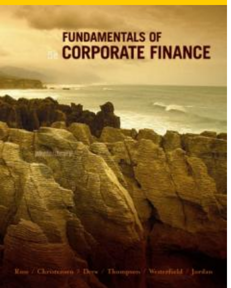
Fundamentals of corporate finance

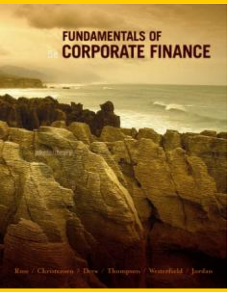


Chapter One

Introduction to corporate finance

PPTs to accompany Fundamentals of Corporate Finance 5e, by Ross, et al.
Slides prepared by Tim Whittaker

Chapter Organization



1.1 Corporate finance and the financial manager

1.2 The Balance Sheet and corporate financial decisions

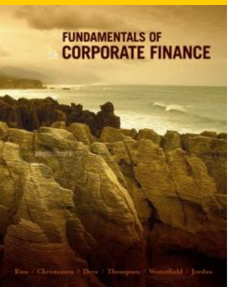
1.3 The corporate form of business organization

1.4 The goal of financial management

1.5 The agency problem and control of the corporation

1.6 Financial markets and the corporation

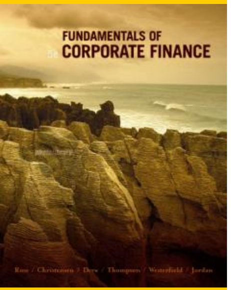
1.7 Summary and conclusions



Chapter Objectives

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

What is Corporate Finance?



- Corporate finance attempts to find the answers to the following questions:
  - What investments should the business take on?

    “The Investment Decision”

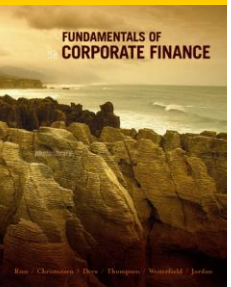
  - How can finance be obtained to pay for the required investments?

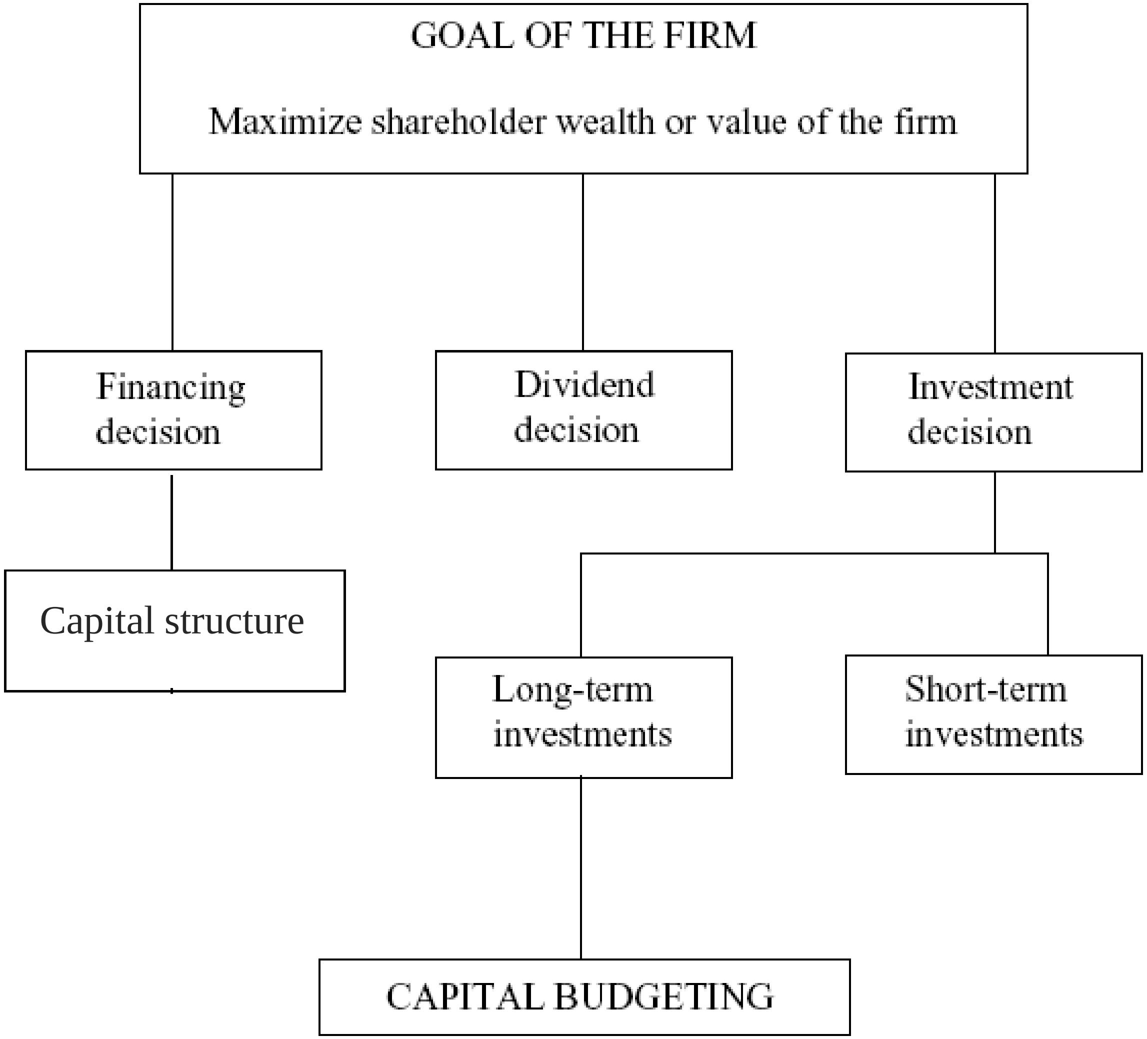
    “The finance decision”

  - Should dividends be paid? If so, how much?

