PART 1 INTRODUCTION TO MANAGERIAL FINANCE

Chapters in this part

Part 1 of *Principles of Managerial Finance* discusses the role that financial managers play in businesses and the financial market environment in which firms operate. We argue that the goal of managers should be to maximise the value of the firm and by doing so, maximise the wealth of its owners. Financial managers act on behalf of the firm's owners by making operating and investment decisions whose benefits exceed their costs. These decisions create wealth for shareholders. Maximising shareholder wealth is important because firms operate in a highly competitive financial market environment that offer shareholders many alternatives for investing their funds. To raise the financial resources necessary to fund the firm's ongoing operations and future investment opportunities, managers have to deliver value to the firm's investors. Without smart financial managers and access to financial markets, firms are unlikely to survive, let alone achieve the long-term goal of maximising the value of the firm.

1 THE ROLE OF MANAGERIAL FINANCE

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Learning outcomes

LO 1 Define finance and the managerial finance function.

LO 2 Describe the legal forms of business organisation.

LO 3 Describe the goal of the firm and explain why maximising the value of the firm is an appropriate goal for a business.

LO 4 Describe how the managerial finance function is related to economics and accounting.

LO 5 Identify the primary activities of the financial manager.

LO 6 Describe the nature of the principal-agent relationship between the owners and managers of a company and explain how various corporate governance mechanisms attempt to manage agency problems.

Why this chapter matters to you

In your professional life

Accounting: You need to understand the relationships between the accounting and finance functions within the firm; how decision-makers rely on the financial statements you prepare; why maximising a firm's value is not the same as maximising its profits; and the ethical duty that you have when reporting financial results to investors and other stakeholders.

Information systems: You need to understand why financial information is important to managers in all functional areas; the documentation that firms must produce to comply with various regulations; and how manipulating information for personal gain can get managers into serious trouble.

Management: You need to understand the various legal forms of a business organisation; how to communicate the goal of the firm to employees and other stakeholders; the advantages and disadvantages of the agency relationship between a firm's managers and its owners; and how compensation systems can align or misalign the interests of managers and investors.

Marketing: You need to understand why increasing a firm's revenues, or market share is not always a good thing; how financial managers evaluate aspects of customer relations such as cash and credit management policies; and why a firm's brands are an important part of its value to investors.

Operations: You need to understand the financial benefits of increasing a firm's production efficiency; why maximising profit by cutting costs may not increase the firm's value; and how managers act on behalf of investors when operating a corporation.

In your personal life

Many of the principles of managerial finance also apply to your personal life. Learning a few simple financial principles can help you manage your own money more effectively.

Corporate governance woes at Eskom

Eskom is a public electricity utility established in 1923 by the South African government in terms of the Electricity Act of 1922 which since grew up to become the largest producer of power in Africa. It is a state-owned enterprise in which the government is the sole shareholder.

In recent years Eskom has been dogged by financial and operational problems that are threatening its sustainability. Financially, it has accumulated more than R450 billion of debt that is unsustainable resulting in the public utility being downgraded deeper into junk status by rating agencies such as Moody's and S & P. Operationally; it has struggled to meet electricity demand resulting in episodes of load-shedding since 2008. Both operational and financial problems have been diagnosed to stem from financial mismanagement, misconduct, and maladministration that have characterised Eskom over many years. In essence, the problems were occasioned by a collapse of corporate governance, that is, Eskom's implementation of rules, norms, processes, and systems that direct the way that it is managed and is held accountable, with reference to key legislation, regulations, national and internal policies, and good governance standards.

The Report of the Portfolio Committee on Public Enterprises on the inquiry into governance, procurement and financial sustainability of Eskom dated 28 November 2018 highlighted numerous breaches in governance. It reported among other transgressions that 'evidence brought before the Committee showed how Eskom's internal policies and procedures were applied in bad faith to victimise or side-line long-standing, competent and/or law-abiding executives, senior staff and experts.'

Governance failures at Eskom could be said to have taken place at all levels. In the first instance, the shareholder (Government) failed in its oversight of the Board, which it had appointed to oversee the operations of the public utility. Secondly, the Board failed to ensure that management followed the best corporate governance practices and adhere to key legislations, rules and regulations governing the operations of Eskom. Thirdly, management failed to ensure that internal controls were adhered to in operations.

Since 2019, that is, following the publication of the Parliamentary Report of the Portfolio on Public Enterprises, the government (shareholder) has been seized on implementing the recommendations of the Committee. These recommendations included the following, among others:

- *Change of leadership and management at Eskom*
- *A full review of Eskom's policies and procedures, as well as the policies and procedures of the Ministry of Public Enterprises to assess their compliance with relevant legislation, for all material concerns, including procurement and procedures for the appointment of executives and board members*
- *Strengthening oversight capacity and clarifying the role of the shareholder*
- *Strengthening the powers of Parliament to hold individuals and institutions accountable.*

Subsequently, a new Board was appointed and tasked with – addressing governance failures and rooting out corruption, the weak financial position, and the declining revenue, all of which were threatening the sustainability of Eskom. Furthermore, a new CEO was appointed and commenced work in early 2020.

- *What does the corporate governance problems at Eskom teach us about the agency problem in companies?*

Source: Report of the Portfolio Committee on Public Enterprises on the inquiry into governance, procurement and financial sustainability of Eskom date 28 November 2018, available at https://www.parliament.gov.za/storage/app/media/Links/2018/November%202018/28-11-2018/Final%20Report%20-%20Eskom%20Inquiry%2028%20NOV.pdf

LO 1 LO 2

1.1 Finance and the firm

The field of finance is broad and dynamic. Finance influences everything that firms do, from hiring personnel to building factories to launching new advertising campaigns. Because there are important financial dimensions to almost any aspects of business, there are many financially oriented career opportunities for those who understand the basic principles of finance described in this textbook. Even if you do not see yourself pursuing a career in finance, you will find that an understanding of a few key ideas in finance will help make you a smarter consumer and a wiser investor with your own money.

What Is finance?

finance the science and art of managing money

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, and how they invest their savings. In a business context, finance involves the same types of decisions: how firms raise money from investors, how firms invest money in an attempt to earn a profit, and how they decide whether to reinvest profits in the business or distribute them back to investors. The keys to good financial decisions are much the same for businesses and individuals, which is why most students will benefit from an understanding of finance, regardless of the career path they plan to follow. Learning the techniques of good financial analysis will not only help you make better financial decisions as a consumer, but it will also help you understand the financial consequences of the important business decisions you will face, no matter what career path you follow.

Matter of fact

- *What drives risk perception?*

A global survey with financial professionals and Lay people

Abstract:
Risk is an integral part of many economic decisions and is vitally important in finance. Despite extensive research on decision-making under risk, little is known about how risks are perceived by financial professionals, the key players in global financial markets. In a large-scale survey experiment with 2,213 finance professionals and 4,559 lay people in nine countries representing ~50% of the world's population and more than 60% of the world's gross domestic product, we expose participants to return distributions with an equal expected return, and we systematically vary the distributions' next three higher moments. Of these, skewness is the only moment that systematically affects financial professionals' perception of financial risk. Strikingly, variance does not influence risk perception, even though return volatility is the most common risk measure in finance in both academia and the industry. When testing other compound risk measures, the probability to experience losses is the strongest predictor of what is perceived as being risky. Analysing professionals' propensity to invest, skewness and loss probability have strong predictive power too. However, volatility and kurtosis also have some additional effect on participants' willingness to invest. Our results are similar for lay people, and they are robust across and within countries with different cultural backgrounds as well as for different job fields of professionals.

Source: https://osf.io/kmgn8/

Career opportunities in finance

Careers in finance typically fall into one of two broad categories: (1) financial services, and (2) managerial finance. Workers in both areas rely on a common analytical 'tool kit,' but the types of problems to which that tool kit is applied vary a great deal from one career path to the other.

