IN THIS CHAPTER

- Understanding the meaning of money
- Looking at the study of corporate finance
- Seeing the role corporate finance plays in your life
- Making corporate finance work for you

Chapter 1

The Tale of Corporate Finance

Corporate finance is more than just a measure of money. As you see in this chapter, money is incidental to finance. When discussing corporate finance, we are actually looking at the entire world in a new way — a way that measures the entire universe and the things within it in a way that makes it useful to us. We can calculate things in terms of corporate finance that simply can't be accurately measured in any other way. Throughout this chapter we talk about the nature of money and how it applies to corporate finance.

Telling a Story with Numbers

Corporate finance is the study of relationships between groups of people that quantifies the otherwise immeasurable. To understand how this definition makes any sense at all, first you have to take a quick look at the role of money in the world.

According to Adam Smith, an 18th century economist, the use of money was preceded by a barter system. In a barter system, people exchange goods and services of relatively equivalent value without using money. Perhaps if you worked growing hemp and making rope out of it, you could give that rope to people in exchange for food, clothes, or whatever else you needed that the people around you might be offering. What happens, though, when someone wants rope, but that person has nothing you want? What about those times when you need food, but no one needs rope? Because of these times, people started to use a rudimentary form of money. So, say that you sell your rope to someone, but they have nothing you want. Instead, they give you a credit for their services that you are free to give to anyone else. You decide to go and buy a bunch of beer, giving the brewer the note of credit, ensuring that the person who bought your rope will provide the brewer a service in exchange for giving you beer. Thus, the invention of money was born, though in a very primitive form.

Looking at money in this way, you come to realize that money is actually debt. When you hold money, it means that you've provided goods or services of value to someone else and that you are now owed value in return. The development of a standardized, commonly used currency among large numbers of people simply increases the number of people willing to accept your paper or coin I.O.U.s, making that currency easier to exchange among a wider number of people, across greater distances, and for a more diverse variety of potential goods and services.

According to 21st century anthropologist David Graebner, this story was probably something closer to bartering with the government as a taxation, which meant providing goods and services to the government (for example, the emperor) and then being provided units of "currency" worth production rations. So, you can say that money was invented for the first government contractors as a method for the government to acquire resources in return for units of early currency worth specific amounts of resources rather than a true barter.

REMEMBER

Simply put, money is debt for the promise of goods and services that have an inherent usefulness, but money itself is not useful except as a measure of debt. People use money to measure the value that they place on things. How much value did a goat have in ancient Egypt? You could say that one goat was worth five chickens, but that wouldn't be very helpful. You could say that a brick maker's labor was worth half that of a beer maker, but you couldn't exactly measure that mathematically, either. Using these methods, people had no real way to establish a singular, definitive measurement for the value that they placed on different things. How can you measure value, then? You measure value by determining the amount of money that people are willing to exchange for different things. This method allows you to very accurately determine how people interact, the things they value, and the relative differences in value between certain things or certain people's efforts. Much about the nature of people, the things they value, and even how they interact together begin to become very clear when you develop an understanding of what they're spending money on and how much they're spending.

Fast-forward more than eight millennia — well after the establishment of using weighted coins to measure an equivalent weight of grain, well after the standardized minting of currency, and well past the point where the origins of money became forgotten by the vast majority of the world's population (welcome to the minority) — all the way into the modern era of finance. Money begins to take on a more abstract role. People use it as a way to measure resource allocations between groups and within groups. They even begin to measure how well a group of people are interacting by looking at their ability to produce more using less. Success is measured by their ability to hoard greater amounts of this interpersonal debt. The ability to hoard debt in this manner defines whether the efforts of one group of people are more or less successful than the efforts of another group. People use money to place a value on everything, and, because of this, it's possible to compare "apples and oranges." Which one is better, apples or oranges? The one that people place more value on based on the total amount of revenues. Higher revenues tell you that people place greater value on one of those two fruits because they are willing to pay for the higher costs plus any additional profits.

