaranteed by partial ownership of stock.
   c. Corporations also suffer from a double taxation of dividends. The firm first pays taxes on the income it earns; after paying taxes on this income, the income is paid to investors in the form of dividends. The investor then pays personal taxes on that dividend income.

D. Organizational Form and Taxes: The Double Taxation on Dividends

E. S-Corporations and Limited Liability Companies (LLC)

1. The S-corporation provides limited liability while allowing the business owners to be taxed as if they were a partnership—that is, distributions back to the owners are not taxed twice as is the case with dividends paid by corporations.
2. The limited liability company (LLC) is a cross between a partnership and a corporation. The LLC retains limited liability for its owners but is run and taxed like a partnership.

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F. Which Organizational Form Should Be Chosen?

V. Finance and the Multinational Firm: The New Role

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ANSWERS TO END-OF-CHAPTER REVIEW QUESTIONS

1-1. There are some practical problems implementing the goal of maximization of shareholder wealth, i.e., maximization of the market value of the firm's common stock. Many things affect stock prices, so identifying which changes in stock price are due to management decisions and which changes are due to external factors such as the state of the economy may be difficult. There may also be uncertainty about the eventual financial pay-off of certain business investments. Managers and investors may have different time horizons and different risk preferences, which can affect their valuation of the firm. In addition, managers may not always act in the best interest of shareholders, a classic case of an agency problem.

1-2. No. The goal of shareholder wealth maximization must be viewed as a long-run goal. As such, the public image of the firm may be of concern inasmuch as it may affect sales and potential legislation. Thus, while these actions may not directly result in increased profits, they may affect consumers' and legislators' attitudes. In addition, charitable contributions are a form of marketing for the firm. If people who hear about the donations buy more products in the future, the expenditure today may lead to increased revenue and profit in the future.

1-3. Almost all financial decisions involve some sort of risk-return trade-off. The more risk the firm is willing to accept, the higher the expected return for the given course of action. For example, in the area of working capital management, the less inventory held, the higher the expected return, but also the greater the risk of running out of inventory. While one manager might accept a given level of risk, another more risk-averse manager may not accept that level of risk. This does not mean that one manager is correct and one is not; rather, it only means that not all managers will view the risk-return trade-off in the same manner.

1-4. The corporate agency problem is a result of the separation of ownership from management, where managers do what is in their own best interests rather than what is in the best interest of the shareholders. Large firms are typically run by professional managers who own a small fraction of the firms' equity. The individual actions of these managers are often motivated by self-interest, which may result in managers not acting in the best interests of the firm's owners. When this happens, the value of the firm will decrease.

1-5. a. **Sole Proprietorship**: The advantages of a sole proprietorship include that a business with its assets is owned by an individual; the proprietor is entitled to the profits of the business; there are no legal requirements that need to be met at the beginning, particularly if the proprietor is conducting the business in their own name; and if a special name is used, an assumed-name certificate should be filed, which requires a small registration fee. The disadvantages are that the owner is responsible for any liabilities incurred, generally without limitation and the proprietor must absorb losses incurred. The termination of the sole proprietorship occurs after the owner's death or by his choice.

b. **Partnership**: The advantages of partnership are that it has more than one owner; it may be a general partnership, where the relationship is dictated entirely by the partnership agreement, or a limited partnership, where partners' liabilities are restricted to the amount of capital invested in the partnership. The disadvantages of a general partnership is that each partner is fully responsible for the liabilities incurred by the partnership and at least one general partner must have unlimited liability. The names of the limited partners may not appear in the name of the firm. Limited partners may not participate in the management of the business. Thus, a limited partnership provides limited liability for a partner who just an investor.

c. **Corporation:** The advantages of a corporation will include that the entity legally functions separately and apart from its owners. It can individually sue and be sued; purchase, sell, or own property; and its personnel are subject to criminal punishment for crimes. A corporation is composed of owners who dictate its direction and policies. In a corporation, ownership is reflected in common stock certificates, each designating the number of shares owned by its holder. The shares are transferable, that is, ownership in a corporation may be changed by a shareholder by simply remitting the shares to a new shareholder. A shareholder's liability is confined to the amount of their investment in the company (preventing creditors from confiscating stockholders' personal assets in settlement of unresolved claims). The life of a corporation is not dependent on the status of the investors.