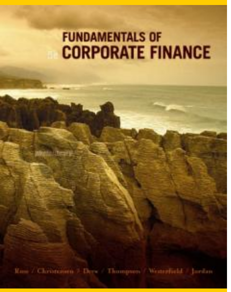
    “The dividend decision”

Financial Management Decisions





The Financial Manager

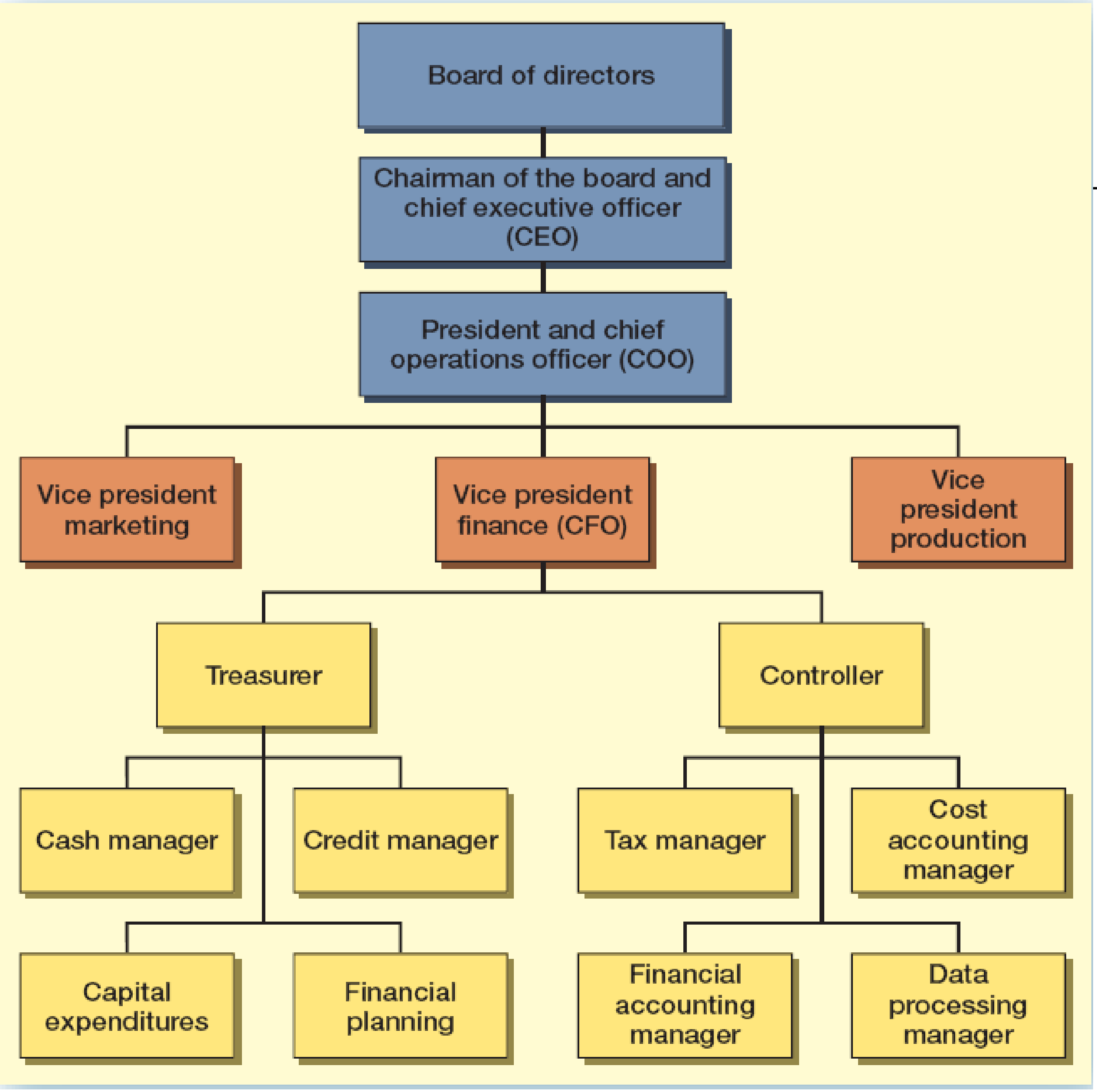


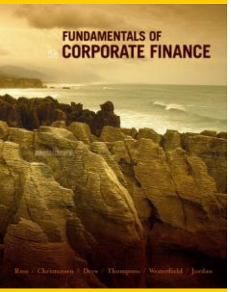
- Financial managers try to answer some or all of these questions.
- The top financial manager within a firm is usually the chief financial officer (CFO).
  - **Corporate Treasurer**

  oversees cash management, credit management, capital expenditures and financial planning.

  - **Controller**

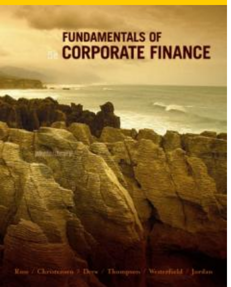
  oversees taxes, cost accounting, financial accounting and data processing.


