Chapter 1
The Role of Managerial Finance

■ Instructor's Resources

Overview

This chapter introduces the students to the field of finance and explores career opportunities in both financial services and managerial finance. The three basic legal forms of business organization (sole proprietorship, partnership, and corporation) and their strengths and weaknesses are described. The managerial finance function is defined and differentiated from economics and accounting. A discussion of the financial manager's goals—maximizing shareholder wealth and preserving stakeholder wealth—and the role of ethics in meeting these goals is presented. The chapter then summarizes the three key activities of the financial manager: financial analysis and planning, making investment decisions, and making financing decisions. The chapter includes discussion of the agency problem—the conflict that exists between managers and owners in a large corporation.

This chapter, and all that follow, emphasizes how the chapter content plays a vital role in the student's professional and personal life. Each chapter includes an early discussion of the relevance of the topic to majors in accounting, information systems, management, marketing, and operations. Throughout each chapter are detailed examples of how the chapter's topic relates to the student's financial life. These pedagogic tools should motivate students to grasp quickly an understanding of the chapter content and employ it in both their professional and personal lives.

■ Suggested Answer to *Opener-in-Review* Question

Facebook sold shares to investors at \$38 each in its IPO. One year later, its stock price was hovering around \$26. What was the percentage drop in Facebook shares in its first year as a public company? Just after the IPO, Facebook's CEO, Mark Zuckerberg, owned 443 million shares. What was the total value of his Facebook stock immediately after the IPO and one year later? How much wealth did Zuckerberg personally lose over the year?

Percentage drop in Facebook shares in its first year as a public company

= (\$38 − \$26) / \$38 × 100 = 31.58%

Total value of Mark Zuckerberg's Facebook stock immediately after the IPO

= \$38 × 443 million = \$16,834 million

Total value of Mark Zuckerberg's Facebook stock one year after the IPO

= \$26 × 443 million = \$11,518 million

Total personal loss of Mark Zuckerberg over the year

= \$16,834 million − \$11,518 million

= \$5,316 million

Answers to Review Questions

1. *Finance* is the art and science of managing money. Finance affects all individuals, businesses, and governments in the process of the transfer of money through institutions, markets, and instruments. At the personal level, finance is concerned with an individual's decisions regarding the spending and investing of income. Businesses also have to determine how to raise money from investors, how to invest money in an attempt to earn a profit, and how to reinvest profits in the business or distribute them back to investors.

2. *Financial services* is the area of finance concerned with the design and delivery of advice and financial products to individuals, businesses, and governments. It involves a variety of interesting career opportunities within the areas of banking, personal financial planning, investments, real estate, and insurance. Managerial finance is concerned with the duties of the financial manager working in a business. *Managerial finance* encompasses the functions of budgeting, financial forecasting, credit administration, investment analysis, and funds procurement for a firm. Managerial finance is the management of the firm's funds within the firm. This field offers many career opportunities, including financial analyst, capital budgeting analyst, and cash manager. (*Note:* Other answers are possible.)

3. Sole proprietorships are the most common form of business organization, while corporations are responsible for the majority of business revenues. The majority of sole proprietorships operate in the wholesale, retail, service, and construction industries. Although corporations engage in all types of businesses, manufacturing firms account for the largest portion of corporate business receipts and net profits.

4. Stockholders are the owners of a corporation, whose ownership, or equity, takes the form of common stock or, less frequently, preferred stock. They elect the board of directors, which has the ultimate authority to guide corporate affairs and set general policy. The board is usually composed of key corporate personnel and outside directors. The president or chief executive officer (CEO) reports to the board. He or she is responsible for day-to-day operations and carrying out the policies established by the board. The owners of the corporation do not have a direct relationship with management but give their input through the election of board members and voting on major charter issues. The owners of the firm are compensated through the receipt of dividends paid by the firm or by realizing capital gains through increases in the price of their common stock shares.

5. The most popular form of limited liability organizations other than corporations are:
   - Limited partnerships—A partnership with at least one general partner with unlimited liability and one or more limited partners who have limited liability. In return for the limited liability, the limited partners are prohibited from active management of the partnership.
   - S corporation—If certain requirements are met, the S corporation can be taxed as a partnership but receive most of the benefits of the corporate form of organization.
   - Limited liability company (LLC)—This form of organization is like an S corporation in that it is taxed as a partnership but primarily functions like a corporation. The LLC differs from the S corporation in that it is allowed to own other corporations and be owned by other corporations, partnerships, and non-U.S. residents.
   - Limited liability partnership (LLP)—A partnership form authorized by many states that gives the partners limited liability from the acts of other partners, but not from personal individual acts of malpractice. The LLP is taxed as a partnership. This form is most frequently used by legal and accounting professionals.

   These firms generally do not have large numbers of owners. Most typically they have fewer than 100 owners.

6. Virtually every function within a firm is in some way connected with the receipt or disbursement of cash. The cash relationship may be associated with the generation of sales through the marketing department, the incurring of raw material costs through purchasing, or the earnings of production workers. Because finance deals primarily with management of cash for operation of the firm, every person within the firm needs to be knowledgeable of finance to work effectively with employees of the financial departments.

   Individuals plan, monitor, and assess the financial aspects of their activities over a given period through the consideration of cash inflows and outflows.

7. The *goal of a firm*, and therefore of all managers, is to maximize shareholder wealth. This goal is measured by share price; an increasing price per share of common stock relative to the stock market as a whole indicates achievement of this goal.

8. Profit maximization is not consistent with wealth maximization due to: (1) the timing, (2) earnings that do not represent cash flows available to stockholders, and (3) a failure to consider risk.

9. *Risk* is the chance that actual outcomes may differ from expected outcomes. Financial managers must consider both risk and return because of their inverse effect on the share price of the firm. Increased risk may decrease the share price, while increased return is likely to increase the share price.

10. In recent years, the magnitude and severity of "white collar crime" has increased dramatically, with a corresponding emphasis on prosecution by government authorities. As a result, the actions of all corporations and their executives have been subjected to closer scrutiny. The increased scrutiny of this type of crime has resulted in many firms establishing corporate ethics guidelines and policies to cover employee actions in dealing with all corporate constituents. The adoption of high ethical standards by a corporation strengthens its competitive position by reducing the potential for litigation, maintaining a positive corporate image, and building shareholder confidence. The result is enhancement of long-term value and a positive effect on share price.

11. The treasurer or the chief financial manager typically manages a firm's cash, investing surplus funds when available and securing outside financing when needed. The treasurer also oversees a firm's pension plans and manages critical risks related to movements in foreign currency values, interest rates, and commodity prices. The treasurer in a mature firm must make decisions with respect to handling financial planning, acquisition of fixed assets, obtaining funds to finance fixed assets, managing working capital needs, managing the pension fund, managing foreign exchange, and distribution of corporate earnings to owners.

12. Finance is often considered a form of applied economics. Firms operate within the economy and must be aware of the economic principles, changes in economic activity, and economic policy. Principles developed in economic theory are applied to specific areas in finance. The primary economic principle used in managerial finance is *marginal cost–benefit analysis*, the principle that financial decisions should be made and actions taken only when the added benefits exceed the added costs. Nearly, all financial decisions ultimately come down to an assessment of their marginal benefits and marginal costs.

13. Accountants operate on an accrual basis, recognizing revenues at the point of sale and expenses when incurred. The financial manager focuses on the actual inflows and outflows of cash, recognizing revenues when actually received and expenses when actually paid.

    Accountants primarily collect and present financial data; financial managers devote attention primarily to decision making through analysis of financial data.