Chapter 1

The Financial Environment: Firms, Investors, and Markets

**Learning Goals**

LG1 Define the term finance and explain why finance is relevant to students.

LG2 Identify the components of the financial environment.

LG3 Explain how investors monitor managers to ensure that managerial decisions are in the best interests of the owners.

LG4 Describe how the financial environment has become internationalized.
finance
The processes by which money is transferred among businesses, individuals, and governments.

What Is Finance?

Virtually all individuals and organizations earn or raise money and spend or invest money. **Finance** is the processes by which money is transferred (financing and investing) among businesses, individuals, and governments.

The activities involved in the field of finance are evident in the financial news that is reported on television shows such as *Money Line* and in business periodicals such as the *Wall Street Journal*. Every day, financial decisions made within firms result in financial actions, such as those listed here, which were taken from the financial news:

- Dell Computer expands its product line.
- The Gap builds additional stores.
- Nike closes a production plant in Asia.
- Du Pont restructures its chemicals business.
- Ford Motor Co. borrows $3 billion.
- Motorola acquires a company in Japan.
- Perot Systems issues stock valued at $3 billion.

Note that each action reflects a decision on either how to invest funds or how to obtain funds.

These financial actions are important not only to the firms involved but also to both existing and prospective investors in the firm. Financial decisions influence the value of the firm as reflected in its stock price, which affects how much investors earn on their investments in the firm. Thus many financial news headlines focus on the impact of a financial event on the firm’s stock price:

- The stock price of Perot Systems rises by 50 percent within 2 days of its stock offering.
- Nike’s stock price declines by 5 percent as a result of poor performance.
- Apple Computer’s stock price declines by 12 percent as executives resign.
- The price of Comp USA stock increases by 30 percent on news that it is being acquired.

The field of finance also involves the conditions of the financial markets in which firms compete for investors and financing. Some of the more common types of financial news headlines are related to financial markets:

- The yields offered on bonds decline in response to a decision announced by the Federal Reserve.
- U.S. stock market prices decline as a result of concerns about the economy.
- U.S. interest rates rise in response to inflation fears.
- The dollar’s value declines against most major currencies as U.S. investors invest more money abroad.

The Relevance of Finance

The wide range of events just cited reflects the breadth of finance. This book discusses finance from two primary perspectives: the manager’s perspective and the investor’s perspective. It also illustrates how financial markets and institutions
facilitate finance activities of both managers and investors. Thus this text is relevant to students who plan to pursue a career as a financial manager of a firm, at a financial institution, or at a business that deals with financial institutions and markets. It is also relevant to those who pursue nonfinancial positions but need to understand how finance is related to their job functions.

An understanding of finance not only prepares students for careers but also equips them to make decisions as investors. Regardless of how much you have to invest, finance can help you decide whether to invest your money, what type of financial instrument to invest in, how much money should be invested, and how invested funds should be allocated among different investments.

**Review Question**

1-1 Why is finance relevant to you as a student?

## Components of the Financial Environment

The financial environment is composed of three key components: (1) financial managers, (2) financial markets, and (3) investors (including creditors). This book discusses each of these components in detail and illustrates how they are integrated. This chapter introduces each component and briefly explains how the components are related. Thus this chapter provides an overview of the text.

### Financial Managers

Financial managers are responsible for deciding how to invest a company’s funds to expand its business and how to obtain funds (financing). The actions taken by financial managers to make financial decisions for their respective firms are referred to as financial management (or managerial finance).

Financial managers are expected to make financial decisions that will maximize the firm’s value and therefore maximize the value of the firm’s stock price. They are usually compensated in a manner that encourages them to achieve this objective.

Some more common career opportunities for financial managers are shown in Table 1.1. This table summarizes the different types of duties that financial managers perform. When a firm is initially established, one person may perform all managerial finance duties. However, as the firm grows, financial managers are hired to specialize in particular managerial finance duties. In larger firms, financial managers direct and manage departments of staff analysts who do the day-to-day analysis.

