

## Topic 1: Overview of Financial Management (Copyright © 2017 Joseph W. Trefzger)

### I. What is Finance?

Defining the field in a functional sense, we might say that Finance involves obtaining and managing money. Our focus in this course is on getting and managing money for business organizations, but financial management concepts are relevant to governmental units, nonprofit organizations, and households, as well as businesses. (My own philosophical definition of the field is that Finance is a way of structuring our thinking about how businesses must operate if all parties that contribute value to an enterprise can expect to get fair value in return.)

Perhaps the most important idea in finance is *risk and return*: choosing low-risk personal or business activities that will lead to low but assured financial returns, vs. choosing high-risk personal or business activities in pursuit of financial returns that will be high if all goes well, but that may not materialize if unfavorable events occur.

Finance is closely related to the fields of *accounting* and *economics*. From accounting we get financial statements and other tools for measuring financial values. From economics we get such philosophical ideas as value maximization (in fact, finance generally is seen as a branch of economics). While there are many important topics in finance (including issues of investing in *assets*), financial analysts spend much of their time dealing, in some way, with the *debt* and *equity* claims that constitute the right-hand side of some company's balance sheet.

A business tends to be defined by doing one (or more) of these three things for its customers: offering convenience, providing technical expertise, and/or owning costly assets for others to make direct or indirect use of. We might think of McDonald's as being primarily a provider of convenience, Geek Squad as primarily a provider of technical expertise, and Weaver's Rent-All as primarily an owner of assets that others pay to use. But the three activities almost always appear in combinations: a medical center needs considerable technical expertise but also expensive buildings and equipment for serving patient needs, and even in providing convenience McDonald's must have land, buildings, griddles, and an inventory of frozen fish and fries. And every firm's assets must be paid for, or financed, with money from money-providing parties.

*One of the key lessons of an introductory finance course is that a company's revenues rise and fall from year to year (e.g., with changes in the economy, changes in competitors' actions, changes in buyers' preferences), but one group that provides the company managers with money to buy assets wants to get pre-determined financial returns (that group is the lenders). And thus there has to be another group that says: just give us what is left (that group is the owners). The lenders' (debt) and owners' (equity) financial claims are those values on the balance sheet's right-hand side.*

### II. Fields of Study Within Finance

Someone employed in the finance arena deals with one or more of the following fields:

A. *Investments*: the proper selection of stocks, bonds, or other investments. They are selected for households or organizations that are able to provide money to businesses or governments.

B. *Financial Intermediaries*: the management of banks, insurance companies, and other firms that earn money by accepting financial risks that households or other businesses do not want to bear.

C. *Real Estate*: dealing with financial aspects of a type of asset characterized by large dollar values, long life, unique fixed locations, and (with respect to mortgage loans) a huge market with standardized instruments.

[*Personal finance* is perhaps best thought of not as a separate field, but rather as a collection of consumer issues in such fields as investments, financial intermediaries, and real estate that might jointly be characterized as *financial services*. In a similar manner, *international finance* deals with the special risks and opportunities that arise when an investment, financial intermediary, real estate, or business finance activity is carried out in more than one country, such that different laws, customs, and currencies are involved.]

D. *Business Finance*: the major focus of this class (and most other introductory finance classes). The focus of business finance is, not surprisingly, the way that businesses obtain and spend money. The main objective is *maximizing the wealth of the company's owners*. Some of the key issues are *capital structure* (how firms get money from lenders and owners), *capital budgeting* (how firms spend money on buildings and equipment), and *working capital* (how firms manage their cash and pay/collect bills in the short run so they can survive to face the long run).

Business finance is also called *financial management*. The field is sometimes further broken down into *corporate finance* and *small business finance*. The broad financial issues affecting businesses tend to apply to firms of all sizes, but some theoretical issues are most applicable to the largest companies, while some practical issues (e.g., federally guaranteed loans) are most applicable to smaller, privately owned firms.

