

PRINCIPLES *of*  
**MANAGERIAL  
FINANCE**

14th Edition



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# Chapter 1

## The Role of Managerial Finance

# What is Finance?

- **Finance** can be defined as the science and art of managing money.
- At the personal level, finance is concerned with individuals' decisions about:
  - how much of their earnings they spend
  - how much they save
  - how they invest their savings
- In a business context, finance involves:
  - how firms raise money from investors
  - how firms invest money in an attempt to earn a profit
  - how firms decide whether to reinvest profits in the business or distribute them back to investors.

# Career Opportunities in Finance: Financial Services

- **Financial Services** is the area of finance concerned with the design and delivery of advice and financial products to individuals, businesses, and governments.
- Career opportunities include:
  - banking
  - personal financial planning
  - Investments
  - real estate
  - insurance

# Career Opportunities in Finance: Managerial Finance

- **Managerial finance** is concerned with the duties of the financial manager working in a business.
- **Financial managers** administer the financial affairs of all types of businesses—private and public, large and small, profit-seeking and not-for-profit. Tasks include:
  - developing a financial plan or budget
  - extending credit to customers
  - evaluating proposed large expenditures
  - raising money to fund the firm's operations.

# Career Opportunities in Finance: Managerial Finance (cont.)

- The recent global financial crisis and subsequent responses by governmental regulators, increased global competition, and rapid technological change also increase the importance and complexity of the financial manager's duties.
- Increasing globalization has increased demand for financial experts who can manage cash flows in different currencies and protect against the risks that naturally arise from international transactions.

# Legal Forms of Business Organization

- A **sole proprietorship** is a business owned by one person and operated for his or her own profit.
- A **partnership** is a business owned by two or more people and operated for profit.
- A **corporation** is an entity created by law. Corporations have the legal powers of an individual in that it can sue and be sued, make and be party to contracts, and acquire property in its own name.

