

Chapter 1 Introduction to Financial Management



RWJ website

Chapter Outline

- 1.1 Finance: A Quick Look
- 1.2 Business Finance and The Financial Manager
- 1.3 Forms of Business Organization
- 1.4 The Goal of Financial Management
- 1.5 The Agency Problem and Control of the Corporation
- 1.6 Financial Markets and the Corporation

Key Concepts and Skills

Have a good understanding of:

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

Basic Areas Of Finance

1. Corporate finance = Business Finance
2. Investments
3. Financial institutions
4. International finance



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Investments

- Work with financial assets such as stocks and bonds
- Value of financial assets, risk versus return, and asset allocation
- Job opportunities
 - Stockbroker or financial advisor
 - Portfolio manager
 - Security analyst



Financial Institutions

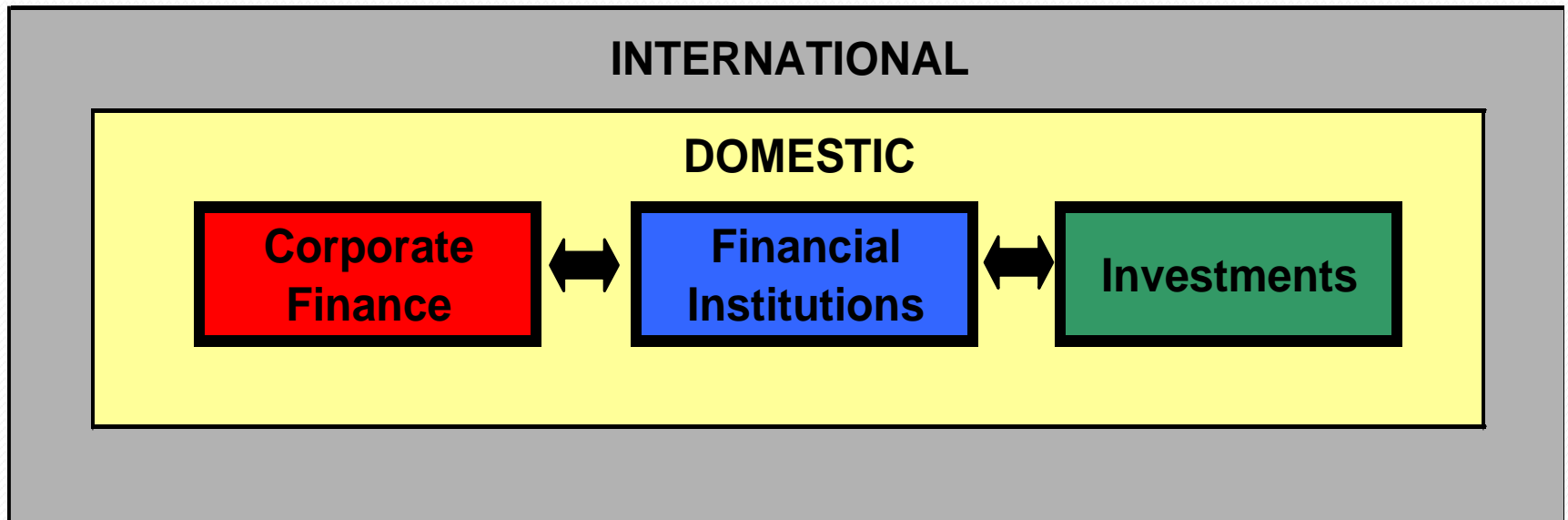
- Companies that specialize in financial matters
 - Banks – commercial and investment, credit unions, savings and loans
 - Insurance companies
 - Brokerage firms
- Job opportunities



International Finance

- An area of specialization within each of the areas discussed so far
- May allow you to work in other countries or at least travel on a regular basis
- Need to be familiar with exchange rates and political risk
- Need to understand the customs of other countries; speaking a foreign language fluently is also helpful

Basic Areas Of Finance



Why Study Finance?

- Marketing
 - Budgets, marketing research, marketing financial products
- Accounting
 - Dual accounting and finance function, preparation of financial statements
- Management
 - Strategic thinking, job performance, profitability
- Personal finance
 - Budgeting, retirement planning, college planning, day-to-day cash flow issues

Business Finance

- Some important questions that are answered using finance
 - What long-term investments should the firm take on?
 - Where will we get the long-term financing to pay for the investments?
 - How will we manage the everyday financial activities of the firm?