In larger firms, financial managers fit within the firm’s organizational structure as shown in Figure 1.1. The key financial decisions of a firm are commonly made by or under the supervision of the chief financial officer (CFO), who typically reports directly to the chief executive officer (CEO). The lower portion of the organizational chart in Figure 1.1 shows the structure of the finance
function in a typical medium-size to large firm, where the treasurer and the controller report to the CFO. The treasurer is commonly responsible for handling financial activities, such as obtaining funds, making capital expenditure decisions, and managing cash. The controller typically handles the accounting activities, such as corporate accounting, tax management, and financial and cost accounting.

Interaction Between Financial Management and Other Business Functions

Most firms required financing when they were first established, but the firm’s finance function is not limited to this initial financing. Rather, the firm’s finance function is conducted continuously and is integrated with other business functions, as illustrated in Figure 1.2. For larger firms, each function may be handled separately by a specific department.

Firms engage in a production function to produce products (including services), and they incur costs from the production function. They engage in a marketing function to forecast sales, promote the products, and distribute them. Because firms frequently incur costs from the production and marketing functions before receiving revenue for the products produced, they may also need to obtain financing. The amount of financing and the time period for which financing is needed depends on information drawn from the production and the marketing functions. Such information includes, for production, the amount of machinery and materials that must be purchased in the near future and, for marketing, the amount of expenses to be incurred from advertising.

Firms rely on information systems to ensure that information flows between the finance function and the other business functions. Firms perform an account-
The finance function that uses information to prepare financial statements on a periodic (such as quarterly) basis, to prepare and file tax returns, and to provide information and reports to other managers. The finance function analyzes these statements to assess the firm’s past performance and to make financing and investing decisions consistent with the firm’s plans and goals.

**Investment Decisions by Financial Managers**

Financial managers assess potential investment opportunities for the firm in order to determine whether to pursue those opportunities. The investment decisions of financial managers significantly affect the firm’s degree of success, because they determine what types of businesses their respective firms engage in. Investment decisions determine the composition of assets found on the left-hand side of the balance sheet: The financial manager attempts to maintain optimal levels of each type of current asset, such as cash and inventory. The financial manager also decides which fixed assets (such as buildings or machinery) to invest in and when existing fixed assets need to be modified, replaced, or liquidated. These decisions are important because they affect the firm’s success in achieving its goals.
The investments made by the firm are intended to generate cash flows that provide a return on the investments. That is, the firm expects to receive back more from an investment than the amount initially put in. However, these investments are subject to risk, or the uncertainty about the return. For example, when Wal-Mart establishes a new store, its forecast of the future cash flows that will be generated may be overly optimistic, in which the return on the investment may be well below the forecast.

**Financing Decisions by Financial Managers**

When firms obtain funds, their financing can be classified as either debt financing or equity financing. In **debt financing**, borrowed funds are used to finance investments in projects. For example, firms can obtain loans or can issue **debt securities**, which are certificates representing credit provided to the firm by the security’s purchaser. In **equity financing**, funds are obtained in exchange for ownership in the firm and used to finance investments in projects. Firms can obtain equity financing either by retaining some of their earnings or by issuing **equity securities** (stocks), which are certificates representing ownership interest in the issuing firm.

Financing decisions focus on the right-hand side of the firm’s balance sheet and involve two major areas. First, levels of short-term and long-term financing must be established. A second and equally important concern is determining the optimal sources of financing at a given point in time. Many financing decisions are dictated by necessity, but some require in-depth analysis of the financing alternatives, their costs, and their long-run implications.

