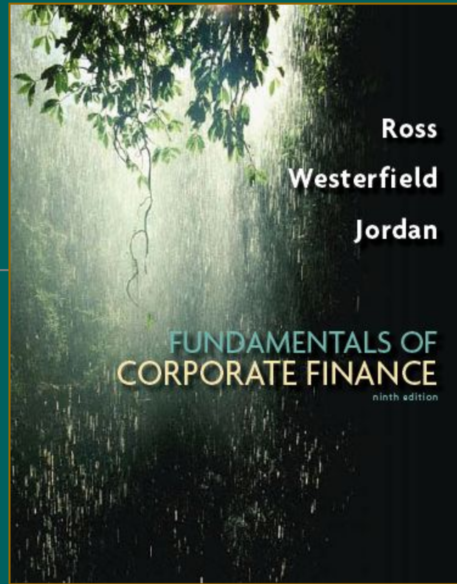
Chapter 1

Introduction to Corporate Finance



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Key Concepts and Skills

- Know the basic types of financial management decisions and the role of the financial manager
- Know the financial implications of the different forms of business organization
- Know the goal of financial management
- Understand the conflicts of interest that can arise between owners and managers
- Understand the various types of financial markets

Chapter Outline

- Corporate Finance and the Financial Manager
- Forms of Business Organization
- The Goal of Financial Management
- The Agency Problem and Control of the Corporation
- Financial Markets and the Corporation

1. Corporate Finance

Imagine that you were to start your own business, you would have to answer the following three questions :

i. What long-term investments should the firm take on?

that is, what lines of business will you be in and what sorts of buildings, machinery, and equipment will you need?

ii. Where will we get the long-term financing to pay for the investment?

Will you bring in other owners or will you borrow the money?

iii. How will we manage the everyday financial activities of the firm?

such as collecting from customers and paying suppliers?

2. The Financial Manager

A striking feature of large corporations is that the owners (the stockholders) are usually not directly involved in making business decisions, particularly on a day-to-day basis. Instead,the corporation employs managers to represent the owners' interests and make decisions on their behalf.

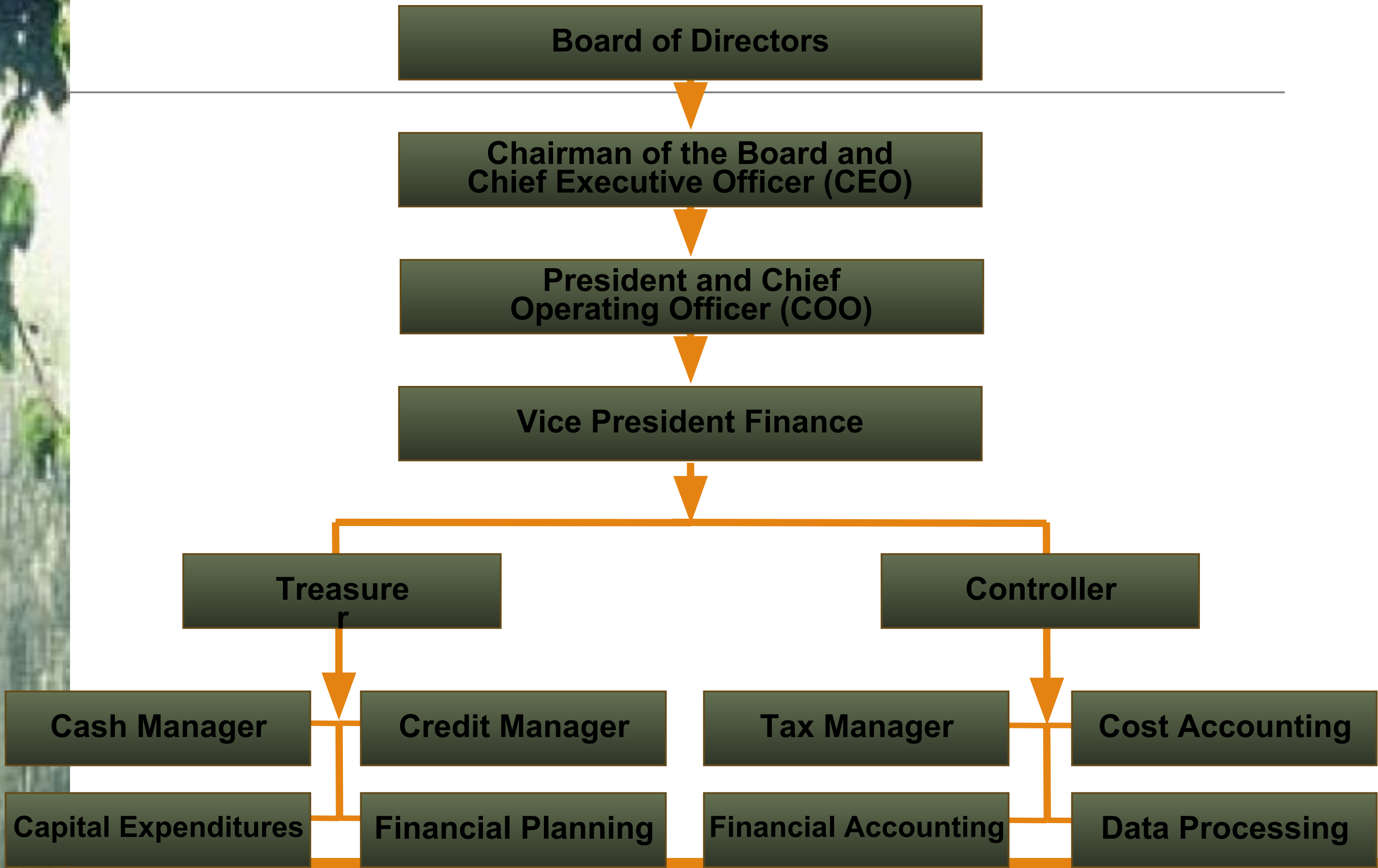
Financial managers try to answer the 3 previous questions