Financial services

financial services the area of finance concerned with the design and delivery of advice and financial products to individuals, businesses, and governments

Financial services are an 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

managerial finance concerns the duties of the financial manager in a business

financial manager actively manages the financial affairs of all types of businesses, whether private or public, large, or small, profit-seeking or not for profit

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. They perform such varied tasks as developing a financial plan or budget, extending credit to customers, evaluating proposed large expenditures, and raising money to fund the firm's operations. In recent years, several factors have increased the importance and complexity of the financial manager's duties. These factors include the recent global financial crisis and subsequent responses by regulators, increased competition, and technological change. For example, globalisation has led US companies to increase their transactions in other countries, and foreign companies have done likewise in the United States. These changes increase the demand for financial experts who can manage cash flows in different currencies and protect against the risks that arise from international transactions. These changes increase the finance functions' complexity, but they also create opportunities for a more rewarding career. The increasing complexity of the financial manager's duties has increased the popularity of a variety of professional certification programmes outlined in the *Focus on practice* section below. Financial managers today actively develop and implement corporate strategies aimed at helping the firm grow and improving its competitive position. As a result, many corporate chief executive officers (CEOs) rose to the top of their organisations by first demonstrating excellence in the finance function. For instance, in South Africa 25 percent of directors of the top 200 companies on the JSE Limited are Chartered Accountants (CAs); 90 percent of CFOs of these top 200 companies are CAs, and 22 percent of the CEOs of the top 40 companies on the JSE are CAs.

Legal forms of business organisation

One of the most basic decisions that all businesses confront is how to choose a legal form of organisation. This decision has important financial implications because how a business is organised legally, influences the risks that the firm's owners must bear, how the firm can raise money, and how the firm's profits will be taxed. The three most common legal forms of business organisation are the *sole proprietorship*, the *partnership*, and the *company*. More businesses are organised as sole proprietorships than any other legal form. However, the largest businesses are almost always organised as companies. Even so, each type of organisation has its advantages and disadvantages.

Sole proprietorships

sole proprietorship a business owned by one person and operated for his/her profit

A **sole proprietorship** is a business owned by one person who operates it for his/her profit. The typical sole proprietorship is small, such as a bike shop, personal trainer, or plumber – most sole proprietorships operate in the wholesale, retail, service, and construction industries.

unlimited liability the condition of a sole proprietorship (or general partnership), giving creditors the right to make claims against the owner's personal assets to recover debts owed by the business

partnership a business owned by two or more people and operated for profit

partnership agreement the written contract used to formally establish a business partnership

Typically, the owner (proprietor), along with a few employees, operates the proprietorship. The proprietor raises capital from personal resources or by borrowing, and he/she is responsible for all business decisions. As a result, this form of organisation appeals to entrepreneurs who enjoy working independently.

A major drawback to the sole proprietorship is **unlimited liability**, which means that liabilities of the business are the entrepreneur's responsibility, and creditors can make claims against the entrepreneur's assets if the business fails to pay its debts. The key strengths and weaknesses of sole proprietorships are summarised in Table 1.1.

Partnerships

A **partnership** consists of two or more owners doing business together for profit. Partnerships are typically larger than sole proprietorships and are common in the finance, insurance, legal and real estate industries. Public accounting and law partnerships often have large numbers of partners.

Most partnerships are established by a written contract known as a **partnership agreement**. In a *general (or regular) partnership*, all partners have unlimited liability, and each partner is legally liable for *all* the debts of the partnership. The key strengths and weaknesses of partnerships are summarised in Table 1.1.

Table 1.1 Strengths and weaknesses of the common legal forms of business organisation

	Sole proprietorships	Partnerships	Companies
Strengths	• Owner receives all profits (and sustains all losses). • Low organisational costs. • Income included and taxed on proprietor's personal tax return. • Independence. • Secrecy. • Ease of dissolution.	• Can raise more funds than sole proprietorships. • Borrowing power enhanced by more owners. • More available brainpower and managerial skill. • Income included and taxed on a partner's personal tax return.	• Owners have *limited liability* which guarantees that they cannot lose more than they invested. • Can achieve large size via a sale of ownership (shares). • Ownership (share) is readily transferable. • Long life of the firm. • Can hire professional managers. • Has better access to financing.
Weaknesses	• Owner has *unlimited liability* – total wealth can be taken to satisfy debts. • Limited fund-raising power tends to inhibit growth. • Proprietor must be Jack-of-all-trades. • Difficult to give employees long-run career opportunities. • Lacks continuity when proprietor dies.	• Owners have *unlimited liability* and may have to cover the debts of other partners. • Partnership is dissolved when a partner dies. • Difficult to liquidate or transfer partnership.	• Taxes generally higher because corporate income is taxed. • More expensive to organise than other business forms. • Subject to greater government regulation. • Lacks secrecy because regulations require firms to disclose financial results.

Matter of fact

The legislation governing the operation of companies in South Africa is the Companies Act, 2008 as amended in 2018. One of its main features, as compared to the previous legislation, is that it has been modernised to be in line with international best practices. This is with regard to public companies, communications and corporate governance. It has also been harmonised with other South African legislation, such as the Promotion of Access to Information Act (PAIA) and the Electronic Communications and Transactions (ECT) Act.

Companies

company an entity created by law

shareholders the owners of a company, whose ownership or equity, takes the form of either ordinary shares or preference shares

limited liability a legal provision that limits stockholders' liability for a corporation's debt to the amount they initially invested in the firm by purchasing stock

ordinary shares the purest and most basic form of company ownership

dividends periodic distribution of cash to the shareholders of a firm

board of directors group elected by the firm's shareholders and typically responsible for approving strategic goals and plans, setting general policy, guiding corporate affairs, and approving major expenditures

managing director or chief executive officer (CEO) corporate official responsible for managing the firm's day-to-day operations and carrying out the policies established by the board of directors

A **company** is an entity created by law. It has the legal powers of an individual in that it can sue and be sued, make and be a party to contracts, and acquire property in its name. Table 1.1 lists the key strengths and weaknesses of companies.

The owners of a company are its **shareholders**, whose ownership, or *equity* takes the form of either ordinary shares or preference shares. Unlike the owners of sole proprietorships or partnerships, shareholders of a company enjoy **limited liability**, meaning that they are not personally liable for the firm's debts. Their losses are limited to the amount they invested in the firm when they purchased shares. In chapter 7, you will learn more about **ordinary** and preference **shares**, but for now, it is enough to say that ordinary shares are the purest and most basic form of company ownership. Shareholders expect to earn a return by receiving **dividends** – periodic distributions of cash – or by realising gains through increases in the share price. Because the money to pay dividends generally comes from the profits that a firm earns, shareholders are sometimes referred to as *residual claimants*, meaning that they are paid last – after employees, suppliers, tax authorities, and lenders receive what they are owed. If the firm does not generate enough cash to pay everyone else, there is nothing available for shareholders.

As noted in the upper portion of Figure 1.1 (on page 10), control of the company is structured like a democracy. The shareholders (owners) vote periodically to elect members of the **board of directors** and to decide on other issues such as amending the corporate charter. The Board of directors is typically responsible for approving strategic goals and plans, setting general policy, guiding corporate affairs, and approving major expenditures. Most importantly, the Board decides when to hire or fire top managers and establishes compensation packages for the most senior executives. The Board consists of 'inside' directors, such as key company executives, and 'outside' or 'independent' directors, such as executives from other companies, major shareholders, and national or community leaders. Outside directors for major companies receive compensation in the form of cash, shares, and share options.

The **managing director** or **chief executive officer (CEO)** is responsible for managing day-to-day operations and carrying out the policies established by the Board of directors. The CEO reports periodically to the firm's directors.

It is important to note the division between owners and managers in a large corporation, as shown by the dashed horizontal line in Figure 1.1. This separation and some of the issues surrounding it will be addressed in the discussion of the *agency issue* later in this chapter.

Why study managerial finance?

An understanding of the concepts, techniques, and practices presented throughout this text will fully acquaint you with the financial manager's activities and decisions. Because the consequences of most business decisions are measured in financial terms, the financial manager plays a key operational role. People in all areas of responsibility – accounting, information systems, management, marketing, operations, and so forth – need a basic awareness of finance so that they will understand how to quantify the consequences of their actions.