Board of directors
Chairman of the board and chief executive officer (CEO)
President and chief operations officer (COO)
Vice president marketing
Vice president finance (CFO)
Vice president production
Treasurer
Controller
Cash manager
Credit manager
Tax manager
Cost accounting manager
Capital expenditures
Financial planning
Financial accounting manager
Data processing manager



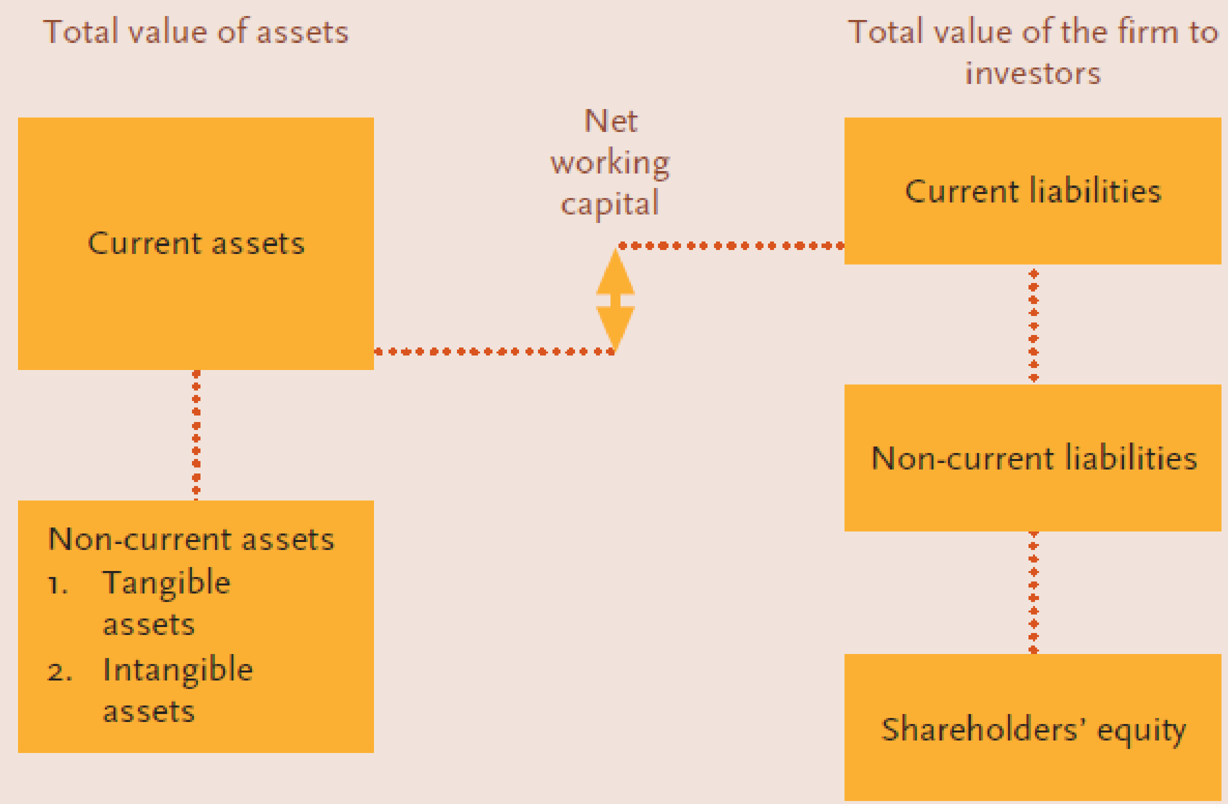
The Balance Sheet

- A convenient means of organizing and summarizing what a firm owns (its **assets**), what a firm owes (its **liabilities**), and the difference between the two (the firm's **equity**) at a given point in time.
- Assets and liabilities can be classified as **current** (having a life less than one year) or **non-current** (having a life longer than one year).
- The difference between a firm's current assets and current liabilities is called **net working capital**.
  – Net working capital is usually positive in a healthy firm.

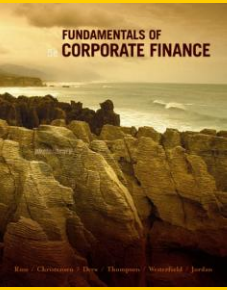


Balance Sheet Model of the Firm

Figure 1.2 *The balance sheet model of the firm*



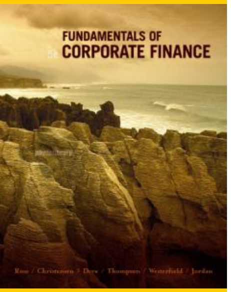
The Investment Decision



- **Capital budgeting** is the planning and managing of a firm's investment in non-current assets.

- Involves evaluating the:
  – size of future cash flows
  – timing of future cash flows
  – risk to future cash flows.

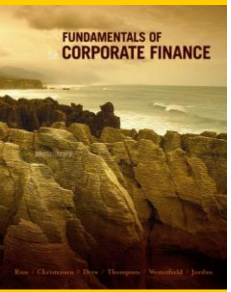
The Balance-Sheet Model of the Firm



The Capital Budgeting Decision

Assets	Liabilities and Equity
Current Assets	Current Liabilities
	Long-Term Debt
Fixed Assets 1 Tangible 2 Intangible	Shareholders' Equity

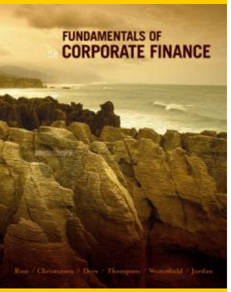
What long-term investments should the firm engage in?