The financial management function is usually associated with a top officer of the firm, such as a vice president of finance or some other chief financial officer (CFO). He/she coordinates the activities of:

Treasurer – oversees cash management, credit management, capital expenditures, and financial planning

Controller – oversees taxes, cost accounting, financial accounting and data processing

Hypothetical Organization Chart



3. Financial Management Decisions

Capital budgeting

The first question concerns the firm's long-term investments. The process of planning and managing a firm's long-term investments is called **capital budgeting.**

What long-term investments or projects should the business take on?

- Buildings
- Machinery
- Equipment
- Research and development (R&D)

Evaluating the *size, timing,* and *risk* of future cash flows is the essence of capital budgeting.

Capital Structure

The second question for the financial manager concerns ways in which the firm obtains and manages the long-term financing it needs to support its long-term investments. A firm's **capital structure** (or financial structure) is the specific mixture of long-term debt and equity the firm uses to finance its operations. The financial manager has two concerns in this area.

- How much should the firm borrow? That is, what mixture of debt and equity is best? The mixture chosen will affect both the risk and the value of the firm.
- what are the least expensive sources of funds for the firm? what percentage of the firm's cash flow goes to creditors and what percentage goes to shareholders. Firms have a great deal of flexibility in choosing a financial structure.

The question of whether one structure is better than any other for a particular firm is the heart of the capital structure issue.

Working Capital Management

The third question concerns **working capital** management. The term *working capital* refers to a firm's short-term assets, such as inventory, and its short-term liabilities, such as money owed to suppliers. Managing the firm's working capital is a day-to-day activity that ensures that the firm has sufficient resources to continue its operations and avoid costly interruptions.

- How much cash and inventory should we keep on hand?
- Should we sell on credit? If so, what terms will we offer, and to whom will we extend them?
- How will we obtain any needed short-term financing? Will we purchase on credit or will we borrow in the short term and pay cash? If we borrow in the short term, how and where should we do it?

4. Forms of Business Organization

We examine the three different legal forms of business organization:

Sole Proprietorship

Formed by a single individual

Advantages

- Easiest to start
- Least regulated
- Single owner keeps all the profits
- Taxed once as personal income

Disadvantages

- Limited to life of owner
- Equity capital limited to owner's personal wealth
- Unlimited liability
- Difficult to sell ownership interest

Partnership

Formed by 2 or more individuals (partners)

- In a *general partnership,* all the partners share in gains or losses, and all have unlimited liability for *all* partnership debts, not just some particular share. The way partnership gains (and losses) are divided is described in the *partnership agreement.* This agreement can be an informal oral agreement or a lengthy, formal written document.
- In a *limited partnership*, one or more general partners will run the business and have unlimited liability, but there will be one or more limited partners who will not actively participate in the business. A limited partner's liability for business debts is limited to the amount that partner contributes to the partnership. This form of organization is common in real estate ventures, for example.

Advantages

- Two or more owners
- More capital available
- Relatively easy to start
- Income taxed once as personal income

Disadvantages

- Unlimited liability
  - General partnership
  - Limited partnership
- Partnership dissolves when one partner dies or wishes to sell
- Difficult to transfer ownership

Corporation

A **corporation** is a legal "person" separate and distinct from its owners and it has many of the rights, duties, and privileges of an actual person.

In a large corporation, the stockholders and the managers are usually separate groups. The stockholders elect the board of directors, who then select the managers. Managers are charged with running the corporation's affairs in the stockholders' interests. In principle, stockholders control the corporation because they elect the directors,

Ownership (represented by shares of stock) can be readily transferred, and the life of the corporation is therefore not limited.

The corporation borrows money in its own name. As a result, the stockholders in a corporation have limited liability for corporate debts. The most they can lose is what they have invested.

If a corporation needs new equity, for example, it can sell new shares of stock and attract new investors.

Advantages

- Limited liability
- Unlimited life
- Separation of ownership and management
- Transfer of ownership is easy
- Easier to raise capital

Disadvantages

- Double taxation (income taxed at the corporate rate and then dividends taxed at the personal rate).

A Corporation by another name

The corporate form of organization has many variations around the world. The exact laws and regulations differ from country to country, of course, but the essential features of public ownership and limited liability remain. These firms are often called *joint stock companies*, *public limited companies*, or *limited liability companies*, depending on the specific nature of the fi rm and the country of origin.

