Financial Management

INTRODUCTION

One of the most important components of any business operation is financial decision making. Business decisions at all levels have some underlying financial implications, either direct or indirect. Financial concepts also arise in the everyday management of personal resources. It's important, therefore, to understand the basics of finance. For example, the time value of money and the analysis of financial statements are basic components of finance used throughout this course and in future finance classes. It's essential that you take time to master these concepts. As you work your way through this course, you'll learn the importance of finance to the success of every entity, both personal and professional.

In Lesson 1, you'll learn some important fundamentals of finance. The lesson also covers issues related to international corporate finance, including a look at international opportunities, issues associated with managing exchange rates, and political risks associated with doing business in a foreign country. The final assignment in the lesson focuses on mergers and acquisitions and an examination of how companies enter into and deal with financial distress.

OBJECTIVES

When you complete Lesson 1, you'll be able to

- Define financial areas, principles, functions, and business organizations
- Analyze international opportunities, risk, and the foreign currency exchange
- Classify various types of mergers, acquisitions, and financial distresses

ASSIGNMENT 1

Read this assignment. Then read Chapter 1 in your textbook.

The textbook defines *finance* as the study of applying specific value to things we own, services we use, and decisions we make. *Financial management* refers to the practice of valuing things from the standpoint of a company or firm. It's vitally important to a firm's success and, looked at broadly, can also be applied to other financial decision-making processes such as personal finance.

Cash flow is the process used to pay and receive money. To understand the concept of cash flow, it's helpful to consider an economy's participants and their relationship to money. Figure 1.1 in your textbook lists four types of economic participants. Two of the four groups are relevant to our study of financial management:

- Type 2 participants, typically called *individual investors,* are those who have money to invest but no ideas of their own in which to invest.

- Type 3 participants are sometimes people but more typically corporations with research and development (R&D) departments focused on the development of innovative ideas (or investment firms formed for the purpose of investing in companies of this type). They have viable business ideas but no money of their own to fund these ideas.

By studying how these two groups interact, we can more easily understand how money (capital) flows in the form of capital investments.

Financial markets and financial institutions in most developed countries allow Type 2 and Type 3 participants to work together in a mutually beneficial manner. When investors lend excess capital to companies, those companies can deploy the capital to pay for expansion projects, as shown in Figure 1.2 in the textbook. If these projects are successful, the companies will eventually have enough money to return the original investment along with a profit to their investors. See Figure 1.3 in the textbook.

The amount of capital sent to investors generally doesn't equal all of the capital earned by a project. Sources of friction include *retained earnings*—funds a company keeps to pay for ongoing operations—and taxes. Figure 1.4 in the textbook demonstrates the various perspectives involved in the investment of capital. Decisions include

- Determining which investment opportunities fit investors' risk tolerance and return potential criteria
- Determining how best to distribute the capital
- Deciding which projects to fund, what type of capital to use, and how much earnings from the project should be returned to investors

Subareas of Finance

The different methods used and entities involved in financial activity in a particular sector of an economy make up what are called *subareas* of finance. They include the following categories:

- ***Investments.*** This subarea involves the means used to decide what type of securities an investor will buy, the specific firms from which an investor will purchase the securities, and how an investor will be repaid for their investment. The investment process is demonstrated in Figure 1.5 of the textbook.
- ***Financial management.*** This subarea focuses on how a firm makes decisions to acquire and use cash (capital) sourced from investors or retained earnings. The financial management process as it applies to investment decisions is outlined in Figure 1.6.
- ***Financial institutions and markets.*** These entities make it easier for capital to flow between investors and companies. See Figure 1.7 in your textbook.
- ***International finance.*** This subarea of finance deserves a place of its own in the category. Uncertainty relating to future exchange rates, political risk, and changes to business laws globally can add significant complexity to business decisions.

The Financial Function

Cash flows don't occur immediately, nor are they guaranteed. The uncertainty involved in future cash flows, both as to timing and size, is referred to as *risk*. For investors, risk involves uncertainty about the return of invested capital. For companies, risk involves uncertainty about their ability to fund and operate business projects. The majority of financial decisions revolve around a comparison of the potential rewards a decision may bring against the risks generated by that decision. When comparing risk and rewards, it helps to determine the current value of cash flows expected to be received in the future. The price of financial assets, like stocks and bonds, depends to a great extent on the expected future cash flows from those investments.

Financial assets are typically categorized by their risk and return characteristics. Commonly recognized asset classes include stocks, bonds, real estate, money market securities, and derivatives. The measure of current cash flows is called *present value*. Relating expected future cash flows to present cash flows is called the *time value of money (TVM)*. Analyzing TVM involves taking into account both the timing and level of risk associated with any projected cash flows.

The highest ranking financial manager at a company is typically the chief financial officer (CFO). A company's treasurer and controller usually report to the CFO. In addition to the financial duties of the CFO and the managers that report to the CFO, finance plays a significant role in other areas of most organizations. It's used to provide guidance for long- and short-term decisions as well as provide feedback about financial decisions made by the firm.

Finance is also used in making personal financial decisions such as

- Borrowing money to buy a new car
- Refinancing your home mortgage at a lower rate
- Making credit card or student loan payments
- Saving for retirement

Topics such as calculating risk, return, and time value of money will be further covered in other assignments.