Capital Structure

- A firm’s capital structure is the specific mix of debt and equity maintained by the firm.
- Decisions need to be made on both the financing mix, and how and where to raise the money.

The Balance-Sheet Model of the Firm



The Capital Structure Decision

Current Assets

Fixed Assets

1 Tangible

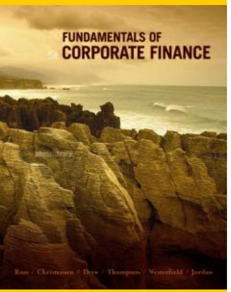
2 Intangible

How can the firm raise the money for the required investments?

Current Liabilities

Long-Term Debt

Shareholders' Equity



Working Capital Management

- How much cash and inventory should be kept on hand?

- Should credit terms be extended? If so, what are the conditions?

- How is short-term financing acquired?

The Balance-Sheet Model of the Firm

The Net Working Capital Investment Decision

Current Assets

Fixed Assets

1 Tangible

2 Intangible

Net Working Capital

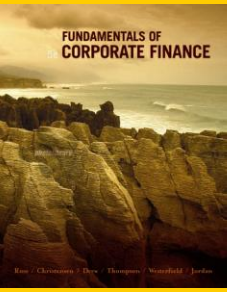
How much short-term cash flow does a company need to pay its bills?

Current Liabilities

Long-Term Debt

Shareholders' Equity

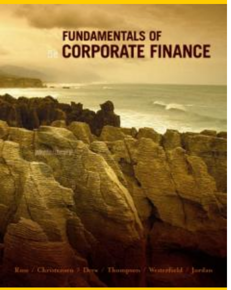
Dividend Decision



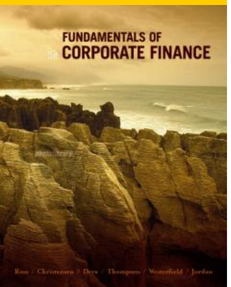
- Involves the decision of whether to pay a dividend to shareholders or maintain the funds within the firm for internal growth.

- Factors important to this decision include growth opportunities, taxation and shareholders' preferences.

Corporate Forms of Business Organization

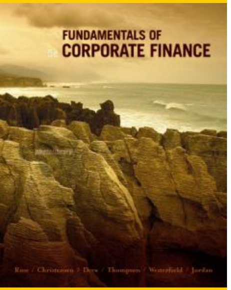


- Three different legal forms of business organization are:
  - Sole proprietorship
  - Partnership
  - Corporation (company)



Sole Proprietorship

- The business is owned by a single individual.
- The least regulated form of organization.
- Owner keeps all the profits, but assumes **unlimited liability** for the business's debts.
- Life of the business is limited to the owner's life span.
- Amount of equity raised is limited to owner's personal wealth.



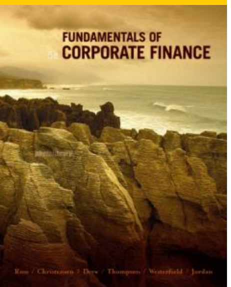
Sole Proprietorship

Advantages

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

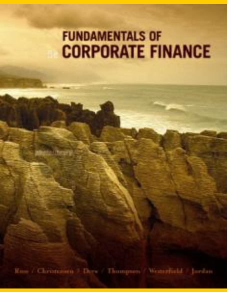
Disadvantages

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



Partnership

- The business is formed by two or more individuals.
- All partners share in profits and losses of the business, and have unlimited liability for debts.
- Easy and inexpensive form of organization.
- Partnership dissolves if one partner sells out or dies.
- Amount of equity raised is limited to the combined personal wealth of the partners.
- Income is taxed as personal income to partners.



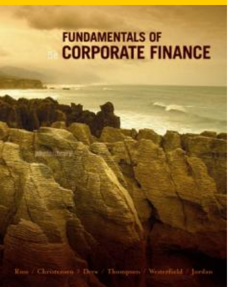
Partnership

Advantages

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

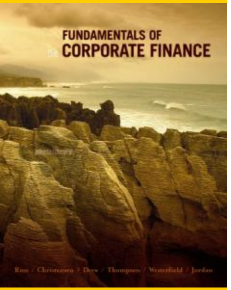
Disadvantages

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



Corporation

- A business created as a distinct legal entity, composed of one of more individuals or entities.
- Most complex and expensive form of organization.
- Shareholders and management are usually separated.
- Ownership can be readily transferred.
- Both equity and debt finance are easier to raise.
- Life of a company is not limited.
- Owners (shareholders) have limited liability.



Corporation

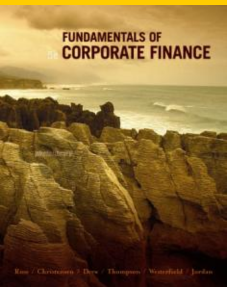
Advantages

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

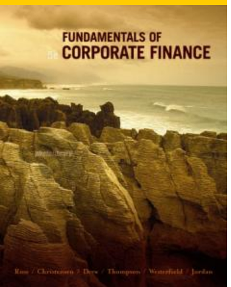
Disadvantages

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

Possible Goals of Financial Management



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

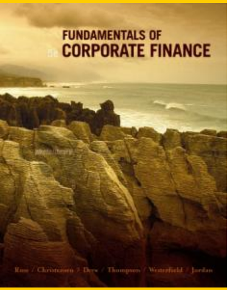


Problems with these Goals

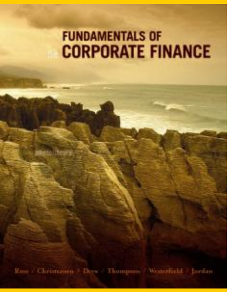
Each of these goals presents problems.