Financial Manager

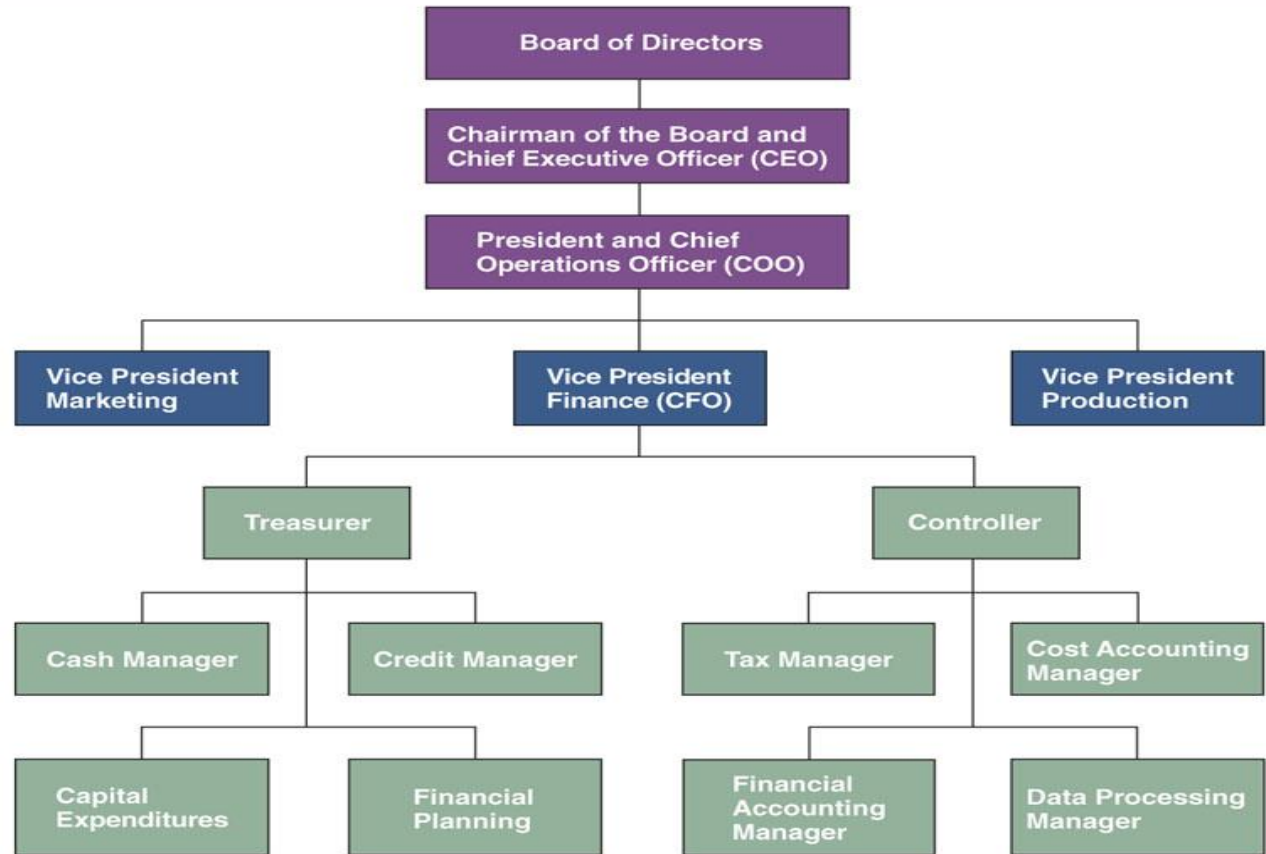
- Financial managers try to answer some, or all, of these questions
- The top financial manager within a firm is usually the Chief Financial Officer (CFO)
 - Treasurer – oversees cash management, credit management, capital expenditures, and financial planning
 - Controller – oversees taxes, cost accounting, financial accounting, and data processing

Corporate Organization Chart

Figure 1.1

FIGURE 1.1

A simplified organizational chart.
The exact titles and organization differ from company to company



Financial Management Decisions

- Capital budgeting
 - What long-term investments or projects should the business take on?
- Capital structure
 - How should we pay for our assets?
 - Should we use debt or equity?
- Working capital management
 - How do we manage the day-to-day finances of the firm?



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Forms of Business Organization

Three major forms in the United States

- Sole proprietorship
- Partnership
 - General
 - Limited
- Corporation
 - S-Corp
 - Limited liability company



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Sole Proprietorship

Business owned by one person

- Advantages
 - Easiest to start
 - Least regulated
 - Single owner keeps all of 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

Business owned by two or more persons

- 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

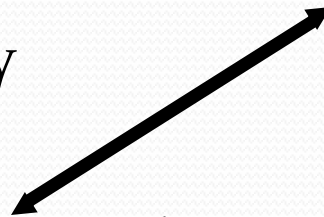
A legal “person” distinct from owners and a resident of a state

- Advantages

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

- Disadvantages

- Separation of ownership and management (agency problem)
- Double taxation (income taxed at the corporate rate and then dividends taxed at personal rate, while dividends paid are not tax deductible)



International Corporate Forms

- *Joint stock companies*
- *Public limited companies*
- *Limited liability companies*

- All share:
 - Public ownership
 - Limited liability



Goal Of Financial Management

- What should be the goal of a corporation?
 - Maximize profit?
 - Minimize costs?
 - Maximize market share?
 - **Maximize the current value per share of the company's existing stock**
 - *Maximize the market value of the existing owners' equity*



Goal Of Financial Management

- Does this mean we should do anything and everything to maximize owner wealth?
 - Outsourcing?
 - Off-shoring?
 - Enron?
 - Corporate support of charities?

