

# Chapter 1 Lecture - Introduction to Financial Management

## Chapter 1 Lecture - Introduction to Financial Management



## Learning Objectives

After studying this chapter, you should be able to:

**LO1** Discuss the basic types of financial management decisions and the role of the financial manager.

**LO2** Identify the goal of financial management.

**LO3** Compare the financial implications of the different forms of business organizations.

**LO4** Describe the conflicts of interest that can arise between managers and owners

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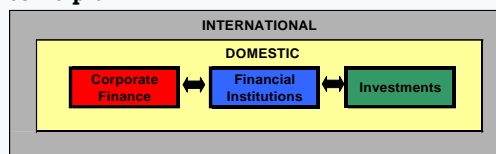
## Basic Areas Of Finance

1. **Corporate finance = Business Finance**
2. **Investments - Work with financial assets such as stocks and bonds. Looks at the value of financial assets, risk versus return, and asset allocation**
  - Job opportunities such as Stockbroker or Financial Advisor, Portfolio Manager, Security analyst
3. **Financial institutions - Companies that specialize in financial matters**
  - Banks – commercial and investment, credit unions, savings and loans
  - Insurance companies
  - Brokerage firms
    - Job opportunities such as Banker, Commercial lender etc.
4. **International finance**

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## 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



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# Chapter 1 Lecture - Introduction to Financial Management

## 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

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## Why is Corporate Finance Important to All Managers?

Corporate finance provides the skills managers need to:

- Identify and select the corporate strategies and individual projects that add value to their firm.
- Forecast the funding requirements of their company, and devise strategies for acquiring those funds

Some important questions that are answered using finance:

1. What long-term investments should the firm take on?
2. Where will we get the long-term financing to pay for the investment?  
**Should we use debt or equity?**
3. How will we manage the everyday financial activities of the firm?

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## Financial Managers



**Chief Financial Officer (CFO):** The top financial manager within a firm

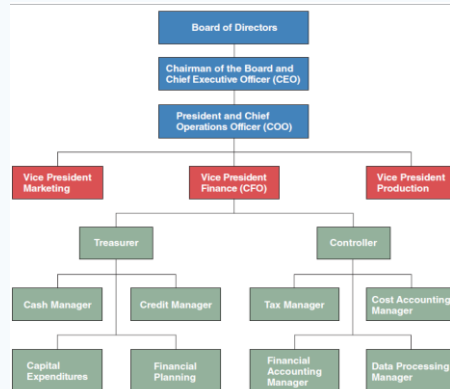
**Treasurer:** Oversees cash management, credit management, capital expenditures, and financial planning

**Controller:** Oversees taxes, cost accounting, financial accounting and data processing



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## Corporate Organization Chart



**FIGURE 1.1**  
A simplified organizational chart. The exact titles and organization differ from company to company.

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## Financial Management Decisions

- **Capital Budgeting** - The process of planning and managing a firm's long-term investments. This means that the value of the cash flow generated by an asset exceeds the cost of that asset.
- Evaluating the *size*, *timing*, and *risk* of future cash flows is the essence of capital budgeting.

### Capital Budgeting: eight steps

Does new project match corporate objectives?	1 Have a good idea/realise the need for a project	4 Carry out financial analysis (Capital Investment Appraisal)	6 Choose the project to undertake
	2 Look for suitable projects	5 Analyse alternatives and identify feasible alternatives	7 Monitor project along with rest of organisation
	3 Identify and consider alternatives	8 Carry out post completion audit	

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## Financial Management Decisions

- **Capital Structure** - ways in which the firm obtains and manages the long-term financing it needs to support its long-term investments.
- Needs to be concerned with 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.
  - (1) 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.
  - (2) What are the least expensive sources of funds for the firm?