- These goals are either associated with increasing profitability or reducing risk.
- They are not consistent with the long-term interests of shareholders.
- It is necessary to find a goal that can encompass both profitability and risk.

The Firm’s Objective



- The goal of financial management is to maximize shareholders’ wealth.
- Shareholders’ wealth can be measured as the **current** value per share of existing shares.
- This goal overcomes the problems encountered with the goals outlined above.

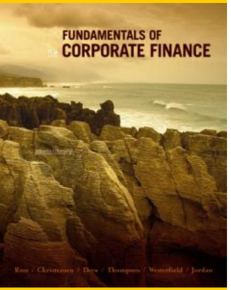


A More General Goal

- What is the appropriate goal for financial management when the firm has no traded shares?

  'Maximise the market value of the owners' equity'

- Good financial decisions increase the market value of the owners' equity, while poor financial decisions decrease it.



Source and Use of Funds

- The **source of funds** can be broken into new funds raised (the financing decision) and funds from running the operations of the business (part of the investment decisions).
- The **use of funds** can be broken into asset and non-asset expenditure (the other part of the investment decision), and payments to the firm's owners (the dividend decision).
- The financial manager cannot make or change one decision without affecting at least one of the other decisions. These decisions are taken in trying to meet the firm's objectives.

Interrelationship of the decisions made by a Financial Manager

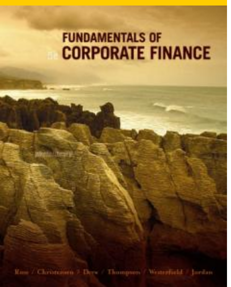
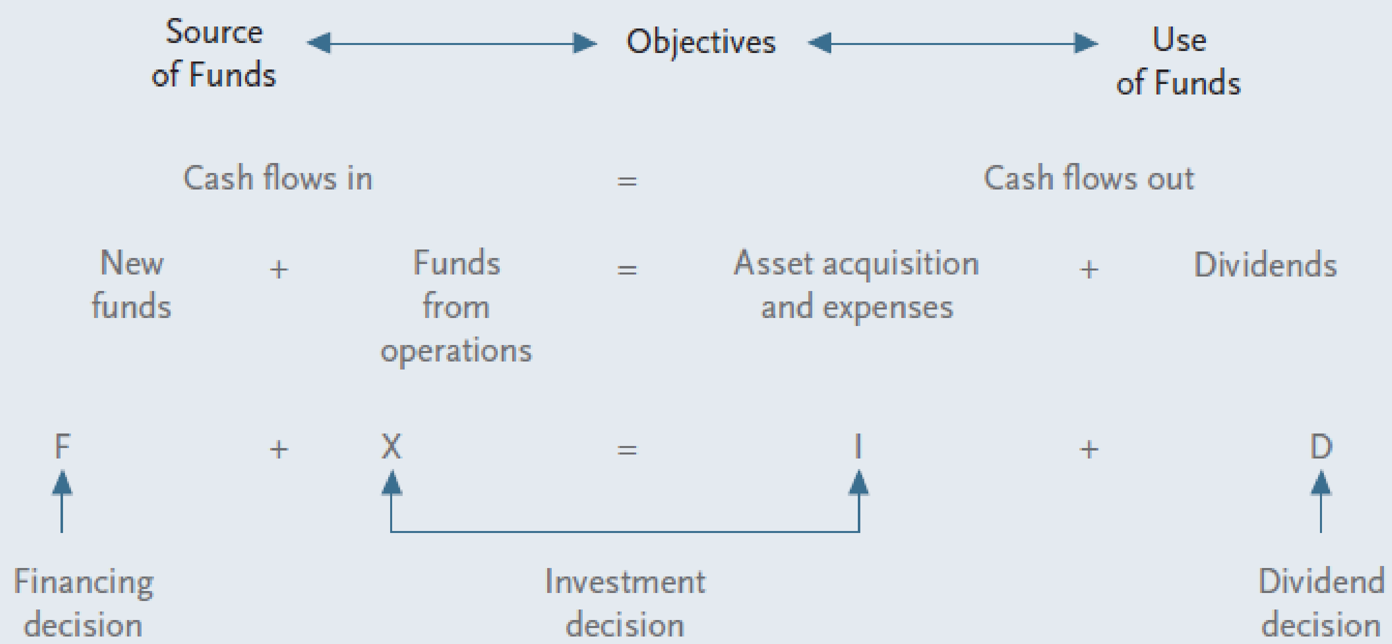
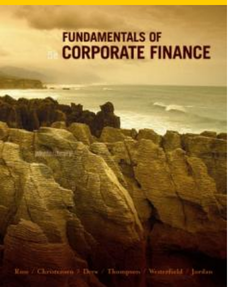


Figure 1.3 *The interrelationship of the decisions made by a financial manager*

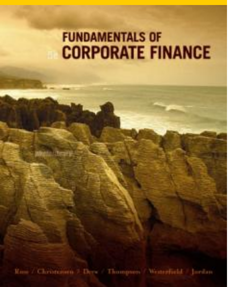


Agency Relationships



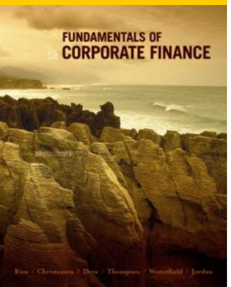
- The **agency relationship** is the relationship between the shareholders (owners) and the management of a firm.
- The **agency problem** is the possibility of conflict of interests between these two parties.
- **Agency costs** refer to the direct and indirect costs arising from this conflict of interest.