**debt financing**
The use of borrowed funds to finance investments.

**debt securities**
Certificates representing credit provided to the firm by the security’s purchaser.

**equity financing**
The use of funds obtained in exchange for ownership in the firm to finance investments.

**equity securities**
Stocks; certificates representing ownership interest in a firm.
Investors are individuals or financial institutions that provide funds to firms, government agencies, or individuals who need funds. In this book, our focus regarding investors is on their provision of funds to firms. Individual investors commonly provide funds to firms by purchasing their securities (stocks and debt securities). The financial institutions that provide funds are referred to as institutional investors. Some of these institutions focus on providing loans, whereas others commonly purchase securities that are issued by firms.

Debt Financing Provided by Investors

Debt financing to firms is provided in various forms by individual and institutional investors. Financial institutions that provide loans employ loan officers, who evaluate the financial condition of potential borrowers to determine whether they are creditworthy. When the financial institutions provide loans, they receive periodic interest payments on the loans as compensation from borrowers. The debt has a specified maturity date at which the amount borrowed, which is called the principal, is repaid.

In another form of debt financing, individual investors and financial institutions purchase debt securities that are issued by firms and governments. They may be compensated by purchasing a debt security at a discount from its principal value, so that the principal they are repaid at maturity exceeds the amount they paid for the debt security. Alternatively, they may be compensated with periodic interest payments. If they desire, investors can sell to other investors most types of debt securities before their maturity, which transfers the loan to the other investors (lenders).

Equity Financing Provided by Investors

Equity financing is obtained when a firm sells shares of stock (ownership) to investors. Because a firm’s ownership is represented by its stock, each investor who purchases stock becomes an owner of the firm. There is no maturity on stock; however, investors can sell the stock they own to other investors. The sale of stock results in the transfer of ownership. Investors who purchase a firm’s stock expect to be compensated by the return on the stock, which results from dividends they receive and from any increase in the value (price) of the stock.

Return and Risk from Investing

Whether investors provide debt or equity financing, they expect to earn a return on their investment in exchange for allowing a firm to use their funds. In general, the return on any investment is the actual benefit (cash flow) that would be received if the investment were purchased at the start of a period and sold at the end of that period. The return to investors who provide funds to a firm can be highly dependent on decisions of the firm’s financial managers. For example, if financial managers use funds received from investors to invest in very profitable projects, the firm earns a high return on its investments.
shareholders who invested in the firm’s stock earn a high return on their investment in the firm. Conversely, bad investment decisions by a firm’s financial managers result in poor returns on the firm’s investments and, accordingly, poor returns to the shareholders who invested in the firm’s stock. A return is sometimes measured as a percentage of the amount initially invested.

All investors are exposed to risk, or the uncertainty surrounding the return on their investments. They are risk-averse, which implies that they prefer less risk for a given expected return. When investors provide debt financing, there is default risk, or the possibility that the firm that borrowed funds will be unable to make scheduled interest payments or repay the principal on the loan. When investors provide equity financing, they are exposed to the risk that the return on their investment will be lower than expected. This may occur if the firm performs worse than expected and cannot pay out the expected dividends, or if its stock price does not rise to the level expected.

**Investor Use of Financial Services**

When deciding how they should invest their funds, investors commonly utilize financial services (such as financial planning and insurance services provided by financial institutions). Thus financial services can affect the volume and the nature of the funds that flow from individual investors to financial institutions and therefore to firms that need financing.

**Financial Markets**

*Financial markets* represent forums that facilitate the flow of funds among investors, firms, and government units and agencies. Each financial market is served by financial institutions that act as intermediaries. The equity market facilitates the sale of equity by firms to investors or between investors. Some financial institutions serve as intermediaries by executing transactions between willing buyers and sellers of stock at agreed-upon prices. The debt markets enable firms to obtain debt financing from institutional and individual investors or to transfer ownership of debt securities between investors. Some financial institutions serve as intermediaries by facilitating the exchange of funds in return for debt securities at an agreed-upon price. Thus it is quite common for one financial institution to act as the institutional investor while another financial institution serves as the intermediary by executing the transaction that transfers funds to a firm that needs financing. For example, Merrill Lynch (a financial institution) serves as an intermediary in an offering of new shares by Intel (a firm in need of financing) by selling these shares to investors, including the California Public Employees Retirement Fund (a financial institution).