Even if you are not planning to major in finance, you still will need to understand how financial managers think to improve your chance of success in your chosen career. Managers in the firm, regardless of their job descriptions, usually have to provide financial justification for the resources they need to do their job. Whether you are hiring new workers, negotiating an advertising budget, or upgrading the technology used in a manufacturing process, understanding the financial aspects of your actions will help you gain the resources you need to be successful. The 'Why this chapter matters to you' section that appears on each chapter opening page should help you understand the importance of each chapter in both your professional and personal life.

As you study this text, you will learn about career opportunities in managerial finance, which are briefly described in Table 1.2. Although this text focuses on publicly held, profit-seeking firms, the principles presented here apply to private and not-for-profit organisations. The decision-making principles developed in this text can also be applied to personal financial decisions. We hope that this first exposure to the exciting field of finance will provide the foundation and initiative for further study and possibly even a future career.

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 finance for approved long-term investments. Co-ordinates 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 co-ordinates 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.

REVIEW QUESTIONS

1.1 What is *finance*? Explain how this field affects all the activities in which businesses engage.

1.2 What is the *financial services* area of finance? Describe the field of *managerial finance*.

1.3 Which legal form of business organisation is most common? Which form is dominant in terms of business revenues?

1.4 Describe the roles and the basic relationships among the major parties in a company – shareholders, Board of directors, and managers. How are corporate owners rewarded for the risks they take?

1.5 Briefly name and describe some organisational forms, other than corporations, that provide owners with limited liability.

1.6 Why is the study of managerial finance important to your professional life regardless of the specific area of responsibility you may have within the business firm? Why is it important in your personal life?

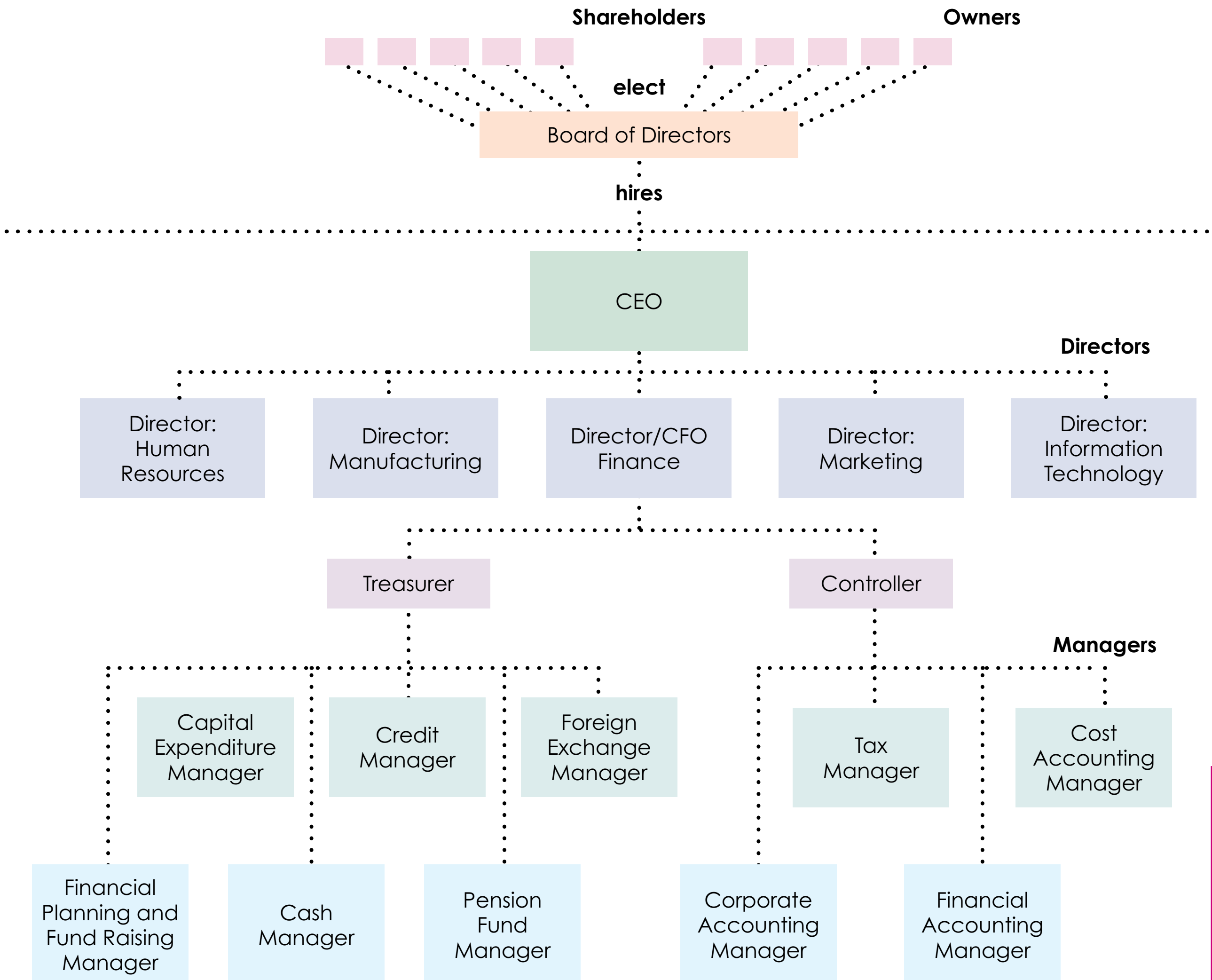

Figure 1.1 **Corporate organisation.** The general organisation of a company and the finance function.

LO 3

1.2 Goal of the firm

What goal should managers pursue? There is no shortage of possible answers to this question. Some might argue that managers should focus entirely on satisfying customers. Progress toward this goal could be measured by the market share attained by each of the firm's products. Others suggest that managers must first inspire and motivate employees; in that case, employee turnover might be the key success metric to watch. The goal that managers select will affect many of the decisions that they make, so choosing an objective is a critical determinant of how business should operate.

Maximise shareholder wealth

Finance teaches that a manager's primary goal should be to maximise the wealth of the firm's owners – the shareholders. The simplest and best measure of shareholder wealth is the firm's share price, so most textbooks (ours included) instruct managers to take actions that increase the firm's share price. A common misconception is that when firms strive to make their shareholders happy, they do so at the expense of other stakeholders such as customers, employees, or suppliers.

This line of thinking ignores the fact that in most cases, to enrich shareholders, managers must first satisfy the demands of these other interest groups. Recall that dividends that shareholders receive ultimately come from the firm's profits. It is unlikely that a firm whose customers are unhappy with its products, or whose employees are looking for jobs at other firms, or whose suppliers are reluctant to ship raw materials will make shareholders rich because such a firm will likely be less profitable in the long run than one that better manages its relations with these stakeholder groups.

Therefore, we argue that the goal of the firm, and managers, should be to *maximise the wealth of the owners for whom it is being operated*, or equivalently, to maximise the share price. This goal translates into a straightforward decision rule for managers – *only take actions that are expected to increase the share price*. Although that goal sounds simple, implementing it is not always easy. To determine whether a course of action will increase or decrease a firm's share price, managers have to assess what return (that is, cash inflows net of cash outflows) the action will bring, and how risky that return might be. Figure 1.2 depicts this process. We can say that *the key variables that managers must consider when making business decisions are returns (cash flows) and risk*.

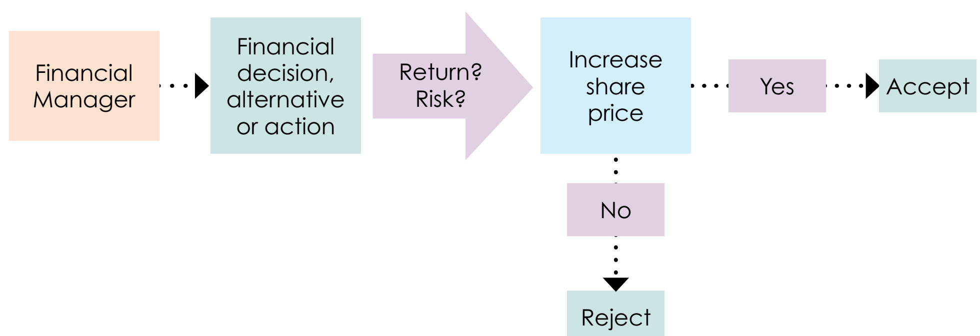

Figure 1.2 **Share price maximisation.** Financial decisions and share price.

