Chapter 1

Introduction and Overview

1.1 The Mysterious World of Finance
1.2 Finance as a Field of Study
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1.5 The Relationship Between Accounting and Finance
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After studying Chapter 1, you should be able to:

- Understand why sound financial management is vital to the survival of a business.
- Identify the three main subject areas in the field of finance.
- Describe different forms of business organization.
- Explain why the goal of a financial manager should be to maximize the wealth of the firm’s shareholders and why this particular goal is preferred over other goals.
- Describe the basic difference between Financial Management and Accounting.
- Understand the importance of cash and the basic relationship between cash flow and value.
1.1 The Mysterious World of Finance

Most successful business enterprises have the following in common: a product (or service) that people want or need, an efficient method of production and/or delivery, effective marketing, quality managers, a trained work force, and a vision and strategy for future growth. The managers of successful firms also usually possess a thorough understanding of the principles of financial management. In fact, the managers of most of the best corporations in the U.S. devote at least as much time to the finances of their firms as they do to operations. This is probably why so many current top managers and CEOs majored in finance in college or graduate school and/or were promoted out of their (or some other) company’s finance department. They know that whereas even the most excellent financial management cannot save a firm with a bad product, poor financial management can cause a firm that efficiently produces, markets and delivers a high demand product to fail. The following story illustrates the importance of financial management to a firm.

When at 7 years of age, Bennie Feldhaus completely disassembled and then rebuilt his father’s riding lawnmower, doubling the mowers top speed and power while reducing its gas consumption by 30 percent, his parents knew that Bennie was destined to be something special. By 10, Bennie had rebuilt the engines in both the family automobiles, achieving similar results. By 14, Bennie had memorized the engine specifications of every car made in the U.S. over the past 5 years. By 16, he knew the specifications of all foreign made automobiles as well.

Bennie, however, disliked school. To him school was boring and a waste of time. He wanted to be working on automobiles. So, after he finally graduated from high school at age 20, Bennie started working in his uncle’s auto garage. Bennie, who was personable and funny as well as talented, soon gained a reputation as a master auto mechanic. Mechanics from all over the city would call Bennie regularly for advice.

After 10 years of working for his uncle, Bennie decided that there had to be a better way to profit from his talent. Accordingly, at age 30, Bennie took all of the money that he had and started an auto parts store. His plan was simple. He would use his reputation and experience among the mechanics in the city to build a solid customer base and he would use his personality and knowledge to provide better instruction and service than any other auto parts store around.
Bennie’s Auto Parts and Service Center was an immediate success. Within a year Bennie was making more money than he ever thought possible. He worked 12 hours per day, 7 days per week and even at that rate could not keep up with the demand for his products and services.

Unfortunately, Bennie had one, what he considered to be minor, problem. He didn’t understand the principles of corporate finance. Approximately forty percent of Bennie’s customers paid with checks. When he received a check from a customer, Bennie would stuff it into a drawer in the counter. Because he was so busy, often he would not deposit the checks for weeks. Another thirty percent of Bennie’s customers paid with credit cards. Bennie never verified the credit cards and in any given month approximately ten percent of these purchases would be returned by the credit card company unpaid. The rest of Bennie’s customers requested that Bennie bill them for their purchases. Again, because he was so busy, often Bennie did not accurately record the credit purchases. Accordingly, any time a customer complained about his bill, Bennie would adjust or wipe out the debt. If a customer did not pay after Bennie sent out a second notice, Bennie would stop sending bills. Collections took too much time and besides, he reasoned, his sales growth would easily make up for a few uncollected accounts.

Bennie did not have an inventory system. He ordered parts whenever it seemed like he needed them and when they arrived he put them on whatever shelves were mostly empty. Often times he would order a part for a customer only to find out later that the needed part was sitting on a shelf in another part of his storeroom. Cataloging inventory took too much time and besides, he reasoned, with the rate his sales were growing, having a few extra parts laying around couldn’t be all that detrimental to his firm’s health.

Finally, Bennie never paid much attention to the bills he received from his suppliers. He was too busy selling products and making money. He would send payments only after he began to receive threatening letters or phone calls. However, because he was so busy he never bothered to balance his checkbook and consequently often times the checks he sent bounced. In one particularly bad month, his bounced check fees to the bank exceeded $1,500.