**Careers of Participants in Financial Markets**

The career opportunities within the financial markets are summarized in Table 1.2. Most of these careers play a role in facilitating the flow of funds within the financial markets.
Integration of Components in the Financial Environment

The integration of components that exist within the financial environment will be explained throughout the text. Figure 1.3 offers a brief overview of that integration. When a firm’s financial managers determine whether to use debt or equity financing, they rely on investors to supply those funds through the financial markets. For example, the investment decision by Dell Computer to expand its product line or by The Gap to establish additional stores that require external financing will result in the firm’s obtaining funds from individual and institutional investors.

Financial managers and investors face similar types of investment decisions. They must decide what to invest in, how much to invest, and the length of the investment period. However, the typical types of investments made by financial managers are distinctly different from the types of investment decisions made by investors. The investment decisions of financial managers commonly focus on real assets such as buildings, machinery, and office equipment; the investment decisions of investors focus on financial assets, which include securities such as bonds and stocks.

Note in Figure 1.3 that the investment decisions of financial managers and investors are related. The investment decisions made by the firm’s financial managers dictate how much funds the firm needs to invest in its businesses. That is, the investment decisions determine the amount of funds that the firm will obtain from investors. The firm issues financial assets (securities) in order to obtain funds, which are used by the firm’s financial managers to invest in real assets.

**TABLE 1.2 Career Opportunities in Financial Markets**

<table>
<thead>
<tr>
<th>Career</th>
<th>Career opportunities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking and related institutions</td>
<td>Loan officers evaluate and make recommendations on various types of loans. Retail bank managers run bank offices and supervise the programs offered by the bank. Trust officers administer trust funds for estates, foundations, and business firms.</td>
</tr>
<tr>
<td>Personal financial planning</td>
<td>Financial planners advise individuals on all aspects of their personal finances and help them develop comprehensive financial plans to meet their objectives.</td>
</tr>
<tr>
<td>Real estate</td>
<td>Real estate agents/brokers negotiate the sale or lease of residential and commercial property. Appraisers estimate the market values of all types of property. Real estate lenders analyze and make decisions with regard to loan applications. Mortgage bankers find and arrange financing for real estate projects. Property managers handle the day-to-day operations of properties to achieve maximum returns for their owners.</td>
</tr>
<tr>
<td>Insurance</td>
<td>Insurance agents/brokers sell insurance policies to meet clients’ needs and assist in claims processing and settlement. Underwriters appraise and select the risks that their company will insure and set the associated premiums.</td>
</tr>
<tr>
<td>Investments</td>
<td>Stockbrokers, or account executives, assist clients in choosing, buying, and selling securities. Securities analysts study stocks and bonds and advise securities firms and insurance companies with regard to them. Portfolio managers build and manage portfolios of securities for firms and individuals. Investment bankers provide advice to security issuers and act as intermediaries between issuers and purchasers of newly issued stocks and bonds.</td>
</tr>
</tbody>
</table>

real assets
Resources such as buildings, machinery, and office equipment.

financial assets
Resources such as bonds and stocks.
**Review Questions**

1-2 How is the finance function related to the marketing and production functions?

1-3 What is the difference between debt financing and equity financing?

1-4 How do investors benefit from investing in a firm?

**Investor Monitoring of Firms**

Like firms, investors attempt to make decisions that will enhance their stream of expected future cash flows. Investors’ cash outflows result from purchases of stocks (and other investment vehicles), so they would like to purchase their investments at relatively low prices. Thus, if investors believe a firm’s stock price may decline and later rise, they may wait until the price declines before buying the stock. Their cash inflows from owning stock result from dividends and from the proceeds from selling the stock. Thus they prefer to sell stock when share prices are high. To make decisions about when to buy and when to sell any investment, investors need information.