Maximise profit

earnings per share (EPS) the amount earned during the period on behalf of each outstanding ordinary share, calculated by dividing the period's total earnings available for the firm's ordinary shareholders by the number of ordinary shares outstanding

It might seem intuitive that maximising a firm's share price is equivalent to maximising its profits, but that is not always correct.

Companies commonly measure profits in terms of **earnings per share (EPS)**, which represents the amount earned during the period on behalf of each outstanding ordinary share. EPS are calculated by dividing the period's total earnings available for the firm's ordinary shareholders by the number of ordinary shares outstanding.

EXAMPLE 1.1
PROFIT MAXIMISATION AND UNCERTAINTY

Suppose you are the manager of a firm intending to choose between two investment projects, A and B, each requires an initial investment of R10 million and produces returns one period from now. Project A will return R10.5 million with certainty yielding a profit of (R10.5 million – R10 million) R500,000. Project B has an uncertain return and will return either R10.5 million or R9 million one period from now, each with a probability of .05. Thus, Project B will yield either a profit of R500,000 or a loss of R500,000. In terms of profit maximisation, which project is preferable?

A risk-averse investor would prefer Project A over Project B because of the certainty of its profit of R500,000.

But does profit maximisation lead to the highest possible share price? For at least three reasons, the answer is often no. Firstly, the timing is important. An investment that provides a lower profit in the short run may be preferable to one that earns a higher profit in the long run. Secondly, profits and cash flows are not identical.

The profit that a firm reports is simply an estimate of how it is doing, an estimate that is influenced by many different accounting choices that firms make when assembling their financial reports. Cash flow is a more straightforward measure of the money flowing into and out of the company. Companies have to pay their bills with cash, not earnings, so cash flow is what matters most to financial managers. Thirdly, risk matters a great deal. A firm that earns a low but reliable profit might be more valuable than another firm with profits that fluctuate a great deal (and therefore can be extremely high or exceptionally low at different times).

Timing

Because the firm can earn a return on funds it receives, *the receipt of funds sooner rather than later is preferred*.

Cash flows

Profits do not necessarily result in cash flows available to the shareholders. There is no guarantee that the Board of directors will increase dividends when profits increase. In addition, the accounting assumptions, and techniques that a firm adopts, can sometimes allow a firm to show a positive profit even when its cash outflows exceed its cash inflows.

Furthermore, higher earnings do not necessarily translate into a higher share price. Only when earnings' increases are accompanied by increased future cash flows is a higher share price expected. For example, a firm with a high-quality product sold in a competitive market could increase its earnings by significantly reducing its equipment maintenance expenditures. The firm's expenses would be reduced, thereby increasing its profits. But if the reduced maintenance results in lower product quality, the firm may impair its competitive position, and its share price could drop as many well-informed investors sell the share in anticipation of lower future cash flows. In this case, the earnings increase was accompanied by lower future cash flows, and therefore a lower share price.

Risk

Profit maximisation also fails to account for **risk** – the chance that actual outcomes may differ from those expected. A basic premise in managerial finance is that a trade-off exists between return (cash flow) and risk. *Return and risk are, in fact, the key determinants of share price, which represents the wealth of the owners in the firm.*

risk the chance that actual outcomes may differ from those expected

Cash flow and risk affect share price differently: Holding risk fixed, higher cash flow is generally associated with a higher share price. In contrast, holding cash flow fixed, higher risk tends to result in a lower share price because the shareholders do not like risk. For example, when Apple's late CEO, Steve Jobs, took a leave of absence to battle a serious health issue, the firm's share suffered as a result. This occurred not because of any near-term cash flow reduction but in response to the firm's increased risk –there was a chance that the firm's lack of near-term leadership could result in reduced future cash flows. Simply put, the increased risk reduced the firm's share price. In general, shareholders are **risk-averse** – that is, they must be compensated for bearing risk. In other words, investors expect to earn higher returns on riskier investments, and they will accept lower returns on relatively safe investments. The key point, which will be fully developed in chapter 5, is that differences in risk can significantly affect the value of different investments.

risk-averse requiring compensation to bear the risk

What about stakeholders?

stakeholders groups such as employees, customers, suppliers, creditors, owners, and others who have a direct economic link to the firm

Although maximisation of shareholder wealth is the primary goal, many firms broaden their focus to include the interests of *stakeholders* as well as shareholders. **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 maximise stakeholder well-being but to preserve it.

The stakeholder view does not alter the goal of maximising shareholder wealth. Such a view is often considered part of the firm's 'social responsibility'. It is expected to provide long-run benefit to shareholders by maintaining positive relationships with stakeholders. Such relationships should minimise stakeholder turnover, conflicts, and litigation. The firm can better achieve its goal of shareholder wealth maximisation by fostering co-operation with its other stakeholders, rather than conflict with them.

The role of business ethics

business ethics standards of conduct or moral judgement that apply to persons engaged in commerce

Business ethics are the standards of conduct or moral judgement 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. The financial press has reported many such violations in recent years, involving well-known South African companies, such as Eskom, Tongat-Hullet, Masterbond and Macmed. As a result, the financial community is developing and enforcing ethical standards. The goal of these ethical standards is to motivate business and market participants to adhere to both the letter and the spirit of laws and regulations concerned with business and professional practice. Most business leaders believe businesses strengthen their competitive positions by maintaining high ethical standards.

Considering ethics

Robert A. Cooke, a noted ethicist, suggests that the following questions be used to assess the ethical viability of proposed action:[1]

1. Is the action arbitrary or capricious? Does it unfairly single out an individual or group?
2. Does the action violate the moral or legal rights of any individual or group?
3. Does the action conform to accepted moral standards?
4. Are there alternative courses of action that are less likely to cause actual or potential harm?

Considering such questions before acting can help to ensure its ethical viability.

Today, many firms are addressing the issue of ethics by establishing corporate ethics policies. To promote ethical business practices in South Africa, Business Unity South Africa, an association of organised business in the country, promulgated the South African Charter of Ethical Business Practice that has set aspirational standards. Frequently, employees are required to sign a formal pledge to uphold the firm's ethics policies. Such policies typically apply to employee actions in dealing with all corporate stakeholders, including the public.

The *Focus on ethics* box provides an example of another aspect of ethical behaviour, namely, social responsibility in South Africa.

1 Robert A. Cooke, 'Business Ethics: A perspective', in *Arthur Anderson Cases on Business Ethics* (Chicago: Arthur Anderson, September 1991), pp. 2 and 5

Focus on ethics

Ethics and share price

An effective ethics programme can enhance corporate value by producing several positive benefits. It can reduce potential litigation and judgement costs, maintain a positive corporate image, build shareholder confidence, and gain the loyalty, commitment, and respect of the firm's shareholders. Such actions, by maintaining and enhancing cash flows and reducing perceived risk, can positively affect the firm's share price. *Ethical behaviour is, therefore viewed as necessary for achieving the firm's goal of owner wealth maximisation.*

REVIEW QUESTIONS

1.7 What is the goal of the firm and, therefore, of all managers and employees? Discuss how one measures the achievements of this goal.

1.8 For what three basic reasons is profit maximisation inconsistent with wealth maximisation?

1.9 What is a *risk*? Why must risk as well as return be considered by the financial manager who is evaluating a decision alternative or action?

1.10 Describe the role of corporate ethics policies and guidelines and discuss the relationship that is believed to exist between ethics and share price.

