CHAPTER 1

Introduction to Corporate Finance

Key Concepts and Skills

- Know the basic types of financial management decisions and the role of the Financial Manager
- Know the financial implications of the various forms of business organization
- Know the goal of financial management
- Understand the conflicts of interest that can arise between owners and managers
- Understand the various types of financial markets

Chapter Outline

1.1 What is Corporate Finance?
1.2 The Corporate Firm
1.3 The Goal of Financial Management
1.4 The Agency Problem and Control of the Corporation
1.5 Financial Markets

The Capital Budgeting Decision

What long-term investments should the firm choose?
The Capital Structure Decision

How should the firm raise funds for the selected investments?

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

Short-Term Asset Management

How should short-term assets be managed and financed?

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

Capital Structure

The value of the firm can be thought of as a pie.
The goal of the manager is to increase the size of the pie.
The Capital Structure decision can be viewed as how best to slice the pie.
If how you slice the pie affects the size of the pie, then the capital structure decision matters.

The Financial Manager

The Financial Manager’s primary goal is to increase the value of the firm by:
1. Selecting value creating projects
2. Making smart financing decisions

Hypothetical Organization Chart

The Firm and the Financial Markets

Ultimately, the firm must be a cash generating activity.
The cash flows from the firm must exceed the cash flows from the financial markets.
1.2 The Corporate Firm

- The corporate form of business is the standard method for solving the problems encountered in raising large amounts of cash.
- However, businesses can take other forms.

Forms of Business Organization

- The Sole Proprietorship
- The Partnership
  - General Partnership
  - Limited Partnership
- The Corporation

A Comparison

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity</td>
<td>Shares can be easily exchanged</td>
</tr>
<tr>
<td>Voting Rights</td>
<td>Usually each share gets one vote</td>
</tr>
<tr>
<td>Taxation</td>
<td>Double</td>
</tr>
<tr>
<td>Reinvestment and dividend payout</td>
<td>Broad latitude</td>
</tr>
<tr>
<td>Liability</td>
<td>Limited liability</td>
</tr>
<tr>
<td>Continuity</td>
<td>Perpetual life</td>
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</tbody>
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1.3 The Goal of Financial Management

- What is the correct goal?
  - Maximize profit?
  - Minimize costs?
  - Maximize market share?
  - Maximize shareholder wealth?

1.4 The Agency Problem

- Agency relationship
  - Principal hires an agent to represent his/her interest
  - Stockholders (principals) hire managers (agents) to run the company
- Agency problem
  - Conflict of interest between principal and agent

Managerial Goals

- Managerial goals may be different from shareholder goals
  - Expensive perquisites
  - Survival
  - Independence
- Increased growth and size are not necessarily equivalent to increased shareholder wealth
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 intended goal
- Corporate control
  - The threat of a takeover may result in better management
- Other stakeholders

1.5 Financial Markets

- Primary Market
  - Issuance of a security for the first time
- Secondary Markets
  - Buying and selling of previously issued securities
  - Securities may be traded in either a dealer or auction market
  - NYSE
  - NASDAQ

Financial Markets

- Primary Market
  - Stocks and bonds
  - Money
- Secondary Market
  - Investors
  - Securities
  - Sue

Quick Quiz

- What are the three basic questions Financial Managers must answer?
- What are the three major forms of business organization?
- What is the goal of financial management?
- What are agency problems, and why do they exist within a corporation?
- What is the difference between a primary market and a secondary market?

Contact Information

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