### III. Issues in Financial Management

The primary job of a financial manager is to plan for, acquire, and utilize money for his or her organization. This job has become more important, and more complex and difficult, in an era of globalization and computerization. Issues: high technology provides more information (not all of which is useful or true), but has a fixed cost that has to be spread over a larger base – so companies keep getting larger. Going global helps to increase size, and facilitates moving some activities to lower cost areas.

As noted, the primary goal or objective of financial managers should be to maximize the value of the firm, and thereby maximize the wealth of the firm's current owners. (If the firm is a corporation they maximize the value of the firm, and thus the owners' wealth, by taking steps that will increase the price at which the firm's currently outstanding shares of *common stock* sell in arm's length transactions.) We can not simply say that the financial manager should "earn the highest possible profit." Problems with the latter statement include:

- the risk/return tradeoff (risky activities that lead to high profits when all goes well might leave the firm exposed to high losses when all does not go well – higher profits in a given period might actually correspond to a reduced stock price if professional investment analysts

recommend that people not buy the stock, or sell it if they already have it, because the profits were generated in a way that does not inspire confidence in the company's future);

- the time value of money (high profits that are not expected to be realized until a future period may have little impact on the company's value today);
- because we typically define "profit" as revenue minus expenses, we could increase a given period's measured profit by cutting expenses in such crucial areas as advertising or research & development, thus hurting future the company's future profitability or even viability; and
- if we raised huge amounts of money from new owners, put that money into government bonds, and then added the interest received to the company's other earnings, we would increase *total* profits but would decrease proportional profits (*earnings per share*).

Note that, in a practical sense, we would define profits as one discrete time period's (typically, a year's) measured revenues minus measured expenses. Profits are very important in the analysis, but profits that arise from excessively risky activities, that are not expected to be realized until distant future periods, that are high in the short run to the detriment of the long run, or that are high in total but low on a per-share basis will cause the firm's value (as reflected in the market value of each existing share of common stock), and thereby the owners' combined wealth, to fall. Managers' success in maximizing the firm's value will be reflected in a higher price for each share of the company's stock, because the stock price is based on investors' expectations of the present and future economic benefits accruing to the firm's owners.

In practice, do financial managers strive to maximize stockholders' wealth? The answer is *no* to the extent that their performance is evaluated over the short run, and to the extent that they may engage in empire-building, "coasting," and avoiding risks to protect their jobs. But the answer is *yes* to the extent that if they do not enhance their firms' long-run viability, financial managers lose their jobs through stockholder unrest, or through having their firms taken over by other companies that can buy large amounts of the stock at low prices from unhappy sellers.

A few interesting points to note:

- Value maximization is not a vulgar idea. In a competitive environment, we maximize a firm's value only by using resources in an efficient way. Companies that waste society's resources go out of business (unless a lack of competition allows them to be wasteful and pass their inefficiently incurred costs along to their customers).
- Maximizing owners' wealth is not a heartless, "the world be damned" strategy. No one wants to hold stock in a company that will suffer the costs of labor unrest, environmental lawsuits, or a reputation for poor quality goods or services. Furthermore, actions that might increase revenues or reduce costs for a short time while hurting long-term prospects will be noticed by the professional stock market analysts who follow the fortunes of large firms. Because their buy/sell recommendations are based on long-term profit expectations, actions that harm society generally harm the stock price and, in turn, the current owners' wealth.

(In some cases corporate managers' actions or statements, from "hype" to overconfidence to fraud, seem to drive the stock price higher for a short period only for it to drop later, thereby not ultimately increasing owners' wealth. Your instructor sees this situation as reflecting imperfections in analysts' and investors' ability to obtain and communicate relevant information about how actions affect the firm's long-term prospects, rather than a problem

with the general goal of maximizing owners' wealth, which occurs in a corporate setting through maximizing the market price of existing shares of common stock based on a long-term perspective.)