Focus on ethics

Corporate social responsibility in South Africa

'Corporate Social Responsibility (CSR) is not a new issue. There has and will always be the need for organisations to make profits and the needs of society. CSR has been considered more strongly than ever since the early 1990s, building on a trend that had been growing since the start of the 20th century. CSR broadly refers to all an organisation's impacts on society and the need to deal responsibly with the impacts on each group of stakeholders. The King IV Report on Governance for South Africa 2016 encapsulates the idiosyncratic South African context of CSR. In the African context these moral duties are manifested in the concept of Ubuntu which is captured in the expression 'uMuntu ngumuntu ngabantu', 'I am because you are; you are because we are'. This model is the premise upon which the CSR partnership is researched herein. Ever since the publication of the King Reports on Corporate Governance, South African businesses have sharpened their focus on their commitment to the 'triple-bottom-line'. Organisations cannot ignore the impact of social, ethical and environmental issues on their business and the economy and the cost of neglecting these issues will be high'.

- *How would you view a sole proprietor's use of firm resources to pursue social goals?*

Source: Extract from: Johannes, Jonathan (2016), 'Corporate Social Responsibility in South Africa: How corporate partnerships can advance the sustainability agenda', Research paper submitted in partial fulfilment of the requirements of the LLM degree at the University of the Western Cape, available online at https://etd.uwc.ac.za/bitstream/handle/11394/5519/Johannes_j_llm_law_2017.pdf?sequence=1&isAllowed=y

LO 4 LO 5

1.3 Managerial finance function

People in all areas of responsibility within the firm must interact with finance personnel and procedures to get their jobs done. For financial personnel to make useful forecasts and decisions, they must be willing and able to talk to individuals in other areas of the firm. For example, when considering a new product, the financial manager needs to obtain sales forecasts, pricing guidelines, and advertising and promotion budget estimates from marketing personnel.

The managerial finance function can be broadly described by considering its role within the organisation, its relationship to economics and accounting, and the primary activities of the financial manager.

Organisation of the finance function

The size and importance of the managerial finance function depends on the size of the firm. In small firms, the finance function is generally performed by the accounting department. As a firm grows, the finance function typically evolves into a separate department linked directly to the company managing director or CEO through the chief financial officer (CFO). The lower portion of the organisational chart in Figure 1.1 on page 10 shows the structure of the finance function in a typical medium- to large-size firm.

Reporting to the CFO are the treasurer and the controller. The **treasurer** (the chief financial manager) typically manages the 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 **controller** (the chief accountant) typically handles the accounting activities, such as corporate accounting, tax management, financial accounting, and cost accounting. The treasurer's focus tends to be more external, whereas the controller's focus is more internal.

If international sales or purchases are important to a firm, it may well employ one or more finance professionals whose job is to monitor and manage the firm's exposure to loss from currency fluctuations. A trained financial manager can 'hedge', or protect against such a loss, at a reasonable cost by using a variety of financial instruments. These **foreign exchange managers** typically report to the firm's treasurer.

treasurer the firm's chief financial manager, who manages the firm's cash, oversees its pension plans and manages key risks

controller the firm's chief accountant, who is responsible for the firm's accounting activities, such as corporate accounting, tax management, financial accounting, and cost accounting

foreign exchange manager the manager responsible for managing and monitoring the firm's exposure to loss from currency fluctuations

Relationship to economics

The field of finance is closely related to economics. Financial managers must understand the economic framework and be alert to the consequences of varying levels of economic activity and changes in economic policy. They must also be able to use economic theories as guidelines for efficient business operation. Examples include supply-and-demand analysis, profit-maximising strategies, and price theory. 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.

marginal cost-benefit analysis economic principle that states that financial decisions should be made, and actions taken, only when the added benefits exceed the added costs

EXAMPLE 1.2

Nokuthula Moyo is a financial manager for ABC Department Stores, a large chain of upscale department stores operating primarily in the Gauteng Province of South Africa. She is currently trying to decide whether to replace one of the firm's computer servers with a new, more sophisticated one that would both speed up processing and handle a larger volume of transactions. The new computer would require a cash outlay of R80,000, and the old computer could be sold for a net value of R20,000. The total benefits from the new server (measured in today's rands) would be R100,000. The total benefits over a similar period from the old computer (measured in today's rands) would be R30,000. Applying marginal cost-benefit analysis, Nokuthula organises the data as follows:

Benefits with a new computer	R100,000
Less: Benefits with old computer	R30,000
Marginal (added) benefits	R70,000
Cost of new computer	R80,000
Less: Proceeds from the sale of old computer	R20,000
Marginal (added) costs	R60,000
Net benefit [(1) – (2)]	**R10,000**

Because the marginal (added) benefits of R70,000 exceed the marginal (added) costs of R60,000, Nokuthula recommends that the firm purchase the new computer to replace the old one. The firm will experience a net benefit of R10,000 because of this action.

Relationship to accounting

The firm's finance and accounting activities are closely related and generally overlap. In small firms, accountants often carry out the finance function, while in large firms, financial analysts often help compile accounting information. However, there are two basic differences between finance and accounting; one is related to the emphasis on cash flows and the other to decision-making.

Emphasis on cash flows

accrual basis in the preparation of financial statements recognises revenue at the time of sale and recognises expenses when they are incurred

cash basis recognises revenues and expenses only with respect to actual inflows and outflows of cash

The accountant's primary function is to develop and report data for measuring the performance of the firm, assess its financial position, comply with and file reports required by securities regulators, and file and pay taxes. Using generally accepted accounting principles, the accountant prepares financial statements that recognise revenue at the time of sale (whether payment has been received or not) and recognise expenses when they are incurred. This approach is referred to as the **accrual basis** of accounting.

The financial manager, on the other hand, places primary emphasis on *cash flows*, the inflow and outflow of cash. He/she maintains the firm's solvency by planning the cash flows necessary to satisfy its obligations and to acquire assets needed to achieve the firm's goals. The financial manager uses this **cash basis** of accounting to recognise the revenues and expenses only with respect to actual inflows and outflows of cash. Whether a firm earns a profit or experiences a loss, *it must have a sufficient flow of cash to meet its obligations as they come due*.

EXAMPLE 1.3

Revenue recognition. A company sells books for R20,000 to a customer in January who pays the invoice in February. Under the cash basis, the company recognises the sale in February when the cash is received. Under the accrual basis, the company recognises the sale in January when it issues the invoice.
Expense recognition. A company buys stationery for R10,000 in March which it pays for in April. Under the cash basis, the company recognises the purchase in April when it pays the bill. Under the accrual basis, the company recognises the purchase in March when it receives the supplier's invoice.

As the example shows, accrual accounting data does not fully describe the circumstances of a firm. Thus, the financial manager must look beyond financial statements to obtain insight into existing or developing problems. Of course, accountants are aware of the importance of cash flows, and financial managers use and understand accrual-based financial statements. Nevertheless, the financial manager, by concentrating on cash flows, should be able to avoid insolvency and achieve the firm's financial goals.

EXAMPLE 1.4
PERSONAL FINANCE

Individuals do not use accrual concepts. Rather, they rely solely on cash flows to measure their financial outcomes. Generally, individuals plan, monitor, and assess their financial activities using cash flows over a given period, typically a month or a year. Ann Bach projects her cash flows during October as follows:

Item	Amount	
	Inflow	Outflow
Net pay received	R44,000	
Rent		R10,200
Car payment		4,500
Utilities		3,000
Groceries		8,000
Clothes		7,500
Dining out		6,500
Fuel		4,400
Interest income	2,200	
Misc. expense		4,250
Totals:	**R46,200**	**R48,350**

Anne subtracts her total outflows of R48,350 from her total inflows of R46,200 and finds that her net *cash flow* for October will be -R2,150. To cover the R2,150 shortfall, Anne will have to either borrow R2,150 (putting it on a credit card is a form of borrowing) or withdraw R2,150 from her savings. Or she may decide to reduce her outflows in areas of discretionary spending – for example, clothing purchases, dining out, or areas that make up the R4,250 of miscellaneous expense.

Decision-making

The second major difference between finance and accounting has to do with decision-making. Accountants devote most of their attention to the *collection and presentation of financial data*. Financial managers evaluate the accounting statements, develop additional data, and *make decisions* based on their assessment of the associated returns and risks. Of course, this does not mean that accountants never make decisions, or that financial managers never gather data, but rather that the primary focuses of accounting and finance are distinctly different.