Halfway into his second year of operations, Bennie’s suppliers began to demand immediate payment for all outstanding bills and refused to ship new parts without first receiving payment in cash or cashiers check. As Bennie began to have trouble getting
parts, he started to lose customers. Soon his cashflow dried up and Bennie was forced to go to the bank to seek a loan to consolidate all of his outstanding debt.

Not surprisingly, all that he received from his bank was a cold shoulder. Bennie had a long history of bounced checks, he did not have any type of financial statements to show to the banker, and he did not have any definite plan for how he was going to repay the loan. Without the loan, Bennie was forced to declare bankruptcy. To make matters worse, one year later he was indicted by the federal government for tax fraud. Because he was too busy to bother with minor details like financial records, Bennie never bothered to send any money to the IRS. Today, Bennie is in jail making license plates pondering, in his spare time, the mysterious world of finance.

A thorough reading of this book will not necessarily qualify you to be a successful financial manager. It will, however, help you to understand the repercussions of Bennie’s actions (or lack thereof) and perhaps allow you to keep from making the same mistakes that Bennie made if you decide to start a business of your own. Who knows - had Bennie read this book before starting Bennie’s Auto Parts and Service Center, he may be spending his spare time playing golf instead of making license plates!

1.2 Finance as a Field of Study

The (actually non-mysterious) field of finance is divided into three separate, though inter-related, subject areas: corporate financial management, investments, and financial markets and institutions. Financial markets and institutions studies the determinants of interest rates, the regulation of financial institutions (banks, savings and loans, insurance companies, pension funds, and so on), the structure and functioning of the various financial markets, such as the stock and bond markets, and the various financial assets (and the secondary markets for the assets) issued by financial institutions (such as mortgages, auto loans, collateralized mortgage obligations, and certificates of deposit).

Investments focuses on how individuals and financial institutions make decisions concerning the allocation of securities within their investment portfolios. The major securities studied in Investments are stocks, bonds, options, and futures contracts. A central theme of this subject area is the determination and management of risk.

Corporate Financial Management, also often referred to as business or corporation finance, involves the actual financial management of a business enterprise. This is the
broadest subject area of finance. It includes topics such as financial reporting and financial analysis, cash flow analysis, financial forecasting, the management of inventory and accounts receivable, current liability management, security valuation, the measurement and analysis of risk, capital budgeting under certainty and uncertainty, dividend policy, capital structure, bankruptcy, mergers and acquisitions, and international financial management. Also, because financial managers must deal with investors and financial institutions when they need to raise outside funds, any study of corporation finance must include at least a survey of the other two subject areas. To see why this is so, consider the following.

In the most basic sense, finance is concerned with the process through which funds are transferred from savers to borrowers. Savers, or surplus units, are those households, businesses, and governments whose income exceeds their consumption. Borrowers, or deficit units, are those households, businesses, and governments whose consumption exceeds their income. Although any household, business, or government may be either a surplus or a deficit unit, in the economy as a whole, most deficit units are businesses and most surplus units are households (in this context, surplus units are commonly referred to as investors).

The transfer of funds from surplus units (investors) to deficit units (businesses) takes place in a financial market or through a financial institution:

Businesses (deficit units) borrow money to purchase physical assets such as machinery, raw materials, real estate, plant and equipment. This money is obtained either directly from surplus units through a financial market (such as the stock or bond market) or
indirectly through a financial institution. In exchange for the funds they receive, these
deficit units issue claims (called financial assets) against the cash flows that the physical
assets they purchase are expected to generate. For example, a firm, which borrows
$1,000,000 to purchase a plant, gives to the provider(s) of the $1,000,000, financial assets
which promise the owner(s) of these financial assets a part of the actual annual cash flow
that the plant produces.

Investors lend money, that is, purchase financial assets, to earn an expected
return. This return is a function of the annual cash flow that the physical asset purchased
with the investor’s funds is expected to generate. As long as the actual cash flow equals
or exceeds the expected cash flow, investors are content. If, however, the actual cash flow
is less than the expected cash flow, the investor loses. In the extreme, the actual cash flow
can even be negative implying that the investor can lose part or all of his/her initial
investment.