TIP

So, when I say that corporate finance is the study of the relationships between groups of people, I'm referring to measuring how groups of people are allocating resources among themselves, putting value on goods and services, and interacting with each other in the exchange of these goods and services. Corporate finance picks apart the financial exchanges of groups of people, all interconnected in professional relationships, by determining how effectively and efficiently they work together to build value and manage that value once it's been acquired. Those organizations that are more effective at developing a cohesive team of people who work together to build value in the marketplace will be more successful than their competitors.

In corporate finance, you measure all this mathematically in order to assess the success of the corporate organization, evaluate the outcome of potential decisions, and optimize the efforts of those people who form economic relationships, even if for just a moment, as they exchange goods, services, and value in a never-ending series of financial transactions. The financial decisions made collectively form a trend of behaviors that can be analyzed using any of several types of indicators:

- **Leading indicators:** Leading indicators include any measures of macroeconomic data that indicate what the health of the economy will look like in the immediate future, including new unemployment claims, for example.
- **Coincident indicators:** Coincident indicators are measures of macroeconomic data that indicate the health of the economy now. One example is new industrial production.
- **Lagging indicators:** Lagging indicators are indicators that tend to confirm what the economy has already begun to do, such as duration of unemployment.

- **Sentiment indices:** These are measures of how people feel about the economy. They aren't entirely accurate nor always helpful, but they do help give us an idea about how people feel about the economy, which does tend to be tied to other hard data. Consumer sentiment, for example, tends to be down when employment is down or when people don't feel confident in their own employment. These factors tend to influence stocks nearly as significantly as other, more solid, indicators.

Characterizing Motivations

Corporate finance plays a very interesting role in all societies. Finance is the study of relationships between people: how they distribute themselves and their resources, place value on things, and exchange that value among each other. Because that's the case, finance (all finance) is the science of decision-making. This is the process of studying human behavior and determining how people make decisions regarding what they do with their lives and the things they own. Corporate finance, as a result, studies decision-making in terms of what is done by groups of people working together in a professional manner.

This definition guides you in two primary directions regarding what makes corporate finance unique:

- It tells you that corporate finance is a critical aspect of human life as an intermediary that allows people to transfer value among themselves.
- It tells you how groups of people interact as a single unit, a corporation, and how decisions are made on behalf of the corporation by people called managers.

REMEMBER

Corporate finance is far more than a study about money. Money is just the unit of measure people use to calculate everything and make sense of it numerically, to compare things in absolute terms rather than relative ones. Corporate finance is a unique study that measures *value*. Once you accept that, it becomes apparent that everything in the world has value. Therefore, you can use corporate finance to measure everything around you that relates to a corporation, directly or indirectly (which, in the vast majority of the world, is everything).

The role of financial institutions

Probably the easiest way to understand how corporate finance acts as a critical intermediary process between groups of people is to look at the role of financial institutions in the greater economy. Financial institutions, such as banks and credit unions, have a role that involves redistributing money between those who want money and those who have excess money, all in a manner that the general population believes is based on reasonable terms.

Now, whether financial institutions as a whole are fully successful in their role is no longer a matter of debate: They are not. The cyclical role being played out time and again prior to the Great Depression, prior to the 1970s economic troubles, and prior to the 2007 collapse are symptomatic of a systematic operational failure yet to be resolved. For the most part, the role they play is necessary, however. These institutions facilitate the movement of resources across the entire world. They accept money from those who have more than they're using and offer interest rate payments in return. Then they turn around and give that money to those seeking loans, charging interest for this service. In this role, financial institutions are intermediaries that allow people on either side of these sorts of transactions to find each other by way of the bank itself. Without this role, investments and loans would very nearly come to a total halt compared to the extremely high volume and value of the current financial system.

Corporate finance plays a similar role as an intermediary for the exchange of value of goods and services between individuals and organizations. Corporate finance, as the representation of the value developed by groups of people working together toward a single cause, studies how money is used as an intermediary of exchange between and within these groups to reallocate value as is deemed necessary.

