Chapter 1:

Introduction to Corporate Finance

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Key Concepts

- 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 various types of financial markets
- Understand the conflicts of interest that can arise between owners and managers

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Financial Management Decisions

- The financial manager is concerned with ***3 primary*** *categories of financial decisions*:
  1. **Capital Budgeting**
  2. **Capital Structure**
  3. **Working Capital Management**

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1. Capital Budgeting

- Process of planning and managing firms L-T investment decisions.
- **What L-T investments or projects should the business take on?**
  - i.e. whether or not to buy a new building, equipment, machinery or to expand manufacturing plant

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2. Capital Structure

- Where will we get the L-T financing to pay for the investment?
- ***How should we pay for our assets?***
  - i.e. borrow money from the bank or issue new securities
- When should the firm raise funds?
- What are the least expensive sources of funds for the firm?
- Should the firm use debt or equity? Is there an optimal mix of debt and equity?

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3. Working Capital Management

- **How will we manage the day-to-day financial activities of the firm?**
  - Day to day activities ensure that the firm have sufficient resources to continue its operations.
  - Are we collecting from customer & paying supplier
- Managing S-T assets and liabilities.
  - ***Eg.*** How much inventory should the firm carry? What credit policy is best? (***Eg.*** credit collection period)

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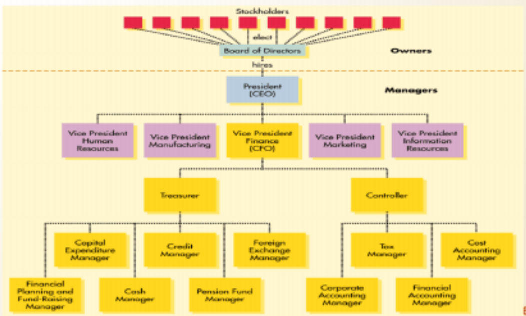
Corporate Form of Organization (Organizational Chart)



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Financial Manager

- The Chief Financial Officer (CFO) coordinate the activity of ….
  - ***Treasurer*** – Corporate finance is concentrate with the function of treasurer office. The firms chief financial manager, who is responsible for the firm's financial activities, such as,
    - ***Eg***. Managing cash, credit, making capital expenditure decisions, financial planning and fund raising and the pension fund, and foreign exchange (managing the firms exposure to loss from currency fluctuations).

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- ***Controller*** – The firms chief accountant, who is responsible for the firm's accounting activities, such as;
  - Handles cost and financial accounting, corporate accounting, tax management, auditing and data processing.

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The Goal of Financial Management

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Forms of Business Organization

- **Sole proprietorship**
  - A business owned by one person
- **Partnership**
  - A business with multiple owner, but not incorporated
    - General Partnership : All partners have unlimited liabilities
    - Limited Partnership : One more general partners run the business and have unlimited liabilities. And one or more limited partners liability is limited to the amount of their investment in the business.
- **Corporation**
  - Largest form of organization
  - A distinct legal entity compose of one or more individuals
  - Owners liability is limited to the amount of investment in the firm
  - Role of ***financial market*** is important for corporations

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Sole Proprietorship

- Advantages
  - Easiest to start
  - Least regulated
  - Single owner keeps all the profits
  - The owners are also the managers
  - Taxed once as personal income
- Disadvantages
  - Limited to life of owner
  - Equity capital limited to owner's personal wealth
  - Hard to raise capital fund
  - Unlimited liability
  - Difficult to sell ownership interest

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Partnership

- Advantages
  - Two or more owners
  - More capital available
  - Relatively easy to start
  - Income taxed once as personal income
- Disadvantages
  - Unlimited liability
    - General partnership
  - Partnership dissolves when one partner dies or wishes to sell
  - Difficult to transfer ownership

Corporation

- Advantages
  - Limited liability, which guarantees that they can not lose more than they invested.
  - Unlimited life
  - Transfer of ownership is easy
  - Easier to raise capital
- Disadvantages
  - Separation of ownership and management (Agency Cost)
  - More expensive to organize than other business forms
  - Double taxation (income taxed at the corporate rate and then dividends taxed at the personal rate)
  - Subject to greater government regulations
  - Lacks secrecy, because stockholders must receive financial reports.

Financial Market

- Financial Market is a way of bringing buyer and seller together.
- The two key financial markets are the **money market** and the **capital market**.
  - Transaction in S-T debt instruments, or marketable securities, take place in the money market.
  - L-T secutities – bonds and stocks – are traded in the capital market.

- Financial Market function as both **primary** and **secondary** market for Debt and Equity securities.

Primary Market

- Market in which newly-issued securities are sold by the company to raise cash.
  - IPO (Initial Public Offering) – occur when private company sell stocks/bonds to the company for the first time
  - ***Eq.*** IBM comp. issued stock to raise money for the first time. Corp. is a seller and transaction raises money for the corporation.

Secondary Market

- Market in which already-issued securities are bought or sold among investors.
- One owner or creditor selling to another – is a mean of transferring ownership of corporate securities.
- There are two kinds of secondary markets: **Dealer Market** and **Auction Market**

Dealer Market and Auction Market

- Dealer Market

Dealer Market and Auction Market

- Auction Market (Broker Market)

The Agency Problem

- Agency relationship
  - Stockholders (principals) hire managers (agents) to run the company and to act on their behalf.
- The Agency Problem

Separation of ownership from control causes Agency Problem. Why?

- ***How can stockholders make sure that 'managers act in the stockholders' interest'?***