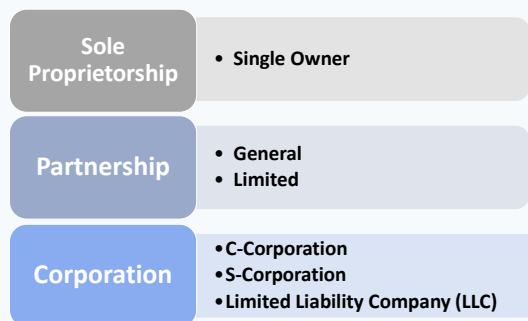
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## Financial Management Decisions

- **Working Capital Management** - *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.
- Some questions about working capital that must be answered are the following:
  - (1) How much cash and inventory should we keep on hand?
  - (2) Should we sell on credit? If so, what terms will we offer, and to whom will we extend them?
  - (3) How will we obtain any needed short-term financing?

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## Forms of Business Organization in the U.S.



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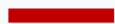
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## Sole Proprietorship



### 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

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

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## Corporation



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

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## Other Types of Business Ownership

- Most corporations (in the USA) are C corporations, which are taxed as an entity by the federal government.
- The S-corporation gives small business owners limited liability protection, but taxes company profits only once, when they are paid out as dividends. It can't have more than one hundred stockholders.
- A limited-liability company (LLC) is similar to an S-corporation: its members are not personally liable for company debts and its earnings are taxed only once, when they're paid out as dividends. But it has fewer rules and restrictions than does an S-corporation. For example, an LLC can have any number of members.
- A cooperative is a business owned and controlled by those who use its services. Individuals and firms who belong to the cooperative join together to market products, purchase supplies, and provide services for its members.
- A not-for-profit corporation is an organization formed to serve some public purpose rather than for financial gain. It enjoys favorable tax treatment.

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# Chapter 1 Lecture - Introduction to Financial Management

## International Corporate Forms

- All of these forms feature public ownership and limited liability

Company	Country of Origin	Type of Company	Translation	TABLE 11
Bayerische Motoren Werke (BMW) AG	Germany	Aktiengesellschaft	Corporation	International corporations
Montblanc GmbH	Germany	Gesellschaft mit beschränkter Haftung	Company with limited liability	
Rolls-Royce PLC	United Kingdom	Public limited company	Public limited company	You can find the translation for any business type at <a href="http://www.corporateinformation.com">www.corporateinformation.com</a> .
Shell UK Ltd.	United Kingdom	Limited	Corporation	
Unilever NV	Netherlands	Naamloze Vennootschap	Limited liability company	
Fiat SpA	Italy	Società per Azioni	Public limited company	
Saab AB	Sweden	Aktiebolag	Joint stock company	
Peugeot SA	France	Société Anonyme	Joint stock company	

<http://www.forbes.com/global2000/list>

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## Goal of Financial Management

What should be the goal of a corporation?

Maximize profits?

Minimize costs?

Maximize market share?

Maximize the current value of the company's stock?

Does this mean we should do anything and everything to maximize owner wealth?

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## What Should Management's Primary Objective Be?

- The primary objective should be **shareholder wealth maximization**, which usually translates to maximizing stock price
- Should firms behave ethically? **YES!**
- Do firms have any responsibilities to society at large? **YES! Shareholders are also members of society.**

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## Shareholder Wealth Maximization

- Considers the timing and risk of the benefits from stock ownership
  - Determines that a good decision increases the price of the firm's common stock ( c/s )
  - Is an impersonal objective
  - Is concerned for social responsibility
- Social Responsibility*

Ethical issues will constantly confront financial managers as they achieve the goal of the firm ( SWM ).

Managers Must:

- Avoid personal conflicts
- Maintain confidentiality
- Be objective
- Act fairly

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## Maximizing Stock Price – Is it Good for Society, Employees, and Customers?

- Employment growth is higher in firms that try to maximize stock price. On average, employment goes up in:
  - firms that make managers into owners (such as LBO firms)
  - firms that were owned by the government but that have been sold to private investors
- What about SOEs?



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## Managing Managers

### Managerial compensation

- Incentives can be used to align management and stockholder interests
- The incentives need to be structured carefully to make sure that they achieve their goal



### Corporate control

The threat of a takeover may result in better management

### Other stakeholders

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## The Agency Problem

### Agency relationship

- Principal hires an agent to represent his/her 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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## Agency Relationship and/or Problem?