Defining investing

It may be helpful to backtrack a bit. What the heck is an investment, anyway? An *investment* is anything that you buy for the purpose of deriving greater value than you spent to acquire it. Yes, yes, stocks and bonds are good examples; you buy them, they go up in value, and you sell them. But you can think of some other examples that aren't so . . . already in this book. A house that you buy for the purpose of generating income is a good example of an investment: You buy it, you generate revenue as its renters pay their rent, and after the house goes up in value, you sell it. (Your own home usually isn't considered an investment.)

Because money places an absolute value on transactions that take place, you can very easily measure not only these transactions but also all of several potential options in a given decision. In other words, you can measure the outcome of a decision before it's made, thanks to corporate finance. That's the second thing that makes corporate finance a very unique study: It analyzes the value of interactions between people, the value of the actions taken, and the value of the decisions made and then compiles that information into a single agglomerate based on professional interconnectedness in a single corporation.

This analysis allows you to measure how effectively you're making decisions and optimize the outcome of future decisions you'll have to make. The decisions that corporations make tend to have very far-reaching consequences, influencing the lives of employees, customers, suppliers, partners, and the greater national economy, so ensuring that a corporation is making the correct decisions is of the utmost importance. Corporate finance allows you to do this, so if you have a favorite corporation, hug the financial analysts next time you see them (or maybe just send a cookie bouquet; you might freak someone out if you just randomly starting hugging people).

Setting the Stage

Unless you're in a rare minority who live "off the grid" (secluded and self-sufficient), nearly every aspect of your life is strongly influenced, directly or otherwise, by corporate finances. The price and availability of the things you buy are decided using financial data. Chances are high that your job relies on decisions made using financial data. Your savings and investments all rely quite heavily on financial information. Your house, car, where you live, and even the laws in your area are all determined using financial information about corporations.

From the very beginning, a corporation needs to decide how it will fund its *start-up*, the time when it first begins purchasing supplies to start operating. This single decision decides a significant amount about the corporation's costs, which, in turn, decide a lot about the prices it will charge. Where it sells its goods depends greatly on whether the corporation can sell its goods at a price high enough to generate a profit after the costs of production and distribution, assuming that competitors can't drive down prices in that area. The number of units that the corporation produces depends entirely on how productive its equipment is, and the corporation will only purchase more equipment if doing so doesn't cost more than the corporation will be able to make in profits.

REMEMBER

These factors affect your job, too; the corporation will hire more people who add value to the company only if it's profitable to do so. Where your job is located will depend greatly on where in the world it's cheapest to locate operations related to your line of work. The decision to outsource your job to some other nation depends entirely on whether that role within the company can be done more cheaply elsewhere, without incurring risks that are too expensive. That's right, even risk can be measured mathematically in financial terms.

You're probably thinking to yourself, "But that's only my work life. Surely corporate finance has no influence on my personal life." Well, besides controlling how much you make, what you can afford, what your job is, and where you work, corporations have this habit of also financially assessing government policy.

When a proposed law (called a *bill*) is introduced, corporations determine what its financial impact will be on them. They also assess whether a law that exists (or doesn't exist) has a financial impact on corporations. If the impact is greater than the cost of hiring a lobbyist in Washington, D.C., they'll hire a lobbyist to pressure politicians into doing what they want. This effort includes campaign contributions, marketing on behalf of the politician, and more. Going even as big as international relations between nations, a single large corporation can bring an entire global industry to a stop by convincing the right people that one nation is selling goods at a price lower than cost, which causes political conflict between nations. This scenario has happened multiple times in the past, with the majority of claims being made by U.S. companies, and it can easily happen again.

Every aspect of your life is influenced in some way by the information derived from corporate finance. Money is a measure of value, and you are valuable, so nearly everything that makes you who you are can be measured in terms of money. If it can be measured in terms of money, decisions will be made in terms of money. If you're not the one making those decisions, you should probably be asking yourself who is.