**Using Information to Value the Firm**

The value of a publicly traded stock changes every day in response to changes in the demand for and the supply of shares (for sale by investors who own the...
Investors monitor the firms in which they are invested or plan to invest, so that they can properly "value" these firms to determine whether to buy or sell the firm's stock. When favorable information about a particular firm's future cash flows (and therefore about its future performance) is disclosed to the market, investors value the firm more highly. The demand for the firm's stock at the prevailing price tends to increase, and the supply of the firm's stock for sale declines. At the prevailing stock price, the quantity of the shares demanded exceeds the quantity of the shares that investors are willing to sell. These forces result in a higher equilibrium price (at which the quantity demanded equals the quantity supplied) per share of the firm's stock.

Conversely, unfavorable information about a particular firm's future cash flows causes investors to revalue that firm downward. The demand for the firm's stock decreases, and the supply of the firm's stock for sale increases, resulting in a surplus of stock for sale at the prevailing price. These forces result in a lower equilibrium price per share of stock.

A firm's stock price can change continuously throughout the day, even though new information about the firm is not disclosed that frequently. Why?
Because the firm’s value is influenced not only by firm-specific information but also by external information concerned with economic and political events that may affect the firm’s cash flows.

**How Investors Influence a Firm’s Value**

The return that investors earn on their equity investment in a firm depends on how the firm’s value changes during the time they hold the stock. Because investors realize that managers make decisions that affect the firm’s cash flows and therefore its value, they attempt to ensure that managers’ actions will maximize the value of the firm. Three of the more common methods used by investors to influence management actions are (1) investor trading, (2) shareholder activism, and (3) threat of takeover.

**Investor Trading**

Investors rely on information to forecast the future cash flows (and therefore performance) of firms in which they invest. If the future performance is expected to be weak, investors may sell their shares of the firm’s stock, which places downward pressure on the firm’s stock price. In this way, investors penalize the firm for its behavior. Any managers of the firm whose compensation is tied to the firm’s stock price will be directly penalized if the stock price declines. In addition, the board of directors, which is supposed to serve shareholders, may enact change if the firm’s executives are not running the firm properly.

Conversely, if the future performance of a firm is expected to be strong as a result of managerial actions, some investors will attempt to buy more shares of the firm’s stock, which places upward pressure on its price. In this way, investors reward the firm for its behavior. Those managers of the firm whose compensation is tied to the firm’s stock price will be directly rewarded if the stock price increases.

**Shareholder Activism**

Alternatively, shareholders may attempt to influence the decisions of the firms in which they are invested, in order to align the firm’s actions more closely with their financial interests. This effort is commonly referred to as shareholder activism. In particular, when institutional investors hold large blocks of the firm’s outstanding shares, they can try to use their voting power to influence, and often change, the firm’s management and/or board of directors. They may also sue the board of directors if they believe it is not acting in the shareholders’ best interests.

In 1955, institutional investors held only about 10 percent of the total stocks (in terms of value) in the United States. Today, institutional investors hold more than 50 percent of the total. Thus institutional investors now have much more power to ensure that managers act in the interests of shareholders. The proportional increase in institutional ownership has significantly increased activism.
**Example** Wilmington Inc. is a financial institution that presently holds 2 million shares of stock of Lexo Co. The portfolio managers of Wilmington Inc. believed that Lexo Co. had much potential when they purchased the stock 3 years ago, but Lexo has performed poorly over this period. Last year, the portfolio managers told Lexo’s board of directors that unless Lexo’s performance improved, Wilmington might sell all the Lexo stock it owns.

Lexo’s board of directors responded by pressuring the executives of Lexo to implement changes that increased the firm’s efficiency. These changes resulted in improved performance, and the stock price increased by $3 per share. Because Wilmington holds 2 million shares, it gained $6 million as a result of exerting its influence on Lexo Co. If Wilmington Inc. had held a much smaller number of shares (as most individual investors do), it would not have been able to influence Lexo’s board of directors.