# Table 1.1 Strengths and Weaknesses of the Common Legal Forms of Business Organization

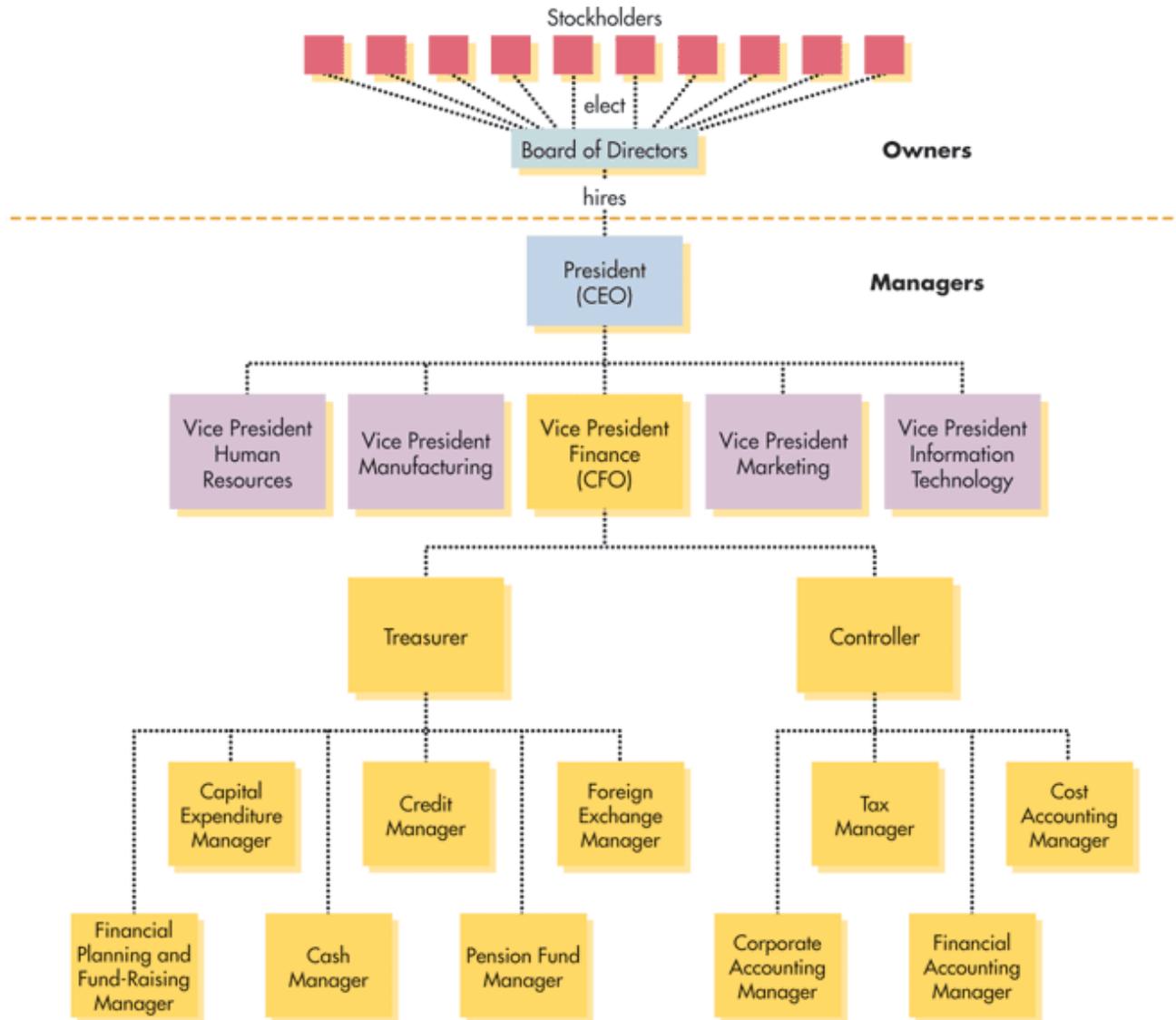
	Sole proprietorship	Partnership	Corporation
Strengths	<ul style="list-style-type: none"> <li>• Owner receives all profits (and sustains all losses)</li> <li>• Low organizational costs</li> <li>• Income included and taxed on proprietor's personal tax return</li> <li>• Independence</li> <li>• Secrecy</li> <li>• Ease of dissolution</li> </ul>	<ul style="list-style-type: none"> <li>• Can raise more funds than sole proprietorships</li> <li>• Borrowing power enhanced by more owners</li> <li>• More available brain power and managerial skill</li> <li>• Income included and taxed on partner's personal tax return</li> </ul>	<ul style="list-style-type: none"> <li>• Owners have <i>limited liability</i>, which guarantees that they cannot lose more than they invested</li> <li>• Can achieve large size via sale of ownership (stock)</li> <li>• Ownership (stock) is readily transferable</li> <li>• Long life of firm</li> <li>• Can hire professional managers</li> <li>• Has better access to financing</li> </ul>
Weaknesses	<ul style="list-style-type: none"> <li>• Owner has <i>unlimited liability</i> in that total wealth can be taken to satisfy debts</li> <li>• Limited fund-raising power tends to inhibit growth</li> <li>• Proprietor must be jack-of-all-trades</li> <li>• Difficult to give employees long-run career opportunities</li> <li>• Lacks continuity when proprietor dies</li> </ul>	<ul style="list-style-type: none"> <li>• Owners have <i>unlimited liability</i> and may have to cover debts of other partners</li> <li>• Partnership is dissolved when a partner dies</li> <li>• Difficult to liquidate or transfer partnership</li> </ul>	<ul style="list-style-type: none"> <li>• Taxes are generally higher because corporate income is taxed, and dividends paid to owners are also taxed at a maximum 15% rate</li> <li>• More expensive to organize than other business forms</li> <li>• Subject to greater government regulation</li> <li>• Lacks secrecy because regulations require firms to disclose financial results</li> </ul>

# Matter of Fact

**BizStats.com Total Receipts by Type of U.S. Firm**

	Sole proprietorships	Partnerships	Corporations
Number of firms (millions)	23.1	3.1	7.7
Percentage of all firms	61%	8%	20%
Total receipts (\$ billions)	1,324	4,244	50,757
Percentage of all receipts	2%	7%	80%

# Figure 1.1 Corporate Organization



# Table 1.2 Career Opportunities in Managerial Finance

Position	Description
Financial analyst	Prepares the firm's financial plans and budgets. Other duties include financial forecasting, performing financial comparisons, and working closely with accounting.
Capital expenditures manager	Evaluates and recommends proposed long-term investments. May be involved in the financial aspects of implementing approved investments.
Project finance manager	Arranges financing for approved long-term investments. Coordinates consultants, investment bankers, and legal counsel.
Cash manager	Maintains and controls the firm's daily cash balances. Frequently manages the firm's cash collection and disbursement activities and short-term investments and coordinates short-term borrowing and banking relationships.
Credit analyst/manager	Administers the firm's credit policy by evaluating credit applications, extending credit, and monitoring and collecting accounts receivable.
Pension fund manager	Oversees or manages the assets and liabilities of the employees' pension fund.
Foreign exchange manager	Manages specific foreign operations and the firm's exposure to fluctuations in exchange rates.