Do Managers Act in Shareholders' Interests?



The answer to this will depend on two factors:

- how closely management goals are aligned with shareholder goals.
- the ease with which management can be replaced if it does not act in shareholders' best interests.



Alignment of Goals

The conflict of interests is limited due to:

- management compensation schemes
- monitoring of management
- the threat of takeover
- other stakeholders

Cash Flows between the Firm and the Financial Markets

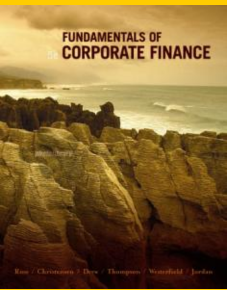
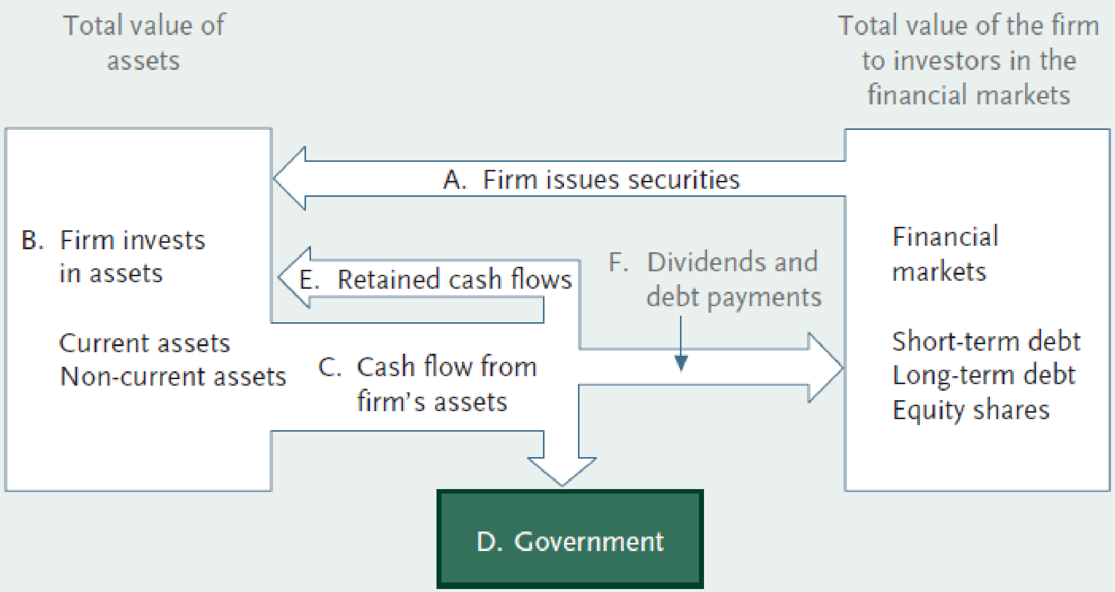
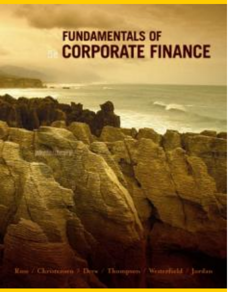


Figure 1.4 *Cash flows between the firm and the financial markets*

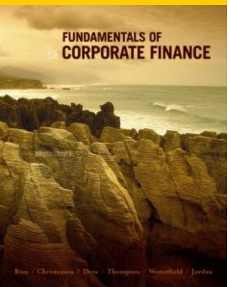


A. Firm issues securities to raise cash (the financing decision).
B. Firm invests in assets (capital budgeting).
C. Firm's operations generate cash flow.
D. Cash is paid to government as taxes.
E. Retained cash flows are reinvested in firm.
F. Cash is paid out to investors in the form of interest and dividends.