- An agency relationship arises whenever one or more individuals, called *principals*, (1) hires another individual or organization, called an *agent*, to perform some service and (2) then delegates decision-making authority to that agent.
- If you are the only employee, and only your money is invested in the business, would any agency problems exist?
  - No agency problem would exist.
  - A potential agency problem arises whenever the manager of a firm owns less than 100 percent of the firm's common stock

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# Chapter 1 Lecture - Introduction to Financial Management

## Agency Relationship and/or Problem?

- An agency relationship could exist between you and your employees if you, the principal, hired the employees to perform some service and delegated some decision-making authority to them.
- If you needed additional capital to buy computer inventory or to develop software then you might end up with agency problems if the capital is acquired from outside investors.
- Agency problems are less for secured than for unsecured debt, and different between stockholders and creditors.
- Thus, it matters whether the new capital comes in the form of an unsecured bank loan, a bank loan secured by your inventory of computers, or from new stockholders.

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## Two Potential Agency Conflicts

### Conflicts between stockholders and managers.

- Compensation
- Direct intervention
- Threat of firing
- Hostile Takeovers



### Conflicts between stockholders and creditors.

Question: Would expansion increase or decrease potential agency problems?

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## Why Might You Want to Make Your Financial Statements Look Artificially Good?

A manager might inflate a firm's reported earnings or make its debt appear to be lower if he or she wanted the firm to look good temporarily. For example just prior to exercising stock options or raising more debt.

### What are the Potential Consequences of Inflating Earnings or Hiding Debt?

If the firm is publicly traded, the stock price will probably drop once it is revealed that fraud has taken place. If private, banks may be unwilling to lend to it, and investors may be unwilling to invest more money.

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## What Kind of Compensation Program Might you Use to Minimize Agency Problems?

- "Reasonable" annual salary to meet living expenses
- Cash (or stock) bonus
- Options to buy stock or actual shares of stock to reward long-term performance
- Tie bonus/options to value of the company

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# Chapter 1 Lecture - Introduction to Financial Management

## Transparency in Financial Reporting

Transparency requires that market participants have reliable, accurate information about a particular company.

### Sarbanes-Oxley (USA)

- An act passed in 2002 that established new regulations for auditors, corporate officers, and securities analysts.
- The goal was to make it less likely that companies and securities analysts would mislead investors, and increase the penalties for doing so.

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## 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)?

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## Short-Term vs. Long-Term Price

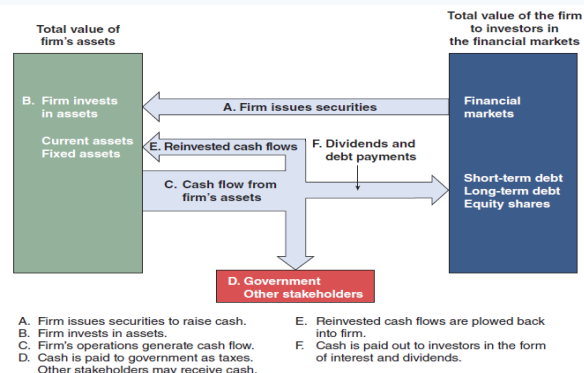
- Management can impact the market price over the short term by releasing incomplete or inaccurate information.
- Over the long term the market price will tend towards the fundamental value as more information becomes available.

What about the recent financial crisis?

[Credit Crisis Explained](#)

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## Cash Flows Between the Firm and the Financial Markets



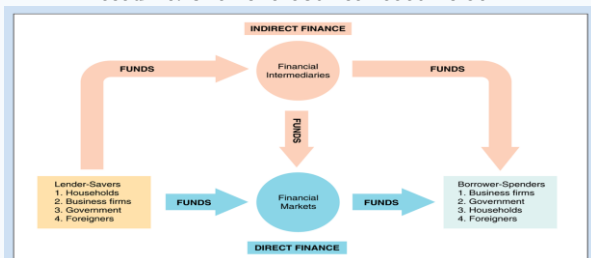
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# Chapter 1 Lecture - Introduction to Financial Management