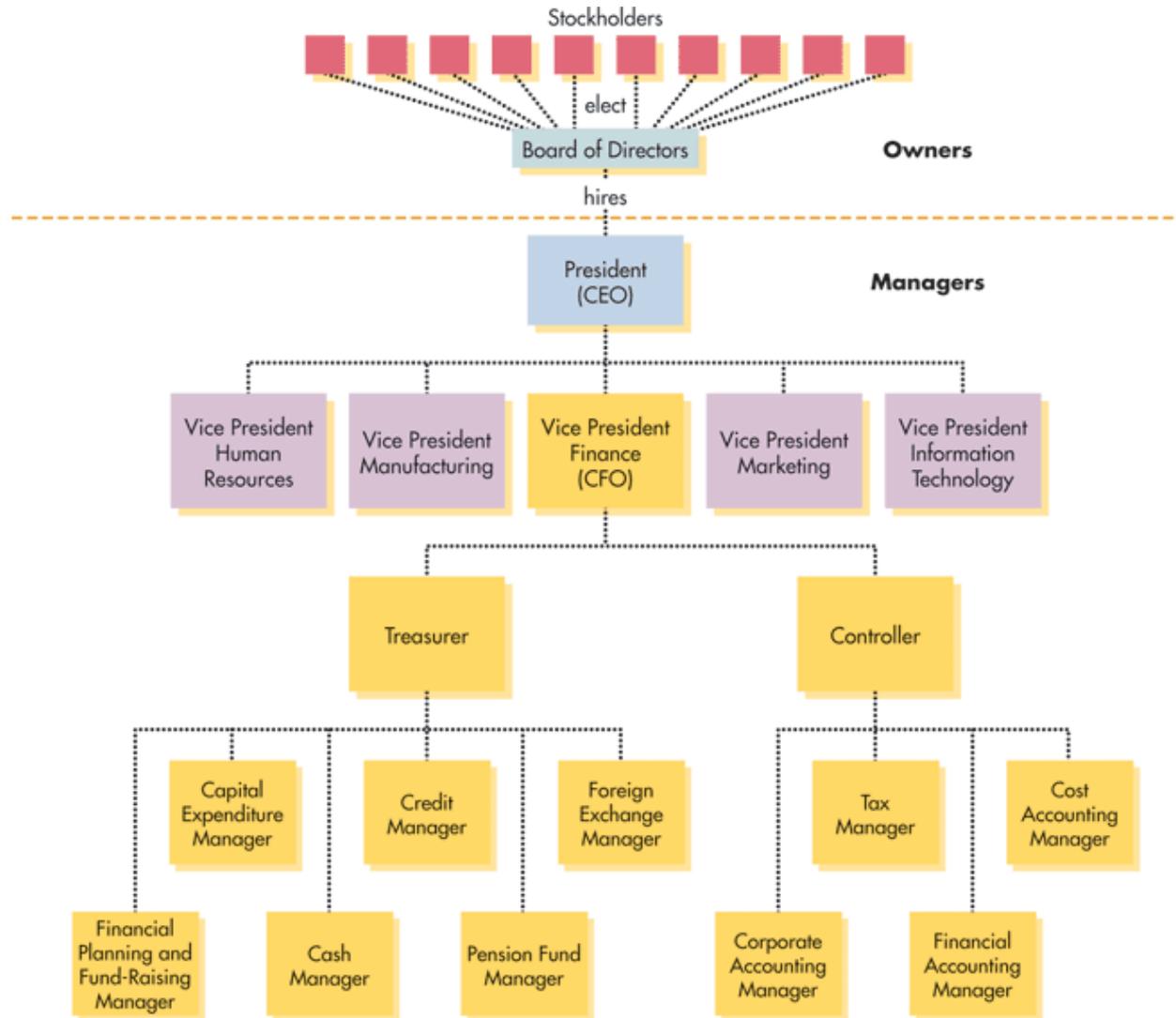
# Goal of the Firm: What About Stakeholders?

- **Stakeholders** are groups such as employees, customers, suppliers, creditors, owners, and others who have a direct economic link to the firm.
- A firm with a *stakeholder focus* consciously avoids actions that would prove detrimental to stakeholders. The goal is not to maximize stakeholder well-being but to preserve it.
- Such a view is considered to be "socially responsible."