Sarbanes-Oxley Act

(SarBox, 2002)

- Driven by corporate scandals
 - Enron, Tyco, WorldCom, Adelphia
- Intended to strengthen protection against accounting fraud and financial malpractice
- Compliance very costly
 - Firms driven to:
 - Go public outside the U.S.
 - Go private (“go dark”)

The Agency Problem

- Agency relationship
 - Principal hires an agent to represent its interests
 - Stockholders (principals) hire managers (agents) to run the company
- Agency problem
 - Conflict of interest between principal and agent
- Management goals and agency costs



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Do Managers Act in the Shareholders' Interests?

- Managerial compensation
 - Incentives can be used to align management and stockholder interests
 - Incentives need to be carefully structured to insure that they achieve their goal
- Corporate control
 - Threat of a takeover may result in better management
- Other stakeholders

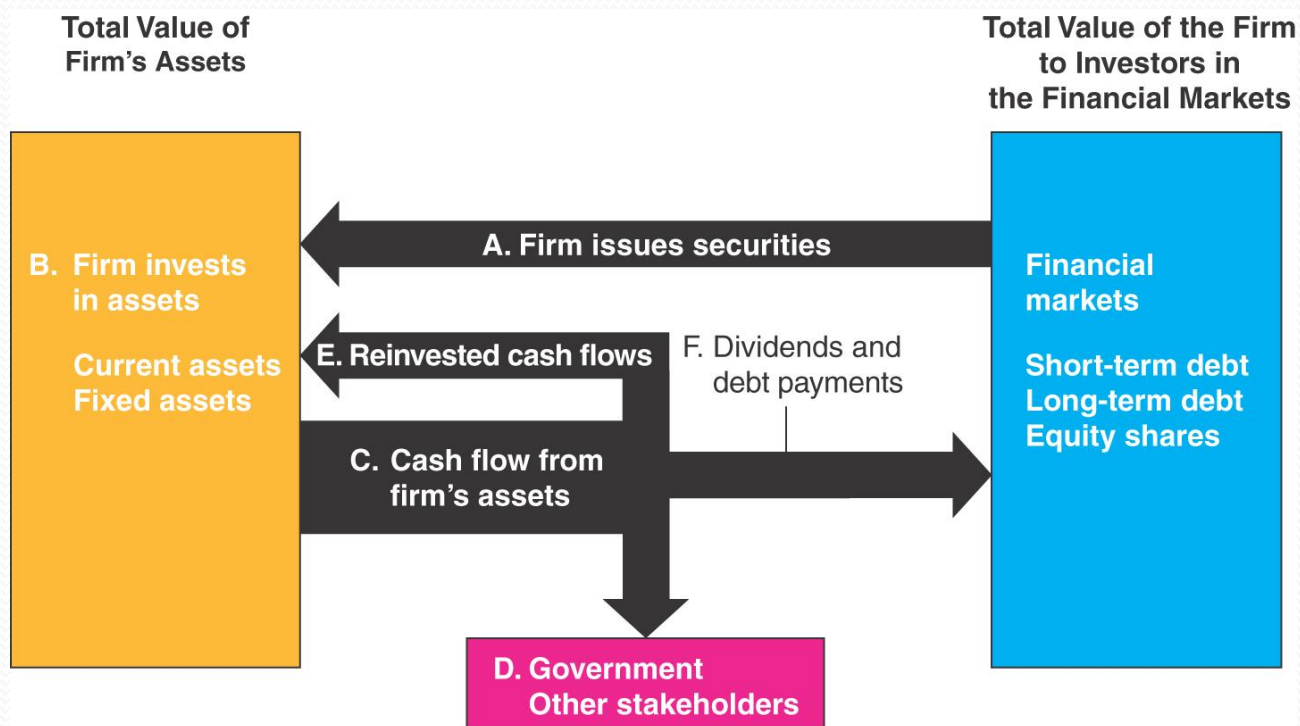
Example: Work the Web

- The Internet provides a wealth of information about individual companies
- “finance.yahoo.com” is an excellent site
- Example:
 - Southwest Airlines (LUV)
 - Harley- Davidson (HOG)
 - Starwood Hotels & Resorts (HOT)
 - American Express (AXP)



Cash Flows Between the Firm and the Financial Markets

Figure 1.2



- A. Firm issues securities to raise cash.
- B. Firm invests in assets.
- C. Firm's operations generate cash flow.
- D. Cash is paid to government as taxes. Other stakeholders may receive cash.

- E. Reinvested cash flows are plowed back into firm.
- F. Cash is paid out to investors in the form of interest and dividends.

Financial Markets

- Cash flows to the firm
- Primary vs. secondary markets
 - Dealer vs. auction markets
 - Listed vs. over-the-counter securities
 - NYSE
 - NASDAQ

Quick Quiz

- What are the four basic areas of finance? ([Slide 1.4](#))
- What are the three types of financial management decisions, and what questions are they designed to answer? ([Slide 1.13](#))
- What are the three major forms of business organization? ([Slide 1.14](#))
- What is the goal of financial management? ([Slide 1.19](#))
- What are agency problems, and why do they exist within a corporation? ([Slide 1.22](#))