Examples of International Corporations

See Page 7 (Ross, Westerfield and Jordan)

5. Goal of Financial Management

Main Goal: to make money or add value for the owners.

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- Survive
- Avoid financial distress and bankruptcy
- Beat the competition.
- Maximize sales or market share.
- Minimize costs.
- Maximize profits.
- Maintain steady earnings growth.

Class 1: Profitability

Class 2 : Controlling risk and stability

The goal of Financial Managers

The financial manager in a corporation makes decisions for the stockholders of the firm. Given this, instead of listing possible goals for the financial manager, we really need to answer a more fundamental question: From the stockholders' point of view, what is a good financial management decision?

The goal of financial management is to maximize the current value per share of the existing stock.

What is the appropriate goal when the firm has no traded stock?

Maximize the market value of the existing owners' equity.

6. The Agency Problem

Agency relationship

The relationship between stockholders and management is called an *agency relationship* . Such a relationship exists whenever someone (the principal) hires another (the agent) to represent his or her interests.

Agency problem

The possibility of conflict of interest between the stockholders and management of a firm.

Management goals and agency costs

Example of an agency cost.

To see how management and stockholder interests might differ, imagine that the firm is considering a new investment. The new investment is expected to favorably impact the share value, but it is also a relatively risky venture. The owners of the firm will wish to take the investment (because the stock value will rise), but management may not because there is the possibility that things will turn out badly and management jobs will be lost. If management does not take the investment, then the stockholders may lose a valuable opportunity.

More generally, the term *agency costs* refers to the costs of the conflict of interest between stockholders and management. These costs can be indirect or direct. An indirect agency cost is a lost opportunity, such as the one we have just described.

Direct Agency Cost

Direct agency costs come in two forms.

The first type is a corporate expenditure that benefits management but costs the stockholders. Perhaps the purchase of a luxurious and unneeded corporate jet would fall under this heading.

The second type of direct agency cost is an expense that arises from the need to monitor management actions. Paying outsideauditors to assess the accuracy of financial statement information could be one example.

7. Managing Managers

Management will frequently have a significant economic incentive to increase share value.

Managerial compensation

- Incentives can be used to align management and stockholder interests

For example, in 2007, Google announced that it was issuing new stock options to all of its 16,000 employees, thereby giving its workforce a significant stake in its stock price.

- The incentives need to be structured carefully to make sure that they achieve their goal

Managers who are successful in pursuing stockholder goals can reap enormous rewards. For example, the best-paid executive in 2007 was Lawrence Ellison, the CEO of Oracle. According to Forbes magazine, he made about $193 million.

Control of the firm

Control of the firm ultimately rests with stockholders. They elect the board of directors, who in turn hire and fire managers.

The fact that stockholders control the corporation was made abundantly clear by Steven Jobs's experience at Apple. Even though he was a founder of the corporation and was largely responsible for its most successful products, there came a time when shareholders, through their elected directors, decided that Apple would be better off without him, so out he went. He was later rehired and helped turn Apple around with great new products such as the iPod and iPhone.

Stakeholders

Our discussion thus far implies that management and stockholders are the only parties with an interest in the firm's decisions. This is an over simplification, of course. Employees, customers, suppliers, and even the government all have a financial interest in the firm.

Taken together, these various groups are called **stakeholders** in the firm. In general, a stakeholder is someone other than a stockholder or creditor who potentially has a claim on the cash flows of the firm. Such groups will also attempt to exert control over the firm, perhaps to the detriment of the owners.

Work the Web Example

The Internet provides a wealth of information about individual companies

One excellent site is finance.yahoo.com

Click on the web surfer to go to the site, choose a company and see what information you can find!

Financial Markets

The primary advantages of the corporate form of organization are that ownership can be transferred more quickly and easily than with other forms and that money can be raised more readily. Both of these advantages are significantly enhanced by the existence of financial markets, and financial markets play an extremely important role in corporate finance.

CASH FLOWS TO AND FROM THE FIRM

Suppose we start with the firm selling shares of stock and borrowing money to raise cash. Cash flows to the firm from the financial markets (A). The firm invests the cash in current and fixed assets (B). These assets generate cash (C), some of which goes to pay corporate taxes (D). After taxes are paid, some of this cash flow is reinvested in the firm (E).The rest goes back to the financial markets as cash paid to creditors and shareholders (F).

Quick Quiz

What are the three types of financial management decisions and what questions are they designed to answer?

What are the three major forms of business organization?

What is the goal of financial management?

What are agency problems and why do they exist within a corporation?

What is the difference between a primary market and a secondary market?

Ethics Issues

- Is it ethical for tobacco companies to sell a product that is known to be addictive and a danger to the health of the user? Is it relevant that the product is legal?
- Should boards of directors consider only price when faced with a buyout offer?
- Is it ethical to concentrate only on shareholder wealth, or should stakeholders as a whole be considered?
- Should firms be penalized for attempting to improve returns by stifling competition (e.g., Microsoft)?

END OF CHAPTER 1