Financial Markets

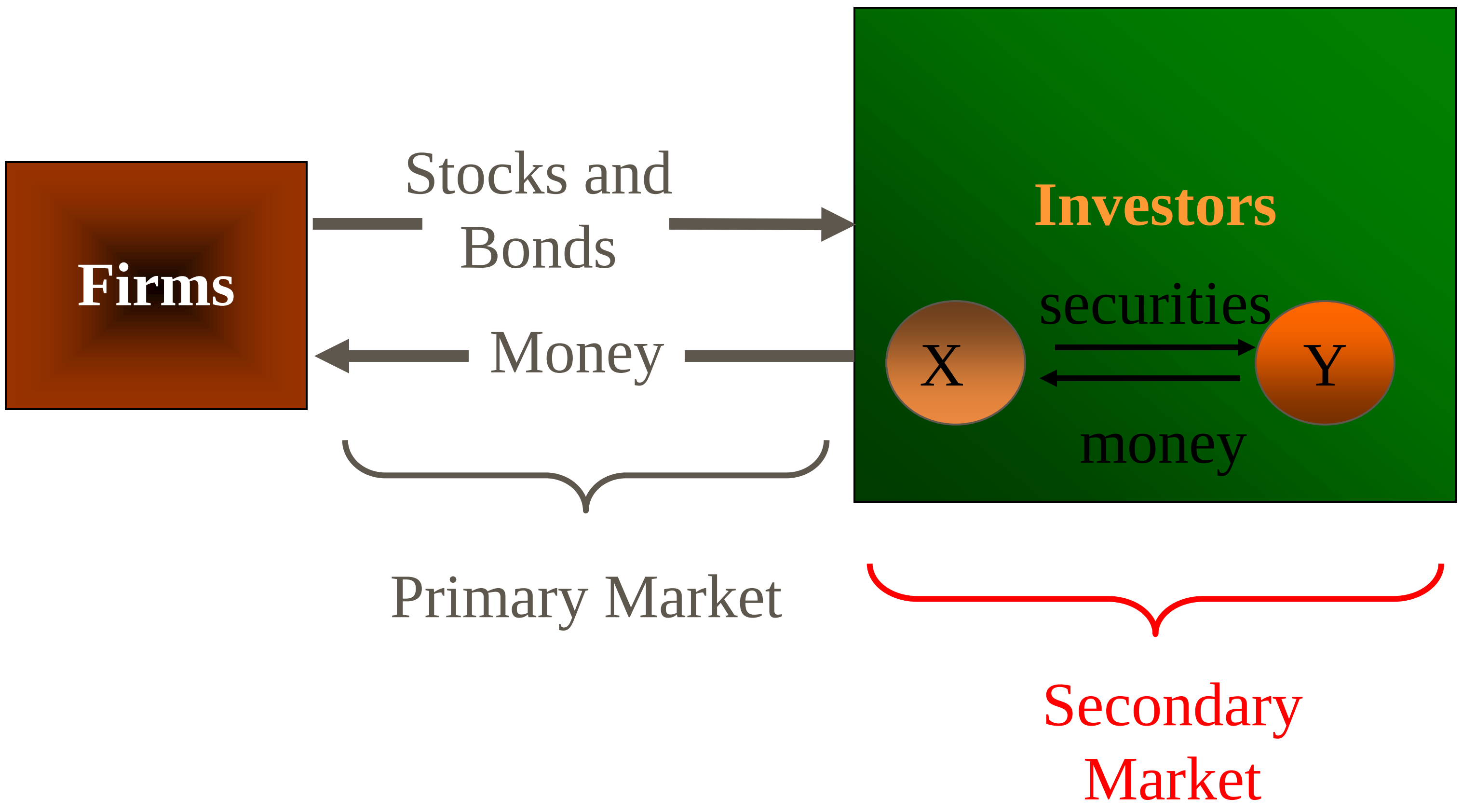
- **Financial markets** bring together the buyers and sellers of debt and equity securities.
- **Money markets** involve the trading of short-term debt securities.
- **Capital markets** involve the trading of long-term debt securities.
- **Primary markets** involve the original sale of securities.
- **Secondary markets** involve the continual buying and selling of issued securities.



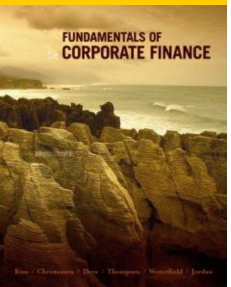
Structure of Financial Markets

- Financial Markets
  - Money Market
    - Primary Market
    - Secondary Market
  - Capital Market
    - Primary Market
    - Secondary Market

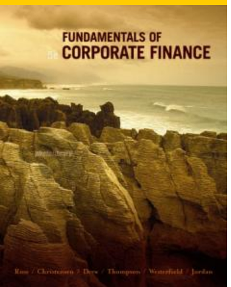
Financial Markets



Summary and Conclusions



- Corporate finance has three main areas of concern: investment, finance and dividend decisions.
- The goal of financial management in a profit firm is to maximise the market value of the equity.
- The corporate form of organization is superior to other forms for raising money, transferring ownership interests
- Conflicts between shareholders and management in a large corporation are called ‘agency problems’.
- Financial markets function as both primary and secondary markets for corporate securities.
- It is only the investment decision that affects firm value.



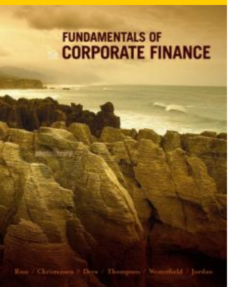
Test Questions

1-"Shareholder wealth" in a firm is represented by:

1. the number of people employed in the firm.
2. the book value of the firm's assets less the book value of its liabilities.
3. the amount of salary paid to its employees.
4. the market price per share of the firm's common stock.

2. management can be broken down into the decisions:

1. financing and investment
2. investment, financing, and dividend
3. financing and dividend
4. capital budgeting, cash management, and credit management



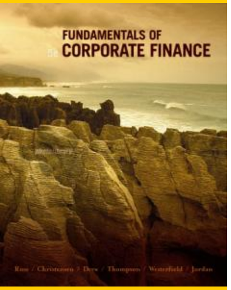
Test Questions

3- Which of the following enjoys limited liability?

1. A general partnership.
2. A corporation.
3. A sole proprietorship.
4. None of the above

4- A major advantage of the corporate form of organization is:

1. reduction of double taxation.
2. limited owner liability.
3. legal restrictions.
4. ease of organization



Test Questions

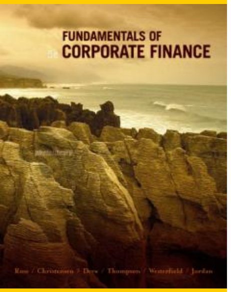
5. In finance, “net working capital" means the same thing as

1. total assets.
2. fixed assets.
3. current assets.
4. current assets minus current liabilities.