Primary activities of the financial manager

In addition to ongoing involvement in financial analysis and planning, the financial manager's primary activities are making investment and financing decisions. Investment decisions determine what types of assets the firm holds. Financing decisions determine how the firm raises money to pay for the assets in which it invests. One way to visualise the difference between a firm's investment and financing decisions is to refer to the balance sheet shown in Figure 1.3. Investment decisions generally refer to the items that appear on the left-hand side of the balance sheet, and financing decisions relate to the items on the right-hand side. Keep in mind, though, that financial managers make these decisions based on their impact on the value of the firm, not on the accounting principles used to construct a balance sheet.

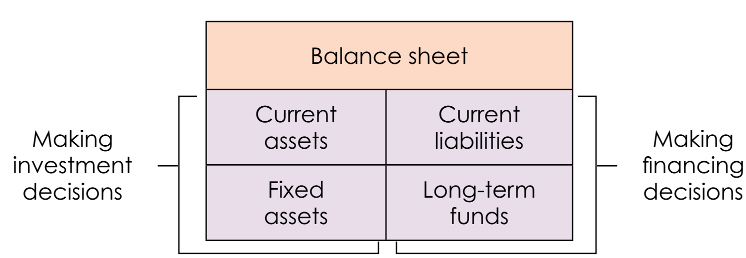

Figure 1.3 **Financial activities.** Primary activities of the financial manager.

REVIEW QUESTIONS

1.11 In what financial activities does a corporate treasurer engage?
1.12 What is the primary economic principle used in managerial finance?
1.13 What are the major differences between accounting and finance with respect to emphasis on cash flows and decision-making?
1.14 What are the two primary activities of the financial manager that are related to the firm's balance sheet?

LO 6

1.4 Governance and agency

As noted earlier, most owners of a company are normally distinct from its managers. Nevertheless, managers are entrusted to only take actions or make decisions that are in the best interest of the firm's owners, its shareholders. In most cases, if managers fail to act on behalf of the shareholders, they will also fail to achieve the goal of maximising shareholder wealth. To help ensure that managers act in ways that are consistent with the interests of shareholders and mindful of obligations to other stakeholders, firms aim to establish sound corporate governance practices.

Corporate governance

corporate governance the rules, processes, and laws by which companies are operated, controlled and regulated

Corporate governance refers to the rules, processes, and laws by which companies are operated, controlled, and regulated. It defines the rights and responsibilities of the corporate participants such as the shareholders, Board of directors, officers and managers, and other stakeholders, as well as the rules and procedures for making corporate decisions. A well-defined corporate governance structure is intended to benefit all corporate stakeholders by ensuring that the firm is run lawfully and ethically, following best practices, and subject to all corporate regulations.

A firm's corporate governance is influenced by both internal factors such as the shareholders, Board of directors, and officers as well as external forces such as clients, creditors, suppliers, competitors, and government regulations. The corporate organisation depicted earlier in Figure 1.1 on page 10 helps to shape a firm's corporate governance structure. In particular, the shareholders elect a board of directors, who in turn hire officers or managers to operate the firm in a manner consistent with the goals, plans, and policies established and monitored by the Board on behalf of the shareholders.

Individual versus institutional investors

individual investors investors who own relatively small quantities of shares to meet personal investment goals

institutional investors investment professionals, such as banks, insurance companies, mutual funds, and pension funds, that are paid to manage and hold large quantities of securities on behalf of others

To better understand the role that shareholders play in shaping a firm's corporate governance, it is helpful to differentiate between the two broad classes of owners – individuals and institutions. Generally, **individual investors** own relatively small quantities of shares, and as a result, do not typically have sufficient means to directly influence a firm's corporate governance. To influence the firm, individual investors often find it necessary to act as a group by voting collectively on corporate matters. The most important corporate matter individual investors vote on is the election of the firm's Board of directors. The Corporate Board's first responsibility is to the shareholders. The Board not only sets policies that specify ethical practices and provide for the protection of stakeholder interests, but it also monitors managerial decision-making on behalf of investors.

Although they also benefit from the presence of the Board of directors, institutional investors have advantages over individual investors when it comes to influencing the corporate governance of a firm. **Institutional investors** are investment professionals that are paid to manage and hold large quantities of securities on behalf of individuals, businesses, and governments. Institutional investors include banks, insurance companies, mutual funds, and pension funds.

Unlike individual investors, institutional investors often monitor and directly influence a firm's corporate governance by exerting pressure on management to perform or communicating their concerns to the firm's Board.

These large investors can also threaten to exercise their voting rights or liquidate their holdings if the Board does not respond positively to their concerns. Because individual and institutional investors share the same goal, individual investors benefit from the shareholder activism of institutional investors.

Government regulation

Unlike the impact that clients, creditors, suppliers, or competitors can have on a firm's corporate governance, government regulation generally shapes the corporate governance of all firms. During the past decade, corporate governance has received increased attention due to several high-profile corporate scandals involving abuse of corporate power and, in some cases, alleged criminal activity by corporate officers. The misdeeds derive from two main types of issues: (1) false disclosures in financial reporting and other material information releases, and (2) undisclosed conflicts of interest between companies and their analysts, auditors, and attorneys and between corporate directors, officers, and shareholders.

In South Africa, the Companies Act 71 of 2008 applies to all South African companies. The Act seeks to promote transparency and accountability in the corporate sector and has provisions that ensure these are legally enforceable. Corporate governance is institutionalised through the King Reports on Corporate Governance ('King Codes'). The King Codes are published by the King Committee that was formed under the auspices of the Institute of Directors of Southern Africa in 1992.

The agency issue

The financial manager has to maximise the wealth of the firm's owners. Shareholders give managers decision-making authority over the firm; thus, managers can be viewed as the agents of the firm's shareholders. Technically, any manager who owns less than 100 percent of the firm is an agent acting on behalf of other owners. Refer to the dashed horizontal line in Figure 1.1, which is representative of the classic **principal-agent relationship**, where the shareholders are the principals. In general, a contract is used to specify the terms of a principal-agent relationship. This arrangement works well when the agent makes decisions that are in the principal's best interest but does not work well when the interests of the principal and agent differ.

principal-agent relationship an arrangement in which an agent acts on behalf of a principal. for example, shareholders of a company (principals) elect management (agents) to act on their behalf

In theory, most financial managers would agree with the goal of shareholder wealth maximisation. However, managers are also concerned with their personal wealth, job security, and fringe benefits. Such concerns may cause managers to make decisions that are not consistent with shareholder wealth maximisation. For example, financial managers may be reluctant or unwilling to take more than moderate risk if they perceive that taking too much risk might jeopardise their job or reduce their personal wealth.

The agency problem

An important theme of corporate governance is to ensure the accountability of managers in an organisation through mechanisms that try to reduce or eliminate the principal-agent problem; however, when these mechanisms fail, agency problems arise. **Agency problems** arise when managers deviate from the goal of maximisation of shareholder wealth by placing their personal goals ahead of the goals of shareholders. These problems, in turn, give rise to agency costs. **Agency costs** are costs borne by shareholders due to the presence or avoidance of agency problems, and in either case, represent a loss of shareholder wealth. For example, shareholders incur agency costs when managers fail to make the best investment decision or when managers have to be monitored to ensure that the best investment decision is made because either situation is likely to result in a lower share price.

agency problems problems that arise when managers place personal goals ahead of the goals of shareholders

agency costs costs arising from agency problems that are borne by shareholders and represent a loss of shareholder wealth

incentive plans management compensation plans that tie management compensation to share price; one example involves the granting of share options

share options options extended by the firm that allows management to benefit from increases in share prices over time

performance plans plans that tie management compensation to measures such as eps or growth in eps. *Performance shares* and/or *cash bonuses* are used as compensation under these plans.

performance shares ordinary shares given to management for meeting stated performance goals

cash bonuses cash paid to management for achieving certain performance goals

Management compensation plans

In addition to the roles played by corporate boards, institutional investors, and government regulations, corporate governance can be strengthened by ensuring that managers' interests are aligned with those of shareholders. A common approach is to *structure management compensation* to correspond with firm performance. In addition to combating agency problems, the resulting performance-based compensation packages allow firms to compete for and hire the best managers available. The two key types of managerial compensation plans are incentive plans and performance plans.

