Learning Objectives

- Introduction
  1. Finance: An Overview
  2. Three Types of Business Organizations
  3. The Goal of the Financial Manager
  4. The Four Basic Principles of Finance

Learning Objectives

1. Understand the importance of finance in your personal and professional lives and identify the three primary business decisions that financial managers make.

2. Identify the key differences between three major legal forms of business.
Learning Objectives

- Understand the role of the financial manager within the firm and the goal for making financial choices.
- Explain the four principles of finance that form the basis of financial management for both businesses and individuals.

1.1 FINANCE: AN OVERVIEW

What is Finance?

- Finance is the study of how people and businesses evaluate investments and raise capital to fund them.
Three Questions Addressed by the Study of Finance:

1. What long-term investments should the firm undertake? *capital budgeting decisions*
2. How should the firm fund these investments? *capital structure decisions*
3. How can the firm best manage its cash flows as they arise in its day-to-day operations? *working capital management decisions*

Why Study Finance?

- Knowledge of financial tools is critical to making good decisions in both professional world and personal lives.
- Finance is an integral part of corporate world
- Many personal decisions require financial knowledge (for example: buying a house, planning for retirement, leasing a car)

1.2 THREE TYPES OF BUSINESS ORGANIZATIONS
How Does Finance Fit into the Firm’s Organizational Structure?

- In a corporation, the Chief Financial Officer (CFO) is responsible for managing the firm’s financial affairs.
1.3 THE GOAL OF THE FINANCIAL MANAGER

The Goal of the Financial Manager

- The goal of the financial manager must be consistent with the mission of the corporation.
- What is the generally accepted mission of a corporation?
- To maximize firm value shareholder’s wealth (as measured by share prices)
Agency Problems in Corporate Finance

- Agency relationship exists when one or more persons (known as the principal) contracts with one or more persons (the agent) to make decisions on their behalf.

- In a corporation, the managers are the agents and the stockholders are the principal.

Agency Problems in Corporate Finance

- Agency problems arise when there is conflict of interest between the stockholders and the managers.
  - Such problems are likely to arise more when the managers have little or no ownership in the firm.
- Examples:
  - Not pursuing risky project for fear of losing jobs,
  - Manipulating accounting data
  - Stealing,
  - Expensive perks.

- All else equal, agency problems reduce firm value.

How to Reduce Agency Problems?

1. Monitoring
   (Examples: Reports, Meetings, Auditors, board of directors, financial markets, bankers, credit agencies)

2. Compensation plans
   (Examples: Performance based bonus, salary, stock options, benefits)

3. Others
   (Examples: Threat of being fired, Threat of takeovers, Stock market, regulations such as SOX)

The above measures will help to reduce cost of agency problems.
- Do not eliminate them
1.4 THE FOUR BASIC PRINCIPLES OF FINANCE

PRINCIPLE 1: Money Has a Time Value.
- A dollar received today is more valuable than a dollar received in the future.
  - We can invest the dollar received today to earn interest.
  - Thus, in the future, you will have more than one dollar, as you will receive the interest on your investment plus your initial invested dollar.

PRINCIPLE 2: There is a Risk-Return Trade-off.
- We only take risk when we expect to be compensated for the extra risk with additional return.
- Higher the risk, higher will be the expected return.
PRINCIPLE 3: Cash Flows Are The Source of Value.

- Net income is an accounting concept designed to measure a business’s performance over an interval of time.

- Cash flow is the amount of cash that can actually be taken out of the business over this same interval.

Profits versus Cash

- It is possible for a firm to report accounting profits but have no cash.

- For example, if all sales are on credit, the firm may report accounting profits even though no cash is being generated.
Incremental Cash Flow

- Financial decisions in a firm should consider “incremental cash flow”
  - The difference between the cash flows the company will produce with the potential new investment and what it would make without the investment.

PRINCIPLE 4: Market Prices Reflect Information.

- Investors respond to new information by buying and selling their investments.

- The speed with which investors act and the way that prices respond to new information determines the efficiency of the market.
  - In efficient markets like United States, this process occurs very quickly.
  - As a result, it is hard to profit from trading investments on publicly released information.

- Investors in capital markets will tend to react positively to good decisions made by the firm resulting in higher stock prices.

- Stock prices will tend to decrease when there is bad information released on the firm in the capital market.