- Financial managers must be acutely aware of potential *agency problems*. An agency problem arises any time one party performs a task for another, or makes decisions on behalf of another. One agency problem encountered in business involves managers *vs.* owners: the managers want to earn very high salaries and have little accountability, while owners fear overpaying the managers (possible solution: tie managers' pay to performance, especially paying partly with common stock or the right to buy common stock). Another involves owners *vs.* lenders: owners have incentives to put more financial risk on lenders even though lenders do not get to share in the profits (possible solution: put provisions in lending agreements that restrict owners' ability to dump additional risks on the lenders).
- Because owners receive only what is left after every other party is paid in full, a company's owners have no place to "run and hide." We thus might question the logic of those who feel that such "stakeholders" as workers or the public – all of whom get paid in full before the owners receive anything – should have a meaningful say in setting company policy.

#### IV. The Capital Formation Process

How does our economy channel money from those who have savings to those who can put the money to productive use? *Capital market* transactions can occur in a few different ways.

- One possibility is a *direct transfer* from a saver to a business. For example, you could lend a local home repair company \$25,000 to buy a new truck. The borrower would pay, let's say, 10% per year in interest, and you would collect the full 10%. A couple of problems arise with this approach. One is that such a transfer might represent a high percentage of a typical household's net worth (putting "all its eggs in one basket"). Another is that an individual household might not have the ability to analyze the risk of turning money over to such an enterprise (you probably do not fully understand the risks of the home repair business).
- Another possibility is an *indirect transfer* through a financial institution, or intermediary. You put your \$25,000 in a bank, which issues you a certificate of deposit. The bank then lends the same \$25,000 to the same home repair business to buy the same truck. But your agreement is with the bank, not the repair business. So even if the repair business is unable to repay the loan, you will be repaid in full unless the bank fails as a business (and even then you will be repaid, because your bank account is guaranteed by the federal government through FDIC insurance). The bank has advantages over the typical household: a \$25,000 loan would be a small portion of a typical bank's financial resources, and bankers know how to analyze a wide range of business risks. Of course, because the bank relieves you of the risk of nonpayment, you will not collect the full 10% annual interest that the borrower pays. The bank collects 10%, pays you 6% on your deposit, and keeps the other 4% to cover its costs of doing business, including the cost imposed by the risk of not being repaid.
- Instead of a local business wanting to borrow \$25,000 consider a case in which a major company wants to raise \$500 million to upgrade its fleet of trucks nationwide. A bank would not likely want to make a \$500 million loan (too much risk exposure with one borrower, though a large bank might organize a group of banks that would make the loan jointly). A

more typical way for a large company to raise money is to arrange an indirect transfer through an *investment banker*. Investment bankers are “Wall Street” investment firms (example: Merrill Lynch). A company that wants to raise a huge amount of money gets it, ultimately, from lenders (by issuing bonds) or owners (by issuing stock). An investment banker (or group of investment bankers) buys all the bonds or shares of stock, and then resells them to households or institutional investors.

## V. Types of Business Organization

*Ownership* is the *claim on residual values*. In a business setting, the residual is the money that remains after all parties other than the owners (*i.e.*, workers, material suppliers, providers of advice and other services, lenders, government taxing bodies) have been paid in full (either from the company’s periodic revenue stream, or else from liquidation proceeds if the company closes and all the assets are sold). There are three basic forms of business ownership:

A. *Proprietorship*: A business owned by one person.

*Advantages*: There is no separate entity to be taxed before the business income is passed along to the owner and taxed at the household level (*i.e.*, there is no *double taxation*). At the same time, if the business loses money (never a happy event) the loss can reduce the income tax the owner pays as an individual (if she has additional income from other appropriate sources). All management decisions are in a sole owner’s hands, so there is ease of taking action and there should be no *agency problems* (the owner has no conflicts of interest with herself). The owner’s claim is *liquid* (as long as an interested buyer exists), because the owner need obtain no one else’s approval before selling. [An asset is liquid if its owner can sell or otherwise convert it to cash without significant effort, cost, or delay. Liquidity is a benefit that reduces an investor’s required rate of return or, equivalently, increases the value of her investment in the business.]