The fact that actual cash flows can, and most often always do, deviate from
expected cash flows is what causes financial assets to be risky. Identifying, managing and
valuing risky cash flows is the essence of finance. These are the central themes that
integrate the three subject areas of finance. Financial markets and institutions, which
encompasses the mechanisms that allow businesses to issue and investors to purchase
financial assets, primarily concerns the risks that different trading systems add to, or
subtract from, financial assets. Investments primarily concerns the manner in which
investors evaluate financial asset risk and determine expected cash flows and use this
information to determine financial asset values. Finally, financial management primarily
concerns the process whereby business managers apply the same risk measurement and
valuation principals used by investors to determine and manage physical asset risk as
well as to raise the funds necessary to grow their businesses.

The primary purpose of this book is to present an overview of the Corporate
Financial Management subject area. In it we outline the basic principles of corporate
financial management. All of the topics under the heading of corporate financial
management are not covered in this text. However, after reading and working through
this book you should possess an appreciation and knowledge of the role and duties of a
financial manager. And, should you decide to take additional courses in finance, you will
possess a solid foundation upon which you can build future knowledge.
1.3 Forms of Business Organizations

All businesses must be organized in some legal manner. In the United States, there are three main forms of business organizations: sole proprietorships, partnerships and corporations. Although other types of business organizations (specifically, limited partnerships, limited liability partnerships and professional corporations) are growing in popularity, the three main types listed above dominate the business world.

A sole proprietorship is a business that is 100 percent owned by a single individual. In most sole proprietorships, this owner is also the operator or chief manager of the business. A sole proprietorship is simple and inexpensive to establish. In most states, one merely obtains a business license and begins operations. Sole proprietorships require no formal charter and are subject to fewer government regulations, and usually a lower tax liability, than corporations.

There are two drawbacks to the sole proprietorship business organization. First, it is very difficult for such companies to raise large amounts of capital. The main sources of capital for sole proprietorships are the owner, friends and family and commercial banks. The first source is limited to the personal wealth of the owner, and even in the case of a wealthy owner, he/she may not wish to invest a significant amount of wealth in a single entity. The second source usually involves difficult personal relationships and identifying an appropriate return to friends and family in the event of success is often tricky. Borrowing from a commercial bank usually requires much red tape, can involve potential intervention in the management of the business and, most significantly, is limited to the amount of money invested in the business by the first two sources. A bank generally will not contribute any more to a business than the owner of the business is willing to contribute. Simply put, if the owner of the business does not believe enough in the potential success of the business to invest most if not all of his/her personal wealth, why should a bank invest in the business?

A second drawback to the sole proprietorship business organization is that the owner of a sole proprietorship has unlimited personal liability to the debt of the business. If the business fails, the creditors of the business are not only entitled to all of the assets of the business, they can also take the personal assets of the owner (until the full value of all of their claims are satisfied) as well. Due to this unlimited liability feature, the business bankruptcy of most sole proprietorships usually results in personal bankruptcy for the owner.
Another form of business organization is a partnership. A partnership is essentially the same as a sole proprietorship except that the business is owned and operated by two or more individuals. These individuals must agree on who will provide the initial start-up capital, who does what work, and how the profits (or losses) of the business will be shared.

Partnerships have basically the same benefits and drawbacks as sole proprietorships, though some differences exist. Multiple partners may be able to contribute more capital to the business than a single owner. On the other hand, unlimited personal liability applies to all owners, regardless of the percent of ownership. Thus, if a business of two partners goes bankrupt and one of the partners with little personal wealth also goes bankrupt, the other owner who may have substantial wealth is responsible for all of the remaining debts of the business. Finally, transfer of ownership of a partnership is often difficult. If one of the owners of the business dies or decides to leave the business, the other owner(s) must buy out the departed owner (or survivors). If the remaining owner does not have sufficient personal wealth to do this, the business usually folds.