Incentive plans tie management compensation to share price. One incentive plan grant **share option** to management. If the firm's share price rises over time, managers will be rewarded by being able to purchase shares at the market price in effect at the time of the grant and then to resell the shares at the prevailing higher market price.

Many firms also offer **performance plans** that tie management compensation to performance measures such as earnings per share (EPS) or growth in EPS. Compensation under these plans is often in the form of performance shares or cash bonuses. **Performance shares** are ordinary shares given to management because of meeting the stated performance goals, whereas **cash bonuses** are cash payments tied to the achievement of certain performance goals.

The execution of many compensation plans has been closely scrutinised, considering the past decade's corporate scandals and financial woes. Both individual and institutional shareholders, as well as the public, continue to publicly question the appropriateness of the multi-million rand compensation packages that many corporate executives receive.

Matter of fact

In South Africa, the remuneration of CEOs has been questioned from several quarters. Gerald Seegers, Head of People and Organisation for PwC Africa, says:

'Executive pay continues to be in the spotlight, with everyone from institutional shareholders, the government, the media and other interested stakeholders, having an opinion on it. One cannot underestimate the value that an effective CEO can add to a company – it is a high-profile position, particularly in a listed environment. Although companies are starting to accept the notion of fair play, more should be done to increase the awareness around fair and responsible remuneration on a national scale.'

The 2019 PwC Report reviewed the executive pay of the top 10 listed companies on the JSE, which account for 62% of the total market capital invested. The median pay for CEOs in 2018 across all sectors was R5,4m (2017: R5,2m). For CFOs, the average was R3,8m (2017: R3,6m) and for executive directors R3,3m (2017: R3,1m).

Top bosses generally received attractive incentives for meeting company goals. Short-term incentives also often referred to as annual incentives are also paid to compensate executives for achieving the short-term business strategy. The intention is to ensure achievement of goals based on KPIs with the directors or management charged with the task of maximising shareholder wealth. There is also an increased focus on aligning companies' environmental, social and governance (ESG) activities with the United Nations Sustainable Development Goals (SDGs). However, South African companies are not yet under any obligation to consider these factors. However, the PwC Report observes pressure from both stakeholders as well as international practice to prioritise ESG factors.

Source: PwC's 11th edition of the Executive directors: Practices and remuneration trends report 2019

Most studies have failed to find a strong relationship between the performance that companies achieve and the compensation that CEOs receive. In South Africa, the 2019 PwC's Executive Directors – Practices and Remuneration Trends Report recommends that CEOs commanding high remuneration should equally back it up by accepting a challenging set of key performance indicators. Furthermore, companies are expected to have contingency plans in place to recover incentives paid to executives who would have overseen large corporate failures. The goal of the King IV Report on Corporate Governance in South Africa is to standardise remuneration disclosure. Research by PwC shows that 83% of the top 40 JSE-listed companies have adopted some form of remuneration disclosure.

The threat of takeover

When a firm's internal corporate governance structure is unable to keep agency problems in check, rival managers will likely try to gain control of the firm. Because agency problems represent a misuse of the firm's resources and impose agency costs on the firm's shareholders, the firm's ordinary shares are generally depressed, making the firm an attractive takeover target. The *threat of takeover* by another firm that believes it can enhance the troubled firm's value by restructuring its management, operations, and financing can provide a strong source of external corporate governance. The constant threat of a takeover tends to motivate management to act in the best interests of the firm's owners. For example, when Cell C, the third largest mobile network operator in South Africa, faced the possibility of a takeover by Telkom in 2019 because of unsustainable debt levels, it restructured its business model for the benefit of shareholders to stave off the takeover bid.

Unconstrained, managers may have other goals in addition to share price maximisation. Still, much of the evidence suggests that share price maximisation – the focus of this book – is the primary goal of most firms.

REVIEW QUESTIONS

1.15 What is *corporate governance*?

1.16 Define *agency problems* and describe how they give rise to *agency costs*. Explain how a firm's *corporate governance structure* can help avoid agency problems.

1.17 How can the firm *structure management compensation* to minimise agency problems? What is the current view with regard to the execution of many compensation plans?

1.18 How do market forces – both shareholder activism and the threat of takeover – act to prevent or minimise the *agency problem*? What role do *institutional investors* play in shareholder activism?

Summary

Focus on value

Chapter 1 established the primary goal of the firm – **to maximise the wealth of the owners for whom the firm is being operated.** For public companies, value at any time is reflected in the share price. Therefore, management should act only on those opportunities that are expected to create value for owners by increasing the share price. Doing this requires management to consider the returns (magnitude and timing of cash flows), the risk of each proposed action, and their combined effect on value.

Review of learning outcomes

LO 1 **Define finance and the managerial finance function.** Finance is the science and art of managing money. It affects virtually all aspects of a business. 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. They perform such varied tasks as developing a financial plan or budget, extending credit to customers, evaluating proposed large expenditures, and raising money to fund the firm's operations.

LO 2

Describe the legal forms of business organisation. The legal forms of business organisation are the sole proprietorship, the partnership, and the company. The company is dominant in terms of business receipts, and its owners are its ordinary and preference shareholders. Shareholders expect to earn a return by receiving dividends or by realising gains through increases in the share price.

LO 3

Describe the goal of the firm and explain why maximising the value of the firm is an appropriate goal for a business. The goal of the firm is to maximise its value and therefore, the wealth of its shareholders. Maximising the value of the firm means running the business in the interest of those who own it – the shareholders. Because shareholders are paid after other stakeholders, it is generally necessary to satisfy the interests of other stakeholders to enrich shareholders.

LO 4

Describe how the managerial finance function is related to economics and accounting. All areas of responsibility within a firm interact with finance personnel and procedures. The financial manager must understand the economic environment and rely heavily on the economic principle of marginal cost-benefit analysis to make financial decisions. Financial managers use accounting but concentrate on cash flows and decision-making.

LO 5

Identify the primary activities of the financial manager. The primary activities of the financial manager, in addition to ongoing involvement in financial analysis and planning, are making investment decisions and making financing decisions.

LO 6

Describe the nature of the principal-agent relationship between the owners and managers of a company and explain how various corporate governance mechanisms attempt to manage agency problems. This separation of owners and managers of the typical firm is representative of the classic principal-agent relationship, where the shareholders are the principals and managers are the agents. This arrangement works well when the agent makes decisions that are in the principal's best interest but can lead to agency problems when the interests of the principal and agent differ. A firm's corporate governance structure is intended to help ensure that managers act in the best interests of the firm's shareholders, and other stakeholders, and it is usually influenced by both internal and external factors.

Opener-in-review

In the chapter opener, you read about the collapse of corporate governance at Eskom. What does this collapse of corporate governance teach us about the agency problem in companies?

Self-test problems (Solutions in Appendix B)

LO 4

ST1-1

Emphasis on cash flows: Bata is a shoe importer located in South Africa that resells its import products to local retailers. Last year Bata imported R25 million worth of shoes from around the world, all of which were paid for before shipping. On receipt of the shoes, the importer immediately resold them to local retailers for R30 million. To allow its retail clients time to resell the shoes, Bata sells to retailers on credit.

Before the end of its business year, Bata collected 85% of its outstanding accounts receivable.

a. What is the accounting profit that Bata generated for the year?
b. Did Bata have a successful year from an accounting perspective?
c. What is the financial cash flow that Bata generated for the year?
d. Did Bata have a successful year from a financial perspective?
e. If the current pattern persists, what is your expectation for the future success of Bata?

Warm-up exercises

LO 2

E1–1

Ann and Jack have been partners for several years. Their firm, A & J Tax Preparation, has been successful, as the pair agrees on most business-related questions. One disagreement, however, concerns the legal form of their business. Ann has tried for the past two years to get Jack to agree to incorporate. She believes that there is no downside to incorporating and sees only benefits. Jack strongly disagrees; he thinks that the business should remain a partnership forever.

First, take Ann's side and explain the positive side of incorporating the business. Next, take Jack's side, and state the advantages to remaining in partnership. Lastly, what information would you need if you were asked to decide for Ann and Jack?