*Drawbacks*: Size of the business is limited to the amount of “equity” money that can be contributed by that one owner (plus the amount of debt that can be supported by that equity level). Also, the sole owner faces *unlimited liability*: if the business can not pay money it owes, the owner might be required to sell her personal home, car, or other non-business assets to pay those business debts. In addition, while the ownership claim is liquid to the extent that no one can prevent the owner from selling, it is *illiquid* to the extent that there is not an efficient, standardized system in place to facilitate the sale of ownership interests in sole proprietorships.

B. *Partnership*: A business owned by two or more individuals.

*Advantages*: There is no separate entity to be taxed before the business income is passed along to the owners and taxed at the individual level (*i.e.*, there is no *double taxation*). At the same time, if the business loses money (never a happy event) the loss can reduce the income tax the owners pay as individuals (assuming they have additional income from other appropriate sources). Also, the size of the business is not limited to what could be supported by one owner’s equity and borrowing power. (Some partnerships are quite large; major accounting firms traditionally were organized as partnerships, with hundreds of partners around the world.) There can be some ease of decision making if the group of partners is small (each partner may hold certain decision-making powers based on his/her expertise), although there can be conflicts and complications.

*Drawbacks:* Size of the business is still limited to the amount of equity that can be contributed by the (typically small) group of owners (plus the amount of debt that can be supported by that equity level). Also, the owners in a *general partnership* face unlimited liability: if the business can not pay its debts, the owners might be required to sell their personal homes, cars, or other non-business assets to pay those business debts.

In fact, the situation is worsened by potential *agency problems*: if one partner in a general partnership made a poor business decision that resulted in a debt that the business could not pay, the other partners could be forced to sell their personal assets to settle the business's obligations. For that reason, a partner in a general partnership who is unhappy typically must get unanimous approval from the other owners before selling his/her ownership interest (you would not want to become a partner with a stranger whose bad business decisions could cost you your house), so it can be difficult to sell a general partnership interest, and the attendant loss in liquidity reduces the value of an investment in a general partnership.

The *limited* partnership form of organization was created to overcome some of the general partnership's drawbacks. Most of the owners are limited partners, who get the tax benefits of a partnership (no double taxation, business losses can reduce their personal income taxes) while facing only limited liability (they can lose only the money they have invested in the business; they could never be forced to sell their personal belongings to meet the business's obligations – thus the name *limited* partnership). Limited partners do not participate in management decisions (perhaps a drawback in some cases), but as a result their claims typically can be freely sold (so liquidity is enhanced). [A new limited partner will not be making business decisions, and even a new *general* partner's decisions can cost the limited partner only what he/she has directly paid into the business.] There has to be at least one general partner that makes the management decisions and has unlimited liability, but the general partner might be a corporation (whose own stockholders enjoy limited liability) rather than an individual. Other *hybrid* forms of business organization include the limited liability partnership and the professional corporation.

C. *Corporation:* A business viewed under the law as an entity that is financially separate from its owners. The owners are called *stockholders*.

*Advantages:* The business can become very large (to take advantage of economies of scale and/or diversify across lines of activity); there can be hundreds of thousands of owners around the world. Stockholders face limited liability (they can lose only the money they have invested in the business; they could never be forced to sell their personal belongings to meet the business's debts). Shares of stock are highly liquid (to the extent that someone else wants to buy the shares), because an owner need obtain no one else's approval before selling shares of stock and can find buyers efficiently through a stock broker (unless the company is a *closely-held* corporation whose shares can not be purchased through a stock brokerage firm). Thus individuals can easily buy ownership claims in different corporations to hold diversified *portfolios* of investments.

*Drawbacks:* The corporation is a separate entity that must pay its own income tax before it can pay dividends to the stockholders. Then the stockholders must pay income tax on the dividends

they receive; thus there is some degree of *double taxation* of earnings (although 2003 federal tax law changes reduced double taxation's impact somewhat). And if one corporation owns stock in another there is the potential for *triple* taxation, although provisions in the tax laws reduce this impact. At the same time, if the business suffers financial losses there are no accompanying personal income tax benefits to the individual stockholders who collectively own the company.