Business Organization

There are a number of ways people can choose to structure a business in the United States. Typically, the number of owners is the crucial determinant as to how a business structure is classified. Structure is based on

- Who controls the firm
- Who owns the firm
- What are the owners' risks
- What access to capital exists
- What are the tax ramifications

Forms of Business

The form of a business is significant. For example, there are tax advantages and disadvantages to certain forms of ownership. The majority of businesses are *sole proprietorships*, owned by a single individual. A sole proprietorship is easy to form and has some tax advantages. However, the primary disadvantage of the sole proprietorship is that the owner has unlimited personal liability. Furthermore, the owner's liability isn't limited to his or her investment in the business. Rather, it extends to all personal assets.

A *partnership* has many of the same features as a sole proprietorship, although the business has two or more owners. As with the sole proprietorship, each partner (owner) in a general partnership is legally liable for the business's debts. Thus, the advantages and disadvantages of this form of business are roughly the same as in the sole proprietorship. A *limited partnership* limits the level of liability for some of the partners. This business arrangement grants one or more partners limited liability for the operations of the business; debts can be extended only to their investment. A limited partnership allows some individuals to invest in the business without bearing personal liability for the firm's debts. One or more of the partners still maintain full legal liability and control over the business operations.

A *corporation* is a legal entity established by the state. The corporation is established as an entity and thus can own assets, collect debt obligations, and pay taxes. The most that individual owners can lose or be liable for is the amount that they've invested in the firm. One disadvantage of a corporation is that taxes are due on the corporation's earnings and also on any dividends paid by the corporation to its shareholders as personal taxes.

A *hybrid organization* is one that offers both limited personal liability for the owners and passes through the earnings of the firm, allowing them to avoid the double taxation corporations are subject to. This type of structure includes *S corporations*, *limited liability partnerships (LLPs)*, and *limited liability corporations (LLCs)*. Hybrid status is generally restricted by the U.S. government to firms with a limited number of shareholders or partners in line with the objective of using these forms of organization to encourage small business formation.

Firm Goals

While some contend that social responsibility should be favored over maximizing profitability, most financial industry participants and academics tend to believe that maximizing shareholder wealth should be the primary focus of a company's managers.

To do this, the textbook identifies the following factors a manager should evaluate:

- How best to bring additional funds into the firm
- Which projects to invest in
- How best to return the profits from those projects to the owners over time

Agency Theory

When one party (the *principal*) employs another party (the *agent*) to work for him or her, this is known as an *agency relationship*. The agent is expected to act in the best interests of the principal. The *agency problem* describes situations in which the agent works for his or her own best interests

instead of those of the principal. For instance, consider the case of a corporate executive who purchases a luxury vehicle with company funds, when a more practical car would have saved the firm money. To deal with the agency problem, a company can take a variety of approaches:

- Simply ignore the conflicts if the monetary value or effect is negligible.
- Monitor the behavior of managers. Excessive monitoring is likely to be counterproductive but can be done via the process of accounting auditing.
- Take steps to align the personal interests of managers with the owners of a company by using methods such as stock ownership in the company via means such as employee stock option plans (ESOPs).

Corporate Governance

Corporate governance is taking steps to monitor managers and align their interests with those of shareholders. Since shareholders don't typically focus on the daily operations of a company and its managers, other methods are used. For a public corporation, this includes the board of directors, who are appointed to safeguard the interests of shareholders. Monitoring the firm from outside are auditors, investment banks, analysts, and credit rating agencies. These entities help investors judge whether a corporation's managers are acting in such a manner as to warrant investment in the securities of the firm.

Ethics

Ethics has a major role in finance. Financial professionals and corporate managers working in agency relationships are responsible for making decisions on behalf of investors and shareholders. These are known as *fiduciary relationships,* and any conflict of interest must be resolved in the best interests of the party that the fiduciary agent is working for. Financial institutions (FIs) help others with transactions involving financial assets that take place in financial markets. Figure 1.10 in the textbook shows how they generate profits by taking the role of an intermediary in the markets.

Markets are subject to the risk of financial contagion as well as risk posed by unethical behavior. The financial crisis that peaked in 2008 and early 2009 was an example of how fear can spread globally in investment markets. The crisis—which arose from problems experienced by defaulting subprime mortgage borrowers in 2006 and 2007—resulted in damage to financial institutions, decreased the availability of credit, and damaged investor confidence. The resulting crisis led to the federal government taking action to stimulate the economy in response to the slowdown in economic activity. As a result, by summer and fall 2009 the domestic economy looked to be starting to recover. However, with lenders and consumers appearing to be more cautious in the wake of the crisis, the process of recovery has been longer and slower than in typical recoveries.

Self-Check 1

At the end of each section of *Financial Management*, you'll be asked to pause and check your understanding of what you've just read by completing a "Self-Check" exercise. Answering these questions will help you review what you've studied so far. Please complete *Self-Check 1* now.

Answer the following questions using this study guide and your textbook. Answers will vary in length.

1. What's accomplished by the successful application of financial theories?
2. How do investors and companies experience risk?
3. What are some of the most commonly accepted types of asset classes?
4. At most companies, what does a person in a finance position use historical figures and current information to determine?
5. What's the biggest disadvantage of sole proprietorship relative to other forms of ownership?
6. Why did Adam Smith argue that the actions of individuals pursuing their own interests in an economy tended also to promote the good of the overall community?
7. Why must ethics play a major role in the practice of finance?
8. What's meant by the term corporate governance?
9. What approaches can a firm use to deal with the agency problem as it relates to the firm's managers?
10. What factors led to the financial crisis that peaked in fall 2008?
11. Why is a corporation said to be subject to double taxation?
12. How do hybrid organizations avoid double taxation?
13. What are some situations in which you can use finance to help you make good personal financial decisions?

Check your answers with those on page 221.