LO 4

E1–2

The end-of-year parties at Jet Stores are known for their extravagance. Management provides the best food and entertainment to thank the employees for their hard work. During the planning for this year's bash, a disagreement broke out between the treasurer's staff and the controller's staff. The treasurer's staff contended that the firm was running low on cash and might have trouble paying its bills over the coming months; they requested that cuts be made to the budget for the party. The controller's staff felt that any cuts were unwarranted as the firm continued to be very profitable.

Can both sides be right? Explain your answer

LO 5

E1–3

You have been made treasurer for a day at DSTV, which is developing technology for video conferencing. A manager of the satellite division has asked you to authorise a capital expenditure in the amount of R100,000. The manager states that this expenditure is necessary to continue a long-running project designed to use satellites to allow video conferencing anywhere on the planet. The manager admits that the satellite concept has been surpassed by recent technological advances in telephony, but he feels that DSTV should continue the project. His reasoning is because R25 million has already been spent over the past 15 years on this project. Although the project has little chance to be viable, the manager believes it would be a shame to waste the money and time already spent.

Use *marginal cost-benefit analysis* to make your decision regarding whether you should authorise the R100,000 expenditure to continue the project.

LO 6

E1–4

Recently, some branches of Taste of Africa Restaurant have dropped the practice of allowing employees to accept tips. Customers who once said, 'Keep the change' now have to get used to waiting for their coins. Management even instituted a policy of requiring that the change be thrown if a customer drives off without it. As a frequent customer who gets coffee and doughnuts for the office, you notice that the lines are longer and that more mistakes are being made in your order.

Explain why tips could be viewed as similar to share options and why the delays and incorrect orders could represent a case of *agency costs*. If tips are gone forever, how could Taste of Africa Restaurant reduce these agency costs?

Problems

LO 2

P1–1

Liability comparisons: Nisha Patel has invested R250,000 in Patel Family Bazaars. The firm has recently declared bankruptcy and has R600,000 in unpaid debts. Explain the nature of payments, if any, by Ms Patel in each of the following situations.

a. Patel Family Bazaars is a *sole proprietorship* owned by Ms Patel.

b. Patel Family Bazaars is a 50-50 *partnership* of Ms Patel and Christopher Black.

c. Patel Family Bazaars is a *corporation*.

LO 4

P1–2

Accrual income versus cash flow for a period: Van Schaik Bookstore supplies textbooks to college and university bookstores. The books are shipped with a proviso that they must be paid for within 30 days but can be returned for a full refund credit within 90 days. In 2021, Van Schaik shipped and billed book titles totalling R7,600,000. Collections, net of return credits, during the year totalled R6,900,000. The company spent R3,000,000 acquiring the books that it shipped.

a. Using accrual accounting and the preceding values show the firm's net profit for the past year.

b. Using cash accounting and the preceding values show the firm's net cash flow for the past year.

c. Which of these statements is more useful to the financial manager? Why?

Personal finance problems

LO 4

P1–3

Cash flows: It is typical for Jane to plan, monitor, and assess her financial position using cash flows over a given period, typically a month. Jane has a savings account and her bank loans money at 6% per year while it offers short-term investment rates of 5%. Jane's cash flows during August were as follows:

Item	Cash inflow	Cash outflow
Clothes		R10,000
Interest received	R4,500	
Dining out		5,000
Groceries		8,000
Salary	45,000	
Car payment		3,500
Utilities		2,800
Mortgage		12,000
Fuel		2,220

a. Determine Jane's total cash inflows and cash outflows.

b. Determine the *net cash flow* for August.

c. If there is a shortage, what are a few options open to Jane?

d. If there is a surplus, what would be a prudent strategy for her to follow?

LO 3 LO 5

P1–4

Marginal cost-benefit analysis and the goal of the firm: Karabo Mabaso capital budgeting analyst for Silver Lakes Motors has been asked to evaluate a proposal. The manager of the automotive division believes that replacing the robotics used on the heavy truck gear line will produce total benefits of R5,600,000 (in today's rands over the next five years. The existing robotics would produce benefits of R4,000,000 (also in today's rands) over that same period. An initial cash investment of R2,200,000 would be required to install the new equipment. The manager estimates that the existing robotics can be sold for R700,000. Show how Karabo will apply *marginal cost-benefit analysis* techniques to determine the following:

a. The marginal (added) benefits of the proposed new robotics.
b. The marginal (added) cost of the proposed new robotics.
c. The net benefit of the proposed new robotics.
d. What should Karabo recommend that the company do? Why?
e. What factors besides the costs and benefits should be considered before the final decision is made?

LO 6

P1–5

Identifying agency problems, costs, and resolutions: Explain why each of the following situations is an agency problem and what costs to the firm might result from it. Suggest how the problem might be dealt with short of firing the individual(s) involved.

a. The front desk receptionist routinely takes an extra 20 minutes of lunchtime to run personal errands.
b. Division managers are padding cost estimates to show short-term efficiency gains when the costs come in lower than the estimates.
c. The firm's chief executive officer has had secret talks with a competitor about the possibility of a merger in which she would become the CEO of the combined firms.
d. A branch manager lays off experienced full-time employees and staffs customer service positions with part-time or temporary workers to lower employment costs and raise this year's branch profit. The manager's bonus is based on profitability.

Ethics problem

LO 3

P1–6

What does it mean to say that managers should maximise shareholder wealth 'subject to ethical constraints'? What ethical considerations might enter decisions that result in cash flow and share price effects that are less than they might otherwise have been?

Spreadsheet exercise

Assume that Van Dyck Carpets (Pty) Ltd is considering the renovation and/or replacement of some of its older and out-dated carpet-manufacturing equipment. Its objective is to improve the efficiency of operations in terms of both speed and reduction in the number of defects. The company's finance department has compiled pertinent data that will allow it to conduct a *marginal cost-benefit analysis* for the proposed equipment replacement.

The cash outlay for new equipment would be approximately R6,000,000. The net book value of the old equipment and its potential net selling price add up to R2,500,000. The total benefits from the new equipment (measured in today's rands) would be R9,000,000. The benefits of the old equipment over a similar period (measured in today's rands) would be R3,000,000.

To do

Create a spreadsheet to conduct a *marginal cost-benefit analysis* for Van Dyck Carpets (Pty) Ltd, and determine the following:

a. The marginal (added) benefits of the proposed new equipment.
b. The marginal (added) cost of the proposed new equipment.
c. The net benefit of the proposed new equipment.
d. What would you recommend that the firm do? Why?

CHAPTER 1 CASE STUDY

Management remuneration and financial performance of JSE firms

Extract from: Elize Kirsten and Elda du Toit (2018), 'The relationship between remuneration and financial performance for companies listed on the Johannesburg Stock Exchange', *South African Journal of Economic and Management Sciences*, Volume 21. Issue. pp. 1–10.

'The executive directors of a company are the agents of the shareholders and should manage the company in the best interest of the shareholders, not only for personal gain. It is therefore important for companies to ensure that they implement remuneration policies which will result in motivated employees who will execute decisions and actions which are in the best interest of the shareholders. However, it is widely acknowledged that the relationship between company performance and executive remuneration is weak. This implies that executives are still rewarded excessive remuneration regardless of the performance of their companies'.

Having stated the preceding background, Kirsten and du Toit (2018) conducted a study to determine whether a relationship exists between the performance-based remuneration of executive directors and the financial performance of South African companies. Their study focused on consumer goods and services companies listed on the Johannesburg Stock Exchange (JSE). The results of their study found that the remuneration policies for executive directors have a direct relationship with the share price of the company rather than profitability or size. They concluded that the link between executive director remuneration and share performance might be an indication that remuneration policies are based on the share price and are thus directly connected to the principle of shareholder wealth maximisation.

To do

a. Is the goal of profit maximisation synonymous with the goal of wealth maximisation?
b. What goal do you think management should pursue, and why?
c. What goal do shareholders want management to pursue, and why?
d. What agency problems could be arising from the actions of management if they are pursuing the profit maximisation goal?
e. Recommend actions that should be taken to align management interests with those of shareholders.