Ch. 1 Overview of Financial Management

Topics

- Forms of Businesses
- Roles of The Financial Manager
- Corporate Goals
- Intrinsic Values, Stock Prices, and Managerial Incentives

Organizing a Business

- Forms of Business Organizations
  1. Sole Proprietorships
  2. Partnerships
     - Limited partnerships
  3. Corporations

Proprietorships & Partnerships

- Advantages
  - Ease of formation
  - Subject to few regulations
  - No corporate income taxes
- Disadvantages
  - Difficult to raise capital
  - Unlimited liability
  - Limited life

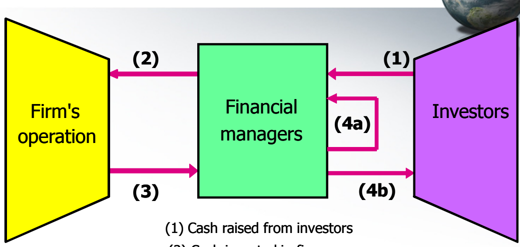
Corporation

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

Forms of Businesses

	Sole Proprietorship	Partnership	Corporation
Ownership belongs to	The Manager	Partners	Stockholders
Separation of ownership and management	No	No	Usually
Owner liability	Unlimited	Unlimited (exceptions)	Limited
Separate taxation	No	No	Yes

Role of The Financial Manager



(1) Cash raised from investors
(2) Cash invested in firm
(3) Cash generated by operations
(4a) Cash reinvested
(4b) Cash returned to investors

Role of The Financial Manager

- Investment Decisions
  - "Capital Budgeting"
  - Buy real assets that are worth more than they cost
- Financing Decisions
  - Source of Funds: "Capital Markets"
  - Capital Structure

Some Important Trends

As a future (financial) manager, you should note three important recent trends:

1. Recent corporate scandals have reinforced the importance of business ethics, and have spurred additional regulations and corporate oversight.
2. The effects of changing information technology have had a profound effect on all aspects of business finance.
3. The continued globalization of business is constantly reshaping the corporate world.

Goals of The Corporation

- Shareholders desire wealth maximization.
- Mangers have many constituencies: "Stakeholders"
- Do managers maximize shareholder wealth?
  - Do firms have any responsibilities to society at large?
  - Is stock price maximization good or bad for society?
  - Should firms behave ethically?
- "Agency Problems" represent the conflict of interest between management and owners.

Balancing Shareholder Value and Society Interests

- The primary financial goal of management is shareholder wealth maximization, which many people often translate it as maximizing stock price.
  - Value of any asset is present value of cash flow stream to owners.
  - Most significant decisions are evaluated in terms of their financial consequences.
  - Stock prices change over time as conditions change and as investors obtain new information about a company's prospects.
- Managers recognize that being socially responsible is not inconsistent with maximizing shareholder value and should try to **maximize the firm's intrinsic value**, not current market price.

Stock Price and Intrinsic Value

- In equilibrium, a stock's price should equal its "true" or intrinsic value.
- Intrinsic value is a long-run concept.
- To the extent that investor perceptions are incorrect, a stock's price in the short run may deviate from its intrinsic value.
- Ideally, managers should avoid actions that reduce intrinsic value, even if those decisions increase the stock price in the short run.

Agency Problem Solutions

1. Pay for performance
2. Internal monitoring system
3. Market for corporate control
4. Specialist monitoring / auditors
5. Product market
6. Lawsuit