In terms of numbers, over 85 percent of all businesses in the U.S. are organized as sole proprietorships or partnerships. In terms of revenue, however, over 80 percent of all business in the country is conducted by corporations. A corporation is a legal entity, separate and apart from its owners or managers. Though much more complex and costly to establish, the corporate form of business organization offers three distinct advantages over the other forms of organization:

1. **Limited Liability.** As a separate legal entity, a corporation bears the entire burden of all debt in the event of bankruptcy. That is, the owners (or shareholders) of a corporation cannot ever lose any more than the amount they invested in the company. If a shareholder purchases 1,000 shares of stock in a corporation at $100 per share and that corporation later goes bankrupt, the shareholder will only lose the $100,000 that was originally invested. If in the bankruptcy the creditors are due $10,000,000 and the total value of all liquidated assets of the firm are only worth $6,000,000, then all assets will be liquidated and the creditors will only get $6,000,000. The owners (i.e., shareholders) of the firm are not in any way liable for the additional $4,000,000 in claims.
2. **Ability to Raise Capital.** Due to the limited liability feature, corporations are able to attract more investors than unincorporated businesses. In fact, the stock of many corporations is public, meaning the company’s stock trades in an organized stock market, such as the New York Stock Exchange. Company’s whose stock trades publicly have access to almost unlimited capital (of course, the company must provide an attractive potential return to obtain this capital). Also, corporations with large amounts of equity capital are able to attract large amounts of debt capital. As noted above, banks, and other creditors, view owner equity as a sign of faith in the future prospects of the company.

3. **Easy Transfer Of Ownership.** The ownership of a corporation is represented by shares of stock. If an owner of a corporation decides to liquidate his/her interest in the corporation all that is necessary is to sell his/her shares of stock. If the company is a public company (i.e., shares trade on an organized exchange), this merely involves a call to a broker or a click of the mouse.

The principles of financial management described in this book directly apply to a publicly traded corporation. Sole proprietorships and partnerships have specific management and operational issues that are unique to those organizations. Nonetheless, the basic goal of financial management and the importance and valuation of cash flow expressed throughout the book apply to all forms of organization.

**1.4 The Goal of Corporate Financial Management**

The goal of any corporation must be to create value for its stockholders. Stockholders are the owners of the corporation and their basic reason for investing in the company in the first place is to make money. The managers of any corporation are merely the employees of the owners of the firm, the shareholders. As such, managers are sometimes referred to as “agents.” Agents are hired by owners to run the company to create as much value for the owners as possible. If the agents do not perform their duties to the satisfaction of the owners, they can be fired or replaced.

To a stockholder, value is represented by the price of the company’s common stock. Note that at any given time, the price per share times the total number of shares outstanding is simply equal to the total value of the equity of the company. This total value is owned by all shareholders in the company according to their percentage ownership (that is, the number of shares they own divided by the total number of shares
outstanding). If the price per share increases, the value of each stockholders stake in the company (i.e., their personal wealth) increases. Thus, all else constant, the goal of a financial manager must be to maximize the price per share of the company’s stock.

It is important to note that maximizing the price per share of the company’s stock is not necessarily equivalent to maximizing the firm’s profit. If you were the owner of a firm, would you rather your firm report profit for the year of $150,000 but have generated no cash or would you rather have $150,000 in cash and report zero net income? As will be shown in the next couple of chapters, such situations are entirely possible. Likewise, would you rather your firm generate $150,000 in net cash flow this year and $0 thereafter, or generate $30,000 in net cash flow per year for the next 5 years? As will be shown in the next section of the book, the former earnings stream will usually be preferred to the latter. Although there are several factors that determine the value of a firm’s common stock, chief among these factors is cash flow (both for the coming year as well as in future years). The proper management and valuation of cash flow is the main theme of this book.

1.5 The Relationship between Accounting and Finance

Because much of finance involves the analysis and management of a firm’s income statement and balance sheet, it is common to ask: “What is the difference between finance and accounting?” The most direct answer to this question is that whereas accounting is backward looking (literally, to some of us), finance is forward looking. Accounting statements present an historical account of the money earned, raised, and spent by a firm from its inception through the current period. It focuses on the book value of the firm’s assets. Conversely, finance is the study of all of the future cash that the firm’s current and prospective collection of assets can potentially earn. It focuses on the market value of the firm. In essence, though related, the two subjects can be said to be diametrically opposed. The following story illustrates the relationship between book (accounting) value and market (finance) value.