**Threat of Takeover**

If a firm’s managers do not act to maximize the value of the firm, some investors may consider acquiring enough of the firm’s stock to gain control of it. They then may restructure the firm in order to better achieve the shareholders’ goal to maximize the share price. The incentive for such an effort is the potential reward from buying stock at a low price (when the firm is undervalued as a consequence of poor management) and then taking actions that cause the price to rise.

**Example** Oregon Co. experienced poor performance in the last 3 years because of poor management, and its stock price declined from $40 to $15 per share over this period. Some institutional investors believed that the firm had excellent potential and that they could improve the firm if they could acquire enough shares to take control. These investors used some of their own money, along with borrowed funds, to acquire the needed shares. They then restructured the firm by firing the inefficient managers and replacing them. Once the better managers improve the firm’s performance, the institutional investors could profit from selling some or all of their shares at a much higher price than the price they paid for them.

In many takeovers, some of the managers of the firm serve as the investors who take control of the firm. They have a vested interest in ensuring that the firm performs well once they become owners, because their investment is at stake. In other cases, managers may not be able to purchase underperforming firms, because the amount of funds needed to gain control of the firm is too large. Under these circumstances, another firm (perhaps a competitor) may serve as the investor and purchase a sufficient proportion of the firm’s shares to gain control. Regardless of whether a firm might be acquired by some of its managers or by another firm, the threat of a takeover should give the firm’s managers an incentive to perform well, because a takeover may result in the elimination of their jobs.
Effects of Asymmetric Information

Investors monitor firms by reviewing the financial statements that firms must provide to their shareholders on a periodic basis. They also rely on firm-specific information provided by various third-party information services (such as Moody’s and Standard and Poor’s) that have more experience in obtaining, summarizing, and analyzing the most relevant public information. They also may periodically meet with managers, and therefore have more detailed information about firms than other investors.

Monitoring the firm’s actions can be difficult for investors, because the amount of information provided within financial statements is limited. A firm may experience problems that cannot be discerned in its published financial statements. This situation results from asymmetric information, whereby more information is available to the firm’s managers than to its investors. Because a firm’s stock price responds to new information, investors prefer that any asymmetric information be eliminated or reduced so that they can better monitor firms over time and make more informed investment decisions. Some firms are more willing than others to disclose relevant information to investors. Thus the degree of asymmetric information varies among firms.

Example

Consider firms called Full-Info Co. and Limited-Info Co. that had the same historical and potential financial performance. Assume that Full-Info Co. discloses all information that its financial managers have about its future expansion plans. Conversely, Limited-Info Co. shares only the financial information that accounting standards require it to disclose. Limited-Info Co. therefore has a much higher degree of asymmetric information. Consequently, investors who monitor Limited-Info Co. are likely to develop less accurate expectations of its future performance. In general, the higher degree of asymmetric information results in greater uncertainty about the value of Limited-Info Co.’s stock.

Some institutional investors subscribe to proprietary services that provide assessments of firms, whereas other institutional investors have an in-house service. These services may reduce the degree of asymmetric information and therefore give institutional investors an advantage over individual investors. For this reason, some individual investors prefer to allow specific institutional investors (such as full-service brokers) to make their investment decisions for them. Yet even those individual investors should attempt to monitor the firms in which they have invested so that they can assess whether the investment advice they receive is reasonable. In essence, individual investors who pay for advice (in the form of higher commissions on transactions or in other ways) must ensure that their advisors are serving their best interests.