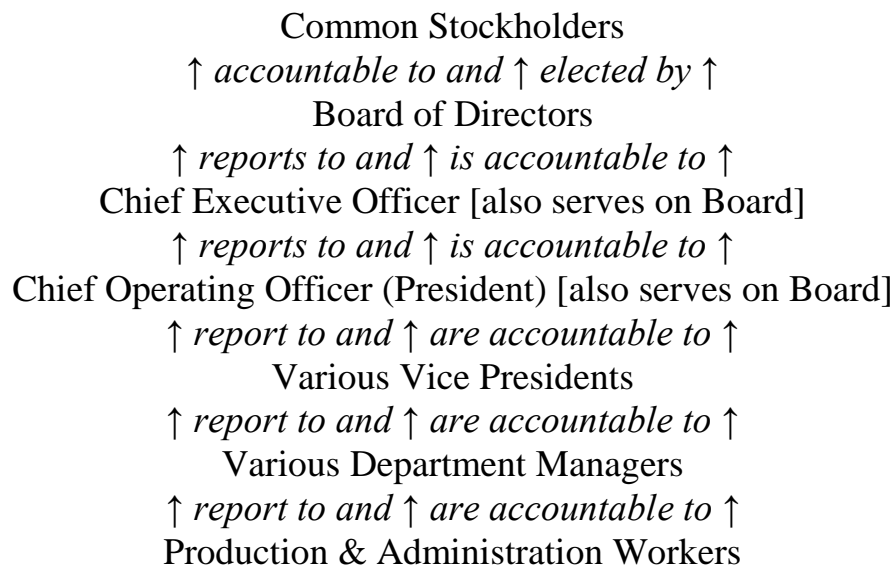
Finally, all management decisions are in the hands of a professional team of operating managers (the president, vice presidents, *etc.*, all of whom are likely to be stockholders as well). While this arrangement allows people to invest in companies without having to know anything about running them, it leads to the potential for the serious conflicts of interest known as *agency problems* (such as when the operating managers decide to increase their own pay without considering the resulting reduction in the owners' financial returns). For this reason, there must be oversight of the operating managers. The stockholders elect a *board of directors* who are paid to set strategic policy for the company, and to hire and oversee the actions and compensation of top operating managers (who, in turn, hire and oversee the company's other employees).

In theory, the stockholders are at the top of the corporate structure. The board of directors is accountable to the stockholders; the president and other operating managers are accountable to the board of directors; and the other employees are accountable to the operating managers. In practice, the top operating managers may have a close relationship with the board of directors (it is typical for the president, and perhaps even some vice presidents, to serve on the board), and the board and the top operating officers could potentially provide themselves with benefits at the stockholders' expense. (Small investors tend to take little interest in management issues. If there is a huge number of stockholders, with each holding only a small amount of stock, the current board members and the top operating managers can end up nominating and selecting new board members when an election is held.)

In recent years, corporations have come under criticism for having too many *inside* directors (with close and friendly ties to the top operating managers) and not enough *outside* directors, while the boards themselves have come under fire for being insufficiently diligent in policing the top operating managers (Enron is one prominent example). The process of how stockholders oversee directors' actions, and directors oversee operating managers' actions, is known as *corporate governance*; this topic has gained renewed interest among investors and market observers in the wake of the stock market debacles of the modern era that included Enron, Adelphia, Global Crossing, WorldCom, and HealthSouth. ✍

## Corporate Governance Chart

How is a corporation governed? In theory, shareholders are at the top of corporate structure. Board of directors is accountable to shareholders; top managers are accountable to board; and other employees are accountable to their managers.



But some observers argue that boards too often are self-perpetuating (elected as “slates” rather than individually in competitive contests), and even today – long after the Enron/WorldCom/Global Crossing scandals – are too cozy with top management, looking out for managers’ well-being rather than stockholders’ interests. One piece of evidence offered is that stockholder votes to restrain executive pay (stockholder advisory votes on executive compensation are required under the 2010 “Dodd-Frank” financial regulatory law) often are ignored by boards of directors.