Joe Vitale is a third year business major at Urban University - a 25,000 student campus located in the downtown area of a large metropolitan city. “Urb-U” is not a traditional campus. Instead, it is actually a disjoint collection of university classroom buildings, labs, offices, dormitories, and other buildings that are interspersed throughout the downtown area.
As fate would have it, the two sets of buildings with the greatest distance between them (approximately 3 miles) are the dormitories and the general classroom buildings. To further complicate matters for students, whereas parking near the dormitories is adequate, parking near the classroom buildings is essentially non-existent. The university refuses to provide a free shuttle service for monetary reasons and is not allowed to run a for-profit service for political reasons. Students are encouraged to walk, bike, or use the public transit system. Most consider the first method to require excessive time and unacceptable effort and the second to be hazardous to life and limb. The city transit system is expensive, slow, overcrowded, and seldom on schedule.

Joe, a budding entrepreneur, realizes that this situation has the potential to earn someone a sizeable amount of money. Following several conversations with his finance professor/consultant, Joe has decided to start a shuttle service between the dorms and the classroom buildings. He plans to use money that his grandfather gave him for MBA school to buy a transport van. The van costs $30,000, has a four year life, and will be depreciated on a straight-line basis to a zero salvage value. Joe and his consultant estimate that the business is capable of producing the following cash flow series:

<table>
<thead>
<tr>
<th>Year</th>
<th>Estimated Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$20,000</td>
</tr>
<tr>
<td>2</td>
<td>$15,000</td>
</tr>
<tr>
<td>3</td>
<td>$15,000</td>
</tr>
<tr>
<td>4</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

These cash flows are the revenue that Joe expects to collect minus the payment of all expenses (gas, insurance, vehicle maintenance, advertising, wages to drivers, applicable taxes, consultant fees, etc.), as well as a salary to himself as the manager of the operation. These are residual cash flows - those left over after all expenses have been paid. They belong to the provider(s) of capital. In this example, the cash flow series above represents Joe's expected return for providing the $30,000 to buy the necessary asset(s) to start/run the business (i.e., Joe's expected return as the owner of the business).

Assuming that Joe starts his business today and that his only asset is the transport van, what is the book value of his firm? The answer is, of course, $30,000. That is, the original purchase price of the van.
What will the book value of the firm be after one year? Note that annual depreciation of the van is:

\[
\text{(Purchase Price} - \text{Salvage Value}) / \text{Useful Life} = ($30,000-0)/4 = $7,500 \text{ per year for 4 years.}
\]

Thus, the book value of the van (and therefore, of Joe’s firm) after one year is:

\[
\text{Purchase Price} - \text{One year of depreciation} = $30,000 - $7,500 = $22,500.
\]

What will the book value of the firm be after (a) two years? (b) three years? (c) four years?

The answers are: (a) $15,000 (b) $7,500 (c) $0.

Now for a more difficult question. Assuming that Joe starts his business today, what is the market value of his firm? The answer to this question has little to do with the cost or book value of the firm. Instead, the answer depends on the cash flows that Joe’s firm is expected to generate. Specifically, it depends on what someone else would be willing to pay today in exchange for these expected cash flows.

Assume that Joe has a very rich uncle to whom Joe has explained the business opportunity and the cash flow series shown in the table above. Joe’s uncle believes that Joe’s assumptions and estimates are fair, reasonable and accurate. In fact, the uncle is willing to give Joe $34,000 today if Joe will agree to sign over to him all of the net cash that the business actually generates for each of the next four years. That is, if Joe agrees to sell ownership of the business to his uncle. If the business generates less cash than expected, Joe’s uncle loses. If, however, it generates more than expected, Joe’s uncle gets the expected cash plus the extra cash.

Why would Joe’s uncle propose such a deal? Is it solely because he is related to Joe? Actually, Joe’s uncle is quite shrewd. He is merely investing his money in Joe’s firm. He has many alternative investments from which to choose. Instead of investing in Joe’s firm, he could deposit the $34,000 into a savings account, buy a CD (certificate of deposit), buy government or corporate bonds, buy publicly traded stock, or invest in some other type of asset. Joe’s uncle chooses Joe’s firm because he considers it to represent the best expected return available given the risks involved (specifically, the risk that the actual cash flow will be significantly less than the expected cash flow).
Do such transactions actually occur? In fact, they occur all the time. Other than risk, this transaction is not unlike a car loan. The bank gives me $34,000 to buy a car in exchange for my promise to pay $717.41 per month for the next 48 months. That is, an amount today in exchange for a future expected cash flow series. A similar comparison can be made with a house loan, credit card line of credit, stock purchase, and so on.