Review Questions

1-5 Why do investors closely monitor a firm’s financial decisions?
1-6 How does new information affect a firm’s stock price?
1-7 How can shareholder activism influence management actions?
1-8 Why is there asymmetric information between a firm’s managers and its investors?
In response to a lowering of various international barriers, financial managers and investors commonly pursue investment opportunities in foreign countries. For example, many firms pursue international business by exporting, in which they transport products to customers in other countries. They also engage in importing, in which they purchase supplies or materials from firms in other countries. Some firms with substantial sales of products in a particular foreign country invest funds to establish production facilities in that country. Such direct foreign investment is especially common in countries with low labor costs. Some U.S. firms, such as Coca-Cola and Exxon, now generate more than half of their total sales from foreign countries as a result of exports and direct foreign investment.

**Risks of International Business**

Firms that pursue international business opportunities are exposed to additional forms of risk that are not normally considered when the focus is on domestic business. International businesses can be exposed to exchange rate risk, which represents the risk that their cash flows will be adversely affected by movements in the price of one currency in relation to another. If a U.S. firm receives a foreign currency that depreciates (weakens) against the U.S. dollar, the dollar cash inflows resulting from this business will be reduced. In addition, if the firm must make payment in a foreign currency that appreciates (strengthens) against the U.S. dollar by the time payment is due, it will be forced to increase its dollar cash outflows. Firms that conduct international business are exposed to other risks as well, such as the risk that the government of the foreign country will impose some restrictions that adversely affect the firm’s cash flows.

**International Finance by Investors**

Just as U.S. firms can attempt to capitalize on foreign business opportunities by engaging in international business, U.S. investors can invest in securities issued by foreign firms. The Internet and other means of global communication are making it easier for investors to obtain information about firms in many other countries.

Some foreign securities are desirable because they may possibly offer a higher return to U.S. investors than any U.S. stocks, but they can cause exposure to exchange rate risk. For example, U.S. investors who invest in a Canadian stock receive dividends in Canadian dollars, which must be converted to U.S. dollars at the prevailing exchange rate. If the value of the Canadian dollar depreciates against the U.S. dollar over the investment horizon, the return to U.S. investors will be reduced. Conversely, these U.S. investors benefit from appreciation of the Canadian dollar.
Review Questions

1–9 Why do firms engage in direct foreign investment?
1–10 How is a firm’s cash flow exposed to exchange rate risk?

Using This Textbook

In this textbook we will focus on three key components of finance: financial managers, financial markets, and investors. As you’ve seen in this chapter, these components play critical roles in finance.

Financial managers: Obtain funds for their firms (arrange financing) and invest the firm’s funds.

Financial markets: Facilitate the flow of funds between investors and firms.

Investors: Provide debt financing and equity financing to firms in pursuit of their own personal financial goals.

The activities of financial managers and investors, and the role of financial markets in channeling funds from investors to firms, are described in this book, which is divided into five parts:

Part 1 The Financial Marketplace
Part 2 Financial Tools for Firms and Investors
Part 3 Financial Management
Part 4 Investment Management
Part 5 How Investors Monitor and Control a Firm’s Managers

Coverage of international events and topics is integrated into the discussions throughout the book.

As you study this book, you will observe that each chapter is organized and developed around a group of learning goals. The numbered learning goals listed at the beginning of each chapter are tied to text sections in the chapter and also to end-of-chapter materials (chapter summaries, questions, and problems). At periodic intervals in each chapter (usually before major section headings) review questions test your understanding of the material just presented. For best results in learning the text material, take a few moments to stop and consider the review questions. Think about what you’ve just read. (If you’re shaky on any of the topics, be honest enough with yourself to go back and reread the material.) If you’re able to answer the review questions, you’ll be well on your way toward mastering the chapter’s learning goals. Mastery of these goals will result in a broad understanding of the concepts, techniques, and practices of finance.
Define the term finance and explain why finance is relevant to students. Finance is the processes by which money is transferred among businesses, individuals, and governments. Virtually all individuals and organizations earn or raise money and spend or invest money.

An understanding of finance can prepare students for careers in managerial finance or in other areas of business, including work in financial institutions or in financial markets. It can also equip students to decide what types of investments to invest in, which securities to invest in, and how much to invest.