## Flows of Funds Through the Financial System

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



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## Structure of Financial Markets

- Debt and Equity Markets.
  - Bonds are debt, stocks are equity.
- The **primary market** is the market where investors purchase newly issued securities.
  - **Initial public offering (IPO)**: An IPO occurs when a company offers stock for sale to the public for the first time.
  - **Seasoned equity offering (SEO)**: If a company already has public shares, an SEO occurs when a company raises more equity.
- The **secondary market** is the market where investors trade previously issued securities. An investor can trade:
  - Directly with other investors.
  - Indirectly through a broker who arranges transactions for others.
  - Directly with a dealer who buys and sells securities from inventory.

[Securities and Exchange Commission](#)

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## Dealer Market

- Security dealers sell/buy for their own account
- Help to stabilize the market
- Commit own capital in process of bringing sellers and buyers together
- Expect to earn a profit by “buying low and selling high”
- Take a risk on a change of price in the securities they own
- Most securities trade in dealer markets
- Over-the counter (OTC)
  - Network of dealers linked together by telephone or computers
- Good marketability of a security implies it can be sold, liquidated, and turned into cash very quickly without a collapse in price

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## Auction Market

- Buyers and sellers confront each other directly to set the price
- Either a single trade between all parties at a single price or a series of trades at different prices
- Particular rules of the auction determine exactly how buyers and sellers are matched up.
- All buy/sell orders are centralized so highest bidders and lowest offers are exposed to each other
- Posts—Specific locations where auctions for individual securities take place
- Specialists—Individual designated by the exchange to represent buy/sell orders tendered by customers

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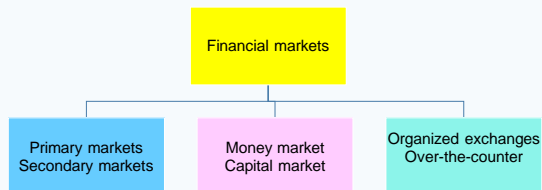
## Brokered Market

- Buyers/sellers employ services of a broker to search for information about the “other side” of the trade
- Broker’s role is to provide information
- Brokers earn a commission
- Real estate brokers—provide information for buyers/sellers of homes
- Municipal bonds are traded primarily in a brokered market

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## Structure of Financial Markets

- Organized Exchanges and Over-the-Counter (OTC) Markets
- Money and Capital Markets
  - Money markets deal in short-term debt instruments. Securities with maturity less than a year. Ex: Repo and reverse-repo market. Short-term liquidity is traded in money markets. Trade Volume is higher in money markets. Capital markets deal in longer-term debt and equity instruments. Bonds with maturity longer than a year and stocks are capital markets. “Long-term securities” refer to longer than 10 years.



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## Stock Quotes

<b>Google Inc. (GOOG)</b>		<b>±-7.26 (-1.04%)</b>	
<b>-Nasdaq</b>		<b>\$697.25</b>	
Prev Close	704.51	Day's Range	696.02 - 705.34
Open	705.00	52wk Range	556.52 - 774.38
Bid	697.17 x 300	Volume	970,625
Ask	697.40 x 300	Avg Vol (3m)	2,386,360
1y Target Est	799.32	Market Cap	229.08B
Beta	1.23	P/E (ttm)	21.85
Next Earnings Date	22-Jan-13	EPS (ttm)	31.91
<small>*data collected 1/22/2013</small>		Div & Yield	N/A (N/A)

1. Go to [finance.yahoo.com](http://finance.yahoo.com) and find the current stock prices for Southwest Airlines (LUV), Harley-Davidson (HOG), and Starwood Hotels & Resorts (HOT).
2. Get a quote for American Express (AXP) and follow the “Key Statistics” link. What information is available on this link? What do mrq, ttm, yoy, and lfy mean?

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## World Stock Markets

[Asian-Pacific Stock Indexes](#)

[Europe, Africa, Middle East Stock Indexes](#)

[Qatar Stock Index](#)

[U.S., North/Latin America Stock Indexes](#)

[World Stock Indexes](#)

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