Obviously, my loan payments to the bank are probably more certain than Joe’s cash payments to his uncle. That is why the expected return on the bank loan is substantially less than the expected return on the investment in Joe’s firm. Whereas (as will be shown later in this book) the expected cash flow stream on the bank loan represents a 7.5 percent annual return, the expected cash flow from Joe’s firm represents a 31.15 percent annual return!

Returning to our earlier question, what is the market value of Joe’s firm? The answer is $34,000 because that is what an investor is willing to give Joe today in exchange for all of the future cash the firm is expected to generate. (If Joe can find another investor who will give him $35,000, then the market value of his firm would be $35,000). Note the difference between market value and book value. Whereas the book value of Joe’s firm is $30,000, the market value of his firm is $34,000. Whereas book value is what was actually paid for the asset(s), market value is what the asset(s) is (are) worth in ability to produce expected cash flow within the context of a firm.

Recall that the goal of a financial manager is to create value for the firms’ shareholders. The most direct way to achieve this goal is to find, purchase, and/or manage assets so that their market value exceeds their book value. That is, assets that are worth more than they cost. In the example above, when Joe sold ownership of the firm to his uncle, he created $4,000 of wealth for himself. If Joe is able to more efficiently manage his firm such that the expected cash flow for each of the next four years is greater than listed in the table above with no additional risk added, Joe can create even more wealth for himself (or for his uncle if he sells to his uncle).

One final question concerning the relationship between finance and accounting: given the fundamental difference between the two subjects, why does much of finance involve the analysis of a firm’s income statement and balance sheet? Financial managers, outside analysts, creditors and stockholders analyze accounting data to identify trends concerning, in particular, cash flow. Accounting statements, as shown in the following two chapters, do not specifically list cash flow. However, taken together, income
statements and balance sheets provide valuable information concerning the flow of cash during a given accounting period. And, although these are historical values, to the degree that historical trends and relationships will continue into the future, they can be important indicators of future potential cash flow - and thus useful in the determination and management of market value. Thus, just as a potential employer will use your school records (i.e., grade point average, major, extracurricular activities) as indicators of the type of employee you may be for his/her firm, financial analysts use accounting data as indicators of the potential of a given business enterprise.

1.6 Value and the Importance of Cash

Count the number of times that the terms “cash” and “value” have been used to this point in the book. The answers are cash (47 times) and value (33 times). Obviously, there is an important connection between these two terms. Consider the following.

Suppose that the shares of ABC Co. trade on the New York Stock Exchange (NYSE). At nine o’clock in the morning, the price of ABC’s stock is $30 per share. Soon after you observe this price, the management of ABC makes the following announcement: “The company’s R&D division has discovered that with a slight modification in its manufacturing process, ABC will be able to generate significant reductions in manufacturing costs.” Assume that the cost of modifying the manufacturing process is negligible and that it will take very little time to incorporate the modification into the manufacturing process. In other words, the cost savings will begin to be realized almost immediately. Also suppose that the announcement made by the firm is truthful and completely believable. What do you think will happen to the price of ABC’s shares? Will the share price increase, decrease, or remain unchanged?

The answer to this question is obvious - the share price will rise. If your answer was that the share price would increase, you already know the most important concept in finance. Let us spend a few minutes on the obvious reason for why the share price will rise. In order to do this, let us begin by answering the following seemingly simple question. (You must circle the one answer that you think is most correct).

**Why does a typical investor buy stock in a firm such as ABC?**

A. The CEO of ABC is the investor’s favorite uncle.
B. The investor loves the company’s name ABC.
C. ABC manufactures products that have great social value.
D. The investor believes that ABC’s share price will increase substantially in the future.

Which answer did you choose? Our guess is that you circled D and, if so, your choice was the most correct. Note that answers A, B, and C are not wrong. It is possible that some investors buy shares for one or more of these reasons. However, we are interested in the reason for the typical investor and, clearly, the most probable reason why an investor buys shares is to make money. Therefore, answer D is the most correct answer. This is one of the most fundamental rules in finance and it is also a very simple rule. Buying shares is just one form of investment and, in fact, this rule applies to all investments. **People make investments in order to make money.**

Let us now go to the next question. Again, you must circle the most correct answer.

**What determines the current price (that is, the price today) of a firm’s share of common stock?**

A. The growth rate of the company’s sales.
B. The quality of the firm’s products.
C. How much money the shareholder will make from owning the firm’s share.