Identify the components of the financial environment. The components are (1) financial managers, who are responsible for investment decisions and financing decisions, (2) investors, who supply the funds to firms that need funding, and (3) financial markets, which facilitate the flow of funds from investors to financial managers.

Explain how investors monitor managers to ensure that managerial decisions are in the best interests of the owners. Investors buy and sell the firm’s stock, an activity that determines the equilibrium price of the stock. If the managers make poor decisions inconsistent with maximizing the value of the stock, the investors will sell the stock, placing downward pressure on its price. To the extent that managers’ compensation levels are tied to the price of the stock, they are penalized when they do not focus on satisfying owners. In addition, investors can initiate various forms of shareholder activism. Some investors may even consider acquiring enough shares to take control of the firm.

Describe how the financial environment has become internationalized. The international financial environment provides additional investment opportunities for firms and investors, which may allow them to improve their stream of cash flows. However, the international environment can also cause future cash flows to be subject to more uncertainty because of currency exchange rate risk and other factors specific to foreign countries.
SELF-TEST EXERCISES

(Solutions in Appendix B)

ST 1-1 What are the key components of the financial environment, and how are these components integrated in a business environment?

ST 1-2 Discuss the three common methods used by investors to influence management to act in their interest.

EXERCISES

1-1 Why is knowledge of finance important even to students in other business disciplines?

1-2 Explain the role of the financial manager in the firm.

1-3 Discuss the alternative sources of financing for a firm.

1-4 How are investment decisions of financial managers different from those of individual investors?

1-5 What factors can influence the equilibrium price of a firm’s stock?

1-6 How does favorable (or unfavorable) information relating to a firm’s future cash flows affect the equilibrium price of its stock?

1-7 Explain why investors would want to monitor the activities of managers in a corporation.

1-8 What other methods do investors have to motivate management to act in their interest?

1-9 Agency issues In each of the following examples, identify possible conflicts of interest between management and shareholders.

a. Keirestus in Japan are large groups of companies affiliated through (1) close business ties, (2) cross-holdings of shares between and among companies within the group, and (3) reliance on financing from each other or from a main partner in the group.

b. Nightlight Inc., a maker of security lights, is owned by Dan Druther, who has members of his own family in key positions in the company. All other management positions are held by employees who own no share in the company. Dan is involved in the day-to-day operations of the company and makes all important decisions, although he solicits input from trusted employees in the company.

c. Corporations in some developing countries are required to disclose only scant information on their operations and earnings once a year. Whether to make detailed disclosures is left to the discretion of each company. Members of the board are appointed by the company’s chief executive officer.

d. Companies in Pandemonia are owned by thousands of shareholders all of whom own the same number of shares as a result of government policies to
“spread the wealth around.” Further, government policies consider the
takeover of companies as a capitalist tool, and members of the management
team are appointed because they are firm supporters of government policies
and are political members of the ruling party.

1-10 What is asymmetric information and how does it affect investors’ ability to
monitor the firm? Does the situation change in the presence of institutional
investors?

1-11 Should managers in firms disclose all information to the investing public? Can
you suggest a situation in which it is prudent for a manager to withhold some
information from the public?

1-12 What is the primary source of risks for firms operating abroad? Can you identify
other sources of risks?

1-13 Identify the benefits to an individual investor in a foreign country. What are the
risks of such an investment?

For a listing of jobs in the financial industry, go to www.monster.com. From the monster.com
home page, click on Search Jobs. On the Search Jobs screen, you can select the job location
you want and then select the job category Finance/Economics. Click on the Search Jobs box.
You can also post your résumé; research companies; tap into a career resource that offers help
with interviewing, networking, and writing résumés; and chat online to share questions and
concerns.

For other job sites, you can go to:
www.careermosaic.com
www.occ.treas.gov/
www.msn.com/

For additional practice with concepts from this chapter, visit
http://www.awl.com/gitman_madura