# The Role of Business Ethics

- **Business ethics** are the standards of conduct or moral judgment that apply to persons engaged in commerce.
- Violations of these standards in finance involve a variety of actions: “creative accounting,” earnings management, misleading financial forecasts, insider trading, fraud, excessive executive compensation, options backdating, bribery, and kickbacks.
- Negative publicity often leads to negative impacts on a firm

# Figure 1.1 Corporate Organization



# Governance and Agency: Government Regulation

## The Sarbanes-Oxley Act of 2002:

- established an oversight board to monitor the accounting industry;
- tightened audit regulations and controls;
- toughened penalties against executives who commit corporate fraud;
- strengthened accounting disclosure requirements and ethical guidelines for corporate officers;
- established corporate board structure and membership guidelines;
- established guidelines with regard to analyst conflicts of interest;
- mandated instant disclosure of stock sales by corporate executives;
- increased securities regulation authority and budgets for auditors and investigators.

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## Chapter 2

### The Financial Market Environment

# Financial Institutions & Markets

Firms that require funds from external sources can obtain them in three ways:

1. through a financial institution
2. through financial markets
3. through private placements

# Financial Institutions & Markets:

## Financial Institutions

- Financial institutions are **intermediaries** that channel the savings of individuals, businesses, and governments into loans or investments.
- The key suppliers and demanders of funds are individuals, businesses, and governments.
- In general, individuals are net suppliers of funds, while businesses and governments are net demanders of funds.

# Commercial Banks, Investment Banks, and the Shadow Banking System

- **Commercial banks** are institutions that:
  - provide savers with a secure place to invest their funds
  - offer loans to individual and business borrowers
- **Investment banks** are institutions that:
  - assist companies in raising capital
  - advise firms on major transactions such as mergers or financial restructurings
  - engage in trading and market making activities

# Commercial Banks, Investment Banks, and the Shadow Banking System (cont.)

- The **Glass-Steagall Act** was an act of Congress in 1933 that created the federal deposit insurance program and separated the activities of commercial and investment banks. It was repealed in 1999 by Congress.
- The **shadow banking system** describes a group of institutions that:
  - engage in lending activities, much like traditional banks
  - but do not accept deposits
  - are not subject to the same regulations as traditional banks

# Matter of Fact

- Consolidation in the U.S. Banking Industry:
  - The U.S. banking industry has been going through a long period of consolidation.
  - According to the FDIC, the number of commercial banks in the United States declined from 11,463 in 1992 to 6,048 in 2013, a decline of 47%.
  - The decline is concentrated among small, community banks, which larger institutions have been acquiring at a rapid pace.

# Financial Institutions & Markets:

## Financial Markets

- **Financial markets** are forums in which suppliers of funds and demanders of funds can transact business directly.
- Transactions in short term marketable securities take place in the money market while transactions in long-term securities take place in the capital market.
- A **private placement** involves the sale of a new security directly to an investor or group of investors.
- Most firms, however, raise money through a **public offering** of securities, which is the sale of either bonds or stocks to the general public.

# Focus on Ethics

- The Ethics of Insider Trading
  - Bryan Shaw received inside information on Herbalife and Skechers from Scott London, a KPMG auditor. Using this information, Shaw made \$1.3 million in trading profits. He pleaded guilty to insider trading charges in 2013.
  - Laws prohibiting insider trading were established in the United States in the 1930s. These laws are designed to ensure that all investors have access to relevant information on the same terms.
  - Some market participants believe that insider trading should be permitted, arguing that information about the trades of insiders would be useful information to the market.
- If efficiency is the goal of financial markets, is allowing or disallowing insider trading more unethical?
- Does allowing insider trading create an ethical dilemma for insiders?

# The Financial Crisis: Financial Institutions and Real Estate Finance

- **Securitization** is the process of pooling mortgages or other types of loans and then selling claims or securities against that pool in a secondary market.
- **Mortgage-backed securities** represent claims on the cash flows generated by a pool of mortgages and can be purchased by individual investors, pension funds, mutual funds, or virtually any other investor.
- A primary risk associated with mortgage-back securities is that homeowners may not be able to, or may choose not to, repay their loans.

# The Financial Crisis: Falling Home Prices and Delinquent Mortgages

- Rising home prices between 1987 and 2006 kept mortgage default rate low.
- Lenders relaxed standards for borrowers and created subprime mortgages.
- As housing prices fell from 2006 to 2009, many borrowers had trouble making payments, but were unable to refinance.
- As a result, there was a sharp increase in the number of delinquencies and foreclosures.