Which answer did you circle? You will notice that, unlike the first question, the answer is not immediately obvious. All three choices appear to be important factors in determining the current share price. Which one, however, is the most important?

Let us consider the choices one by one. Suppose that the sales of a firm increase by leaps and bounds. Although high sales and high sales growth are generally favorable signs, the profits that these sales generate depend upon the firm’s costs - high sales result in high profits only if costs are less than revenues. It is possible that a firm may be better off by reducing sales of products whose production costs are greater than the price that they fetch. Therefore, the volume of sales and/or sales growth is not the most important determinant of the share price.

How about the quality of the firm’s products? Again, it depends upon the cost of achieving quality. If the marginal (i.e., additional) cost of producing a high quality (as opposed to say an average quality) product exceeds the marginal revenue from the
product, then the firm is better off making only average quality products. Thus, product quality alone cannot be the most important determinant of the share price.

That leaves us with the third choice, what the share price will be in the future. Aside from the fact that it is the only alternative left, there is another reason why this is the most appropriate answer. Recall that the main reason an investor buys a share is to make money. The money that an investor will make depends upon what the future share price will be - if the price in the future is high, the investor will make more money. We have just argued that increases in sales or product quality do not necessarily translate into more money for the shareholder. Therefore, the most important determinant of the current price of a share is how much money the investor can make from owning that share. This leads us to the next rule.

**The price of an investment depends upon how much money that investment will generate.**

These two simple rules justify your answer to the original question that the price of ABC’s shares will rise as result of the cost-reducing modification to the manufacturing process. Because the modification reduces costs, the profits of the firm will be higher. These higher profits will ultimately result in more money for the shareholders (for example, in the form of higher dividends). Finally, because the price of the share depends upon how much money the shareholders will make, the fact that they expect to make more money will result in an increase in the price that they would be willing to pay for the share and, consequently, the share price will go up.

This brings us to the fundamental concept (mentioned earlier) in finance:

**The value of an investment is determined by the future cash flows that the investment generates for the investor.**

The concept above may, at first, appear to be a simple restatement of what we had been discussing before. However, some important words have been changed and added. These are underlined. First, the word price was replaced with value. Second, the fact that it is the cash flows in the future that are relevant was never made explicit before. Finally, the term cash flows was substituted for money. There are reasons for these changes.

The terms price and value are usually considered to be equivalent in finance. One way to see this equivalence is to consider an asset, say a share of ABC company’s stock.
Suppose that this share belongs to you and you believe (on the basis of how much money this share is going to generate for you) that this share is worth $30. In other words, you value this share at $30. If you received an offer from a buyer for this share of $35, would you sell the share? The answer is yes. If the offer price were $28? No. In other words, you the seller would be willing to sell your share at a price that is no less than $30, the value that you place on the share. Now suppose that the buyer is a person just like you and knows exactly what you know about ABC Co. and, consequently, also places a value of $30 on the share. Would this buyer buy this share at $28? The answer is yes. At $35? Certainly not! In other words, the buyer will be willing to buy this share at a price no greater than $30. Therefore, if a transaction involving this share of ABC did take place between you and the buyer, it could only take place at the price of $30, the value that both you and the buyer place on the share.

Next, let us consider the concept that it is only the money that the asset generates in the future that determines its value. The rationale underlying this concept is quite straightforward. When you buy an asset, what the asset generated in the past went to its previous owner, not to you. The only money that you will get is what the asset will generate for you after you buy it, that is, in the future. Therefore, the value that you place on an asset will be determined solely by the money that the asset will generate in the future. This is not to say that the money that the asset generated in the past is not useful information. However, it is useful only to the extent that it may provide you with some idea as to what the asset will generate in the future.

Finally, let us turn to the use of the phrase “cash flows” instead of money. The reason for considering only cash flows is simple. The only thing that an investor can spend is cash. Therefore the only thing that the investor cares about is the stream of cash flows that the asset will generate in the future. This fact may seem somewhat trivial at this point but its importance will become apparent later in the course.

