

CHAPTER 1

An Overview of Financial Management

- What is finance?
- Career opportunities
- Forms of business organization
- Goals of the corporation
- Social responsibility

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What is Finance?

- Finance is the application of economic principles and concepts to business decision making and problem solving.

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Field of Finance

- The field of finance can be considered to comprise three broad categories:
 - financial management,
 - investments, and
 - financial institutions (money and capital markets).

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Areas of Finance

- Financial management (corporate finance) – primarily concerned with financial decision making within a business entity.
- Investments – focuses on behavior of financial markets and the pricing securities.
- Financial institutions – deals with banks and other firms that specialize in bringing the suppliers of funds together with the users of funds.

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Career Opportunities in Finance

- For more information:

www.careers-in-business.com

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Areas of Finance

- **It is important that we understand all three areas of finance.**
- Bank lending officers must be able to judge how well a business is being operated.
- Security analysts and stockbrokers need an understanding of general financial principles to provide customers intelligent advice regarding the best investment choices.
- Corporate financial managers need to know what their bankers are considering and how investors judge a firm's performance.

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Areas of Finance

- This course is corporate finance based, but covers topics from all three areas of finance.
- We discuss financial markets, security pricing, and corporate financial management techniques.
- Further, many of the topics and techniques covered are applicable to personal financial decisions.

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This Course

- In this course we primarily study corporate financial functions (often called financial management).
- Financial management focuses on the creation and maintenance of wealth.
- As a result, this course focuses on techniques and procedures that help financial managers make “good” decisions.

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Alternative Forms of Business Organization

- Financial choices are influenced by the type of business organization involved.
- There are three main types of business organizations.
 - Sole proprietorship
 - Partnership
 - Corporation

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Sole Proprietorship

- Advantages:
 - Ease of formation
 - Subject to few regulations
 - No corporate income taxes
- Disadvantages:
 - Limited life
 - Unlimited liability
 - Difficult to raise capital
- A partnership has roughly the same advantages and disadvantages as a sole proprietorship.

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Corporation

- Advantages:
 - Unlimited life
 - Easy transfer of ownership
 - Limited liability
 - Ease of raising capital *****
- Disadvantages:
 - Double taxation
 - Cost of set-up and report filing

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Agency relationships

- An agency relationship exists whenever a principal hires an agent to act on their behalf.
- Within a corporation, agency relationships exist between:
 - Shareholders and managers
 - Shareholders and creditors

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Shareholders versus Managers

- Managers are naturally inclined to act in their own best interests.
- But the following factors affect managerial behavior:
 - Managerial compensation plans
 - Direct intervention by shareholders
 - The threat of firing
 - The threat of takeover

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Shareholders versus Creditors

- Shareholders (through managers) could take actions to maximize stock price that are detrimental to creditors.
- In the long run, such actions will raise the cost of debt and ultimately lower stock price.

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Goal of the Corporation

- Common stockholders are the owners of the firm.
- Managers “report” to shareholders, and should try to make decisions that satisfy (benefit) shareholders.
- As mentioned before, financial management focuses on the creation and maintenance of wealth.

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Goal of the Corporation

- To maximize the “benefit” for shareholders, the primary goal of the firm should be:
shareholder wealth maximization.
- This roughly translates to maximizing stock price (although dividends must also be considered).

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Goal of the Corporation

- What do investors (shareholders) consider when analyzing a firm?

Everything!

- They use the information they gather to determine what they believe is a fair price for investing in the firm. (They are trying to set the stock price they are willing to pay.)

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Goal of the Corporation

- How do investors set stock prices?
- They:
 - estimate future cash flow amounts
 - estimate when cash flows will occur
 - assess the firm's risk
- They then use all this information to determine a current value for the firm.

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Goal of the Corporation

- Thus, as managers, to maximize shareholder wealth we have to simultaneously consider:
 - expected cash flows
 - risk of the cash flows
 - timing of the cash flows

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Does profit maximization equal stock price maximization?

No, there is generally a high correlation between EPS, cash flow, and stock price, but today's stock price relies not only on current earnings, but future earnings and cash flows.

Some actions may increase earnings, yet cause stock price to decrease (and vice versa).

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Basic Concepts of Finance

- Finance is an involved subject, but based on the discussion so far you probably can see that the main concepts are relatively simple.

- Let's list them again to make the point more clear.

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Basic Concepts of Finance

- 1. Risk and return

- investors will only take on additional risk if they expect to receive adequate compensation

- How we measure risk and what we mean by “adequate” are the “complicated” parts of this concept.

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Basic Concepts of Finance

■ 2. Time value of money

- money has a time value associated with it – a dollar today is worth more than a dollar tomorrow.

- This simply means that if you have the dollar today you can invest it so it will grow to be worth more over time.

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Basic Concepts of Finance

■ 3. Cash flow (not profit) –

- focus on the “cash” available for our use not accounting profits.

- We should be concerned with the amount of funds “in our hands” not the “profit” shown. It is also important to focus on “incremental cash flows” (the cash flows added to the firm by a project).

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Firm's Responsibilities to Others

- Maximization of shareholder wealth does not mean firms lack social responsibilities.
- Stock price maximization actually requires that firms provide socially desired services.
- Stockholder wealth maximization requires:
 - products to meet consumer needs and wants
 - efficient, low-cost plants
 - high quality goods
 - good service
 - adequate stocks of merchandise
 - well-located businesses

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Societal Concerns

- On the other hand, firms will find it difficult to unilaterally pursue socially responsible actions.
- Acting alone will likely increase costs and put the firm at a disadvantage relative to less socially responsible firms.

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Societal Concerns

- In such cases, it is either up to:
 - consumers to show a preference for socially responsible actions (buy only from socially responsible firms, etc.)
 - government to require socially responsible behavior through regulation and enforcement