1-6. One of the main drawbacks of the corporate form is the double taxation of dividends when a corporation pays taxes on profits (the first taxation of earnings), and then pays dividends to its shareholders. Consequently, the shareholders pay personal income taxes on those dividends (the second taxation of those earnings). Under the current law, qualified dividends from domestic corporations and qualified foreign corporations are taxed at a maximum rate of 20 percent.

1-7. a. **Number of owners:** A sole proprietorship is owned by a single individual. A partnership has two or more individuals coming together as co-owners with no limit on the number of owners, while a limited partnership is required to have at least one general partner with no restrictions on the number of limited partners. In case of a corporation and a limited liability company, there are no limits to the number of partners, while the number of owners is restricted to 100 for an S corporation.

b. **Liability for firm's debts:** In a sole proprietorship, the owner is personally liable for all debts incurred. In a partnership, all general partners have unlimited liability, however, under certain conditions a partner's liability may be restricted to the amount of capital invested in the partnership. In case of a corporation, investors' liability is limited to the amount of their investment.

c. **Change in ownership dissolves the firm:** In a sole proprietorship, the termination of the business occurs due to owner's decision to discontinue the business or after their death. A partnership may be terminated as per the wishes of any partner within the organization or upon a partner's death. The life of a

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corporation does not depend on the status of the investors, therefore the death or withdrawal of an investor does not disrupt the life of the corporation.

d. **Taxation:** A sole proprietorship is subject to personal taxes, as is a partnership. A corporation, however, is subject to both corporate and personal taxes.

1-8. This is an Internet question. Answers will vary.

1-9. This is an internet question. Answers will vary.

1-10. This is an Internet question. Answers will vary.

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SOLUTION TO MINI CASE

a. One of the primary goals of any company is to generate value for the firm's owners and shareholders by making right decisions for maximizing the market value of the existing shareholders' common stock. This objective is frequently declared as "maximization of shareholder wealth."

b. The agency theory is essential in this framework. It implies a potential for "managerial mischief" (Dalton et al., 2007: 1) in case the interests of shareholders and managers (agents) are not aligned. While this is not an issue within sole proprietorship because the owner is the manager, agents' equity ownership and a tailored compensation provide a solution to this problem (Fama and Jensen, 1983; and Jensen and Meckling, 1976) for partnerships and corporations.

c. Every business is influenced by three areas of business: finance entitled capital budgeting, capital structure, and working capital management. The essential questions that have to be answered in every business are which long-term investments are adequate, where to get money, and how to manage it. As a consequence, an understanding of finance is important for every businessman. In particular, these topics influence risk management (Froot and Stein, 1998; Singh et al., 2013). However, financial decisions are omnipresent, in both personal and professional life.

d. Yes. An efficient market is a basic principle. An efficient market is one where the prices of the assets traded fully reflect all available information any time. In general, the markets are swift when transforming new information into prices, which tend to be correct (Timmermann and Granger, 2004; Malkiel, 2005; LeRoy, 2015). However, there appear to be an international differences within these processes (Lee et al., 2014).

e. Ethics and trust are essential and complex elements in organizations to that/ increase transparency and perspectives in goals of organizations (Brenkert, 1998; Cohen and Dienhart, 2013; Neill and Syzdek, 2015). Financial scandals show that ethical business practices in financial management impact the sustainability of organizations (Low et al., 2008). Ethical behavior is defined as "doing the right thing." (Stark, 1992). However, there is no clear answer to each dilemma. Especially, the culture and business areas play significant roles in ethical questions (King et al., 2002; Svensson et al., 2004; Martinsons and Ma, 2009; Nobuo, 2015).

f. Generally, financial decisions involve comparing money at different times. Within this framework, the time value of money matters. In addition, the concept of opportunity costs–the highest-valued alternative of a choice–is instrumental (Mulligan, 1997). When focusing on the creation and measurement of value, the concept of the time value of money takes the future benefits (cash flows) and costs of a project into account by discounting to present day value. Accordingly, if the benefits (cash inflows) outweigh the costs, the project creates value and, therefore, is recommended to be accepted (Bagamery, 1991; Ammar, 2010).

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g. Multinational corporations have grown considerably over the last few decades. Recent trends in the evolving patterns of global organizations stress the opportunities available across international borders (Sethi, 2002; Tan, 2009; Michailova and Mustaffa, 2012).

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