1.7 Purpose and Organization of Text

A main purpose of this book is to explain the concept of valuation of assets. Those of you who study finance further (we hope all of you will) will discover that almost everything in finance is somehow or other related to valuing assets. When you study corporate finance (this course), you will learn some methods to value the assets of a firm and its investment opportunities. You will also study how this method can be used to value the securities that firms issue, for example bonds and stocks. When you study
investments, you will concentrate on how to value stocks, bonds, futures, options and the myriad of investment possibilities that exist in the financial markets. When you study financial institution management, you will spend a considerable amount of time on loan analysis. A loan is nothing but an asset that a bank invests in; it accepts deposits from people (which is equivalent to borrowing money from depositors) and invests them by making loans to its clients. In order to determine whether to make a loan, the bank will, therefore, have to value that loan. If you study real estate finance, you will value a different category of assets, namely, real estate, including homes, apartment complexes, retail stores and many others.

Our earlier discussion indicated that the value of an asset is determined by the future cash flows that the asset will generate. In order to perform the actual valuation we will, therefore need to know two things: how to determine cash flows and, once we have determined these cash flows, how to value them. Both of these aspects are vitally important. Accordingly, this book is divided into two major sections. The first section (Chapters 2 - 6) focuses on the importance, determination and management of cash flows, particularly the past and potential future cash flows indicated by a firm’s financial statements. The second section (Chapters 7 - 12) concentrates on the principles, process and applications of valuation in corporate finance.
Questions

1. If within 5 years of receiving your degree you were earning $20,000 per month ($240,000 per year), would you consider yourself to be successful? If your monthly expenses were $25,000 per month and creditors were constantly calling you for payment and threatening repossession of your assets, would you still consider yourself to be successful? In what ways is this example analogous to corporate financial management?

2. In the example concerning Bennie’s Auto Parts and Service Center in the beginning of this chapter, assume that Bennie could save, on average, $850 per month with better management of his accounts receivable, $1,200 per month with better inventory management, and $750 per month in better cash management (specifically, saved bounced check fees). These savings total $2,800 per month. The time required to effect this better management would be approximately 20 hours per week. Bennie does not have this amount of time to give to proper financial management. What is the obvious solution?

3. As a follow-up to question 2, what are some of the major job responsibilities or functions of a financial manager?

4. List the three main areas (i.e., fields) of finance. Briefly describe each area. How are these areas related?

5. In what major ways does a corporation differ from a sole proprietorship or a partnership? Upon which form of business organization is this book based? Do the principles of financial management described in this book apply to the other forms of business organization?

6. What should be the main goal of a financial manager?

7. Profit maximization is not the same as shareholder value (i.e., stock price) maximization. How is it possible that profit maximization may not lead to stock price maximization?
8. According to the text, maximizing shareholder wealth, maximizing stock price per share, and maximizing the value of the firm’s assets are one and the same. That is, if a manager maximizes the value of the firm’s assets, he/she will also be maximizing shareholder wealth and the price per share of the company’s common stock. Explain this relationship.

9. What is the difference between book value and market value? How would you feel about owning stock in a firm whose market value was less than its book value? Could such a relationship exist? If so, what would it indicate?

10. Describe the similarities and differences between physical assets and financial assets. Why are financial assets risky? Why would anyone purchase a financial asset?

11. Given your accounting background, are there any accounting procedures or peculiarities that could make it difficult to compare the performance of one firm to another over time? What specific procedures come to mind? Is it possible to “massage” accounting information, that is, to legally ‘window dress’ financial statements that are distributed to shareholders? Why might a firm engage in such a practice? What would be the consequence of being caught engaging in outright financial statement fraud? (Note: If you don’t know answers to any of these questions, you will know after reading chapter 2 and 3).

12. Does the goal of stockholder wealth maximization necessarily imply that firms will not be socially responsible (that is, responsible for the welfare of their employees, customers, the environment or the community in which they operate)?

13. Assume that a firm is deciding whether or not to undertake some action that will increase the firm’s stock price but hurt the environment (i.e., be socially irresponsible). How might government regulations affect the firm’s decision?

14. Assume that you own $15,000 worth of stock in a company whose stock is widely held and actively traded on the NYSE. Is it necessary for you to actively monitor the manager’s performance (that is, to make sure that the manager’s of the firm are doing their best to maximize the value of your stock)? Why or why not? Now consider a bank that has made a large loan to this company. Is it necessary for the bank to actively monitor the manager’s performance? Why or why not?