6. A capital investment (budgeting) is one that

1. has the prospect of long-term benefits.
2. has the prospect of short-term benefits
3. is only undertaken by large corporations.
4. None of the above

Test Questions

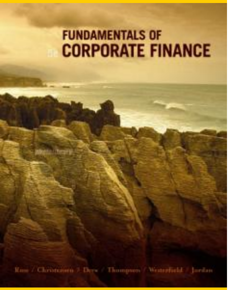


7. A business created as a distinct legal entity composed of one or more individuals or entities is called a(n):

1. Sole proprietorship.
2. Partnership.
3. Corporation.
4. Open structure.

8. The possibility of conflict of interest between the stockholders and management of the firm is called:

1. The shareholders' conundrum.
2. The agency problem.
3. Corporate breakdown.
4. Legal liability.



Test Questions

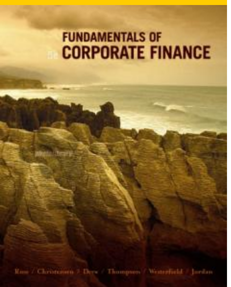
9. A stakeholder is:

1. Given to each stockholder when they first purchase their stock.
2. A founding stockholder of the firm.
3. An original creditor of the firm.
4. A person or entity including a stockholder or creditor, who potentially has a claim on the cash flows of the firm.

10. Capital structure refers to:

1. The management of long-term investments.
2. The accounts receivable policy.
3. The amount of cash on hand.
4. The mixture of debt and equity

Test Questions



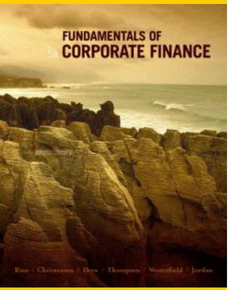
11. Retained earning are

1. an indication of a company's liquidity.
2. the same as cash in the bank.
3. not important when determining dividends.
4. the cumulative earnings of the company after dividends.

12. A business owned by a single individual is called a(n):

1. Partnership.
2. Sole proprietorship.
3. Corporation.
4. None of the above

Test Questions



13. Managers are generally defined as:

A. stockholders

B. agents

C. creditors

D. suppliers

14. The conflict between owners, employees, suppliers, and customers of a company is known as:

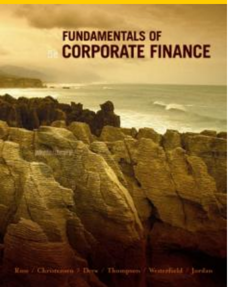
A. regulatory risk

B. problem of agency

C. conflict of multiple environments

D. conflict of interests

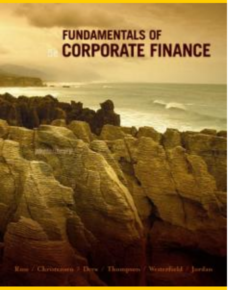
Test Questions



15. Agency costs are:

1. The costs that result from default and bankruptcy of the firm.
2. The total interest paid to creditors over the lifetime of the firm.
3. The total dividends paid to shareholders over the lifetime of the firm.
4. The costs of the conflict of interest between stockholders and management

Test Questions



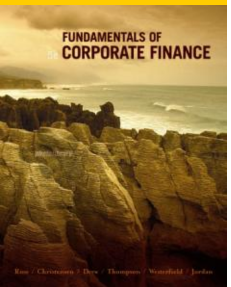
16. The original sale of securities by governments and corporations occurs in the:

1. Dealer market
2. Liquidation market.
3. Primary market
4. Auction market

17. The purchase and sale of securities after the original issuance occurs in the:

1. Secondary market
2. Liquidation market.
3. Dealer market
4. Primary market.

Test Questions

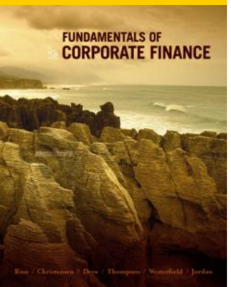


18. The Chief Financial Officer of a corporation is the:

1. Chairman of the Board.
2. Corporate Controller.
3. President.
4. Vice President of Finance.

19. The management of the firm's short-term assets and liabilities is called:

1. Financial depreciation.
2. Capital structure.
3. Capital budgeting.
4. Working capital management.



True or False Questions

1. In most corporations, the CFO ranks under the CEO.

   a. True   b. False

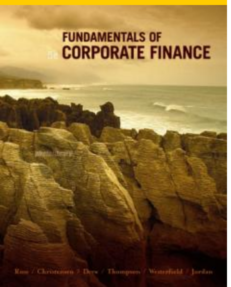
2. Partnerships and proprietorships generally have a tax advantage over corporations.

   a. True   b. False

3. In order to maximize its shareholders' value, a firm's management must attempt to maximize the expected EPS.

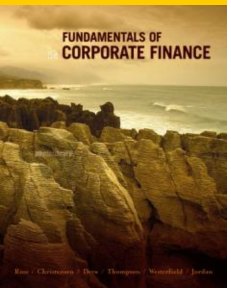
   a. True   b. False

Concept Questions



1. What are the three types of financial management decisions?
2. What is the capital budgeting decision?
3. What are the three major forms of business organization?
4. What are the primary advantages and disadvantages of sole proprietorships and partnerships?
5. What is the goal of financial management?
6. What decisions affect firm value?

Concept Questions



7. What is an agency relationship?

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

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

10. What incentives do managers in large corporations have to maximize share value?