Chapter 1
Introduction to Corporate Finance

http://www2.gsu.edu/~fnccwh/pdf/rwjch1v3overview.pdf

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 regulations that firms face

Chapter Outline

1.1 What is Corporate Finance?
1.2 The Corporate Firm
1.3 The Importance of Cash Flows
1.4 The Goal of Financial Management
1.5 The Agency Problem and Control of the Corporation
1.6 Regulation

1.1 What Is Corporate Finance?

Corporate Finance addresses the following three questions:
1. What long-term investments should the firm choose?
2. How should the firm raise funds for the selected investments?
3. How should short-term assets be managed and financed?
The Capital Structure Decision

How should the firm raise funds for the selected investments?

Fixed Assets
1 Tangible
2 Intangible

Shareholders' Equity

Current Liabilities

Long-Term Debt

Current Assets

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

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

Short-Term Asset Management

How should short-term assets be managed and financed?

Net Working Capital

Fixed Assets
1 Tangible
2 Intangible

Shareholders' Equity

Current Liabilities

Long-Term Debt

Current Assets

Hypothetical Organization Chart

Chairman of the Board and Chief Executive Officer (CEO)

President and Chief Operating Officer (COO)

Vice President and Chief Financial Officer (CFO)

Treasurer

Controller

Cash Manager

Capital Expenditures

Credit Manager

Financial Planning

Tax Manager

Financial Accounting

Cost Accounting

Data Processing

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."
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>
</tr>
</tbody>
</table>

1.3 The Importance of Cash Flow

Ultimately, the firm must be a cash generating activity.

1.4 The Goal of Financial Management

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

1.5 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
1.6 Regulation

- The Securities Act of 1933 and the Securities Exchange Act of 1934
  - Issuance of Securities (1933)
  - Creation of SEC and reporting requirements (1934)
- Sarbanes-Oxley (“Sarbox”)
  - Increased reporting requirements and responsibility of corporate directors

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 major regulations impact public firms?

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