Chapter 1 – Fin 3320 - Moore

Getting Started:

Principles of Finance

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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.

3. Understand the role of the financial manager within the firm and the goal for making financial choices.

4. Explain the four principles of finance that form the basis of financial management for both businesses and individuals.

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:

- What long-term investments should the firm undertake? (capital budgeting decisions)
- How should the firm fund these investments? (capital structure decisions)
- 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**
  - How will GM’s strategic decision to invest $740 million to produce the Chevy Volt require the expertise of different disciplines within the business school such as marketing, management, accounting, operations management, and finance?

• Many **personal decisions require financial knowledge** (for example: buying a house, planning for retirement, leasing a car)

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Business Organizational Forms

- Business Forms
  - Sole Proprietorships
  - Partnerships
  - Corporations
  - Hybrids

FINC-301, Chapter 1, Russel
**Sole Proprietorship**

- It is a business owned by a single individual that is entitled to all the firm’s profits and is responsible for all the firm’s debt.
- There is no separation between the business and the owner when it comes to debts or being sued.
- Sole proprietorships are generally financed by personal loans from family and friends and business loans from banks.

**Advantages:**
- Easy to start
- No need to consult others while making decisions
- Taxed at the personal tax rate

**Disadvantages:**
- Personally liable for the business debts
- Ceases on the death of the proprietor

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**Partnership**

- A **general partnership** is an association of two or more persons who come together as co-owners for the purpose of operating a business for profit.

- There is no separation between the partnership and the owners with respect to debts or being sued.

**Advantages:**
- Relatively easy to start
- Taxed at the personal tax rate
- Access to funds from multiple sources or partners

**Disadvantages:**
- Partners jointly share unlimited liability
Partnership (cont.)

• In **limited partnerships**, there are two classes of partners: general and limited.

• The general partners run the business and face unlimited liability for the firm’s debts, while the limited partners are only liable on the amount invested.

• One of the drawbacks of this form is that it is difficult to transfer the ownership of the general partner.

Corporation

• Corporation is “an artificial being, invisible, intangible, and existing only in the contemplation of the law.”

• Corporation can individually sue and be sued, purchase, sell or own property, and its personnel are subject to criminal punishment for crimes committed in the name of the corporation.

• Corporation is legally owned by its current stockholders.

• The Board of directors are elected by the firm’s shareholders. One responsibility of the board of directors is to appoint the senior management of the firm.
Corporation (cont.)

- Advantages
  - Liability of owners limited to invested funds
  - Life of corporation is not tied to the owner
  - Easier to transfer ownership
  - Easier to raise Capital
- Disadvantages
  - Greater regulation
  - Double taxation of dividends

Hybrid Organizations

- These organizational forms provide a cross between a partnership and a corporation.
- Limited liability company (LLC) combines the tax benefits of a partnership (no double taxation of earnings) and limited liability benefit of corporation (the owner’s liability is limited to what they invest).
- S-type corporation provides limited liability while allowing the business owners to be taxed as if they were a partnership – that is, distributions back to the owners are not taxed twice as is the case with dividends in the standard corporate form.
Figure 5.1

Characteristics of Different Forms of Business

<table>
<thead>
<tr>
<th>Business Form</th>
<th>Number of Owners</th>
<th>Are Owners Liable for the Firm’s Debts?</th>
<th>Do Owners Manage the Firm?</th>
<th>Does an Ownership Change Dissolve the Firm?</th>
<th>Access to Capital</th>
<th>Taxation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole Proprietorship</td>
<td>One</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Very limited</td>
<td>Personal Taxes</td>
</tr>
<tr>
<td>Partnership</td>
<td>Unlimited</td>
<td>Yes, each partner has unlimited liability</td>
<td>Yes</td>
<td>Yes</td>
<td>Very limited</td>
<td>Personal Taxes</td>
</tr>
<tr>
<td>Limited Partnership (with General Partners (GPs) and Limited Partners (LPs))</td>
<td>At least one GP, but no limit on LPs</td>
<td>GPs—unlimited liability LPs—limited liability</td>
<td>GPs—manage the firm LPs—no role in management</td>
<td>GPs—Yes LPs—No, can change¹</td>
<td>Limited</td>
<td>Personal Taxes</td>
</tr>
<tr>
<td>Limited Liability Company</td>
<td>Unlimited</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Dependent upon size</td>
<td>Personal Taxes</td>
</tr>
<tr>
<td>Corporation</td>
<td>Unlimited</td>
<td>No</td>
<td>No—although managers generally have an ownership stake²</td>
<td>No</td>
<td>Very easy access</td>
<td>Double Taxation: Earnings taxed at corporate level; Dividends taxed at personal level</td>
</tr>
</tbody>
</table>

¹It is common for LLCs to require approval from the other partners before a partner’s ownership can be transferred.
²Owners are not prohibited from managing the corporation.
The Goal of the Financial Manager

- The goal of the financial manager must be consistent with the mission of the corporation.
- Generally accepted mission of a corporation. To maximize firm value (or shareholder’s wealth as measured by share prices).

Example Corporate Mission Statements

- “To achieve sustainable growth, we have established a vision with clear goals: Maximizing return to shareholders while being mindful of our overall responsibilities” (part of Coca-Cola’s mission statement)
- “Our final responsibility is to our stockholders ...when we operate according to these principles, the stockholders should realize a fair return” (part of Johnson & Johnson’s credo)
- “Optimize for the long-term rather than trying to produce smooth earnings for each quarter” (Google)
Corporate Mission

- While managers have to cater to all the stakeholders (such as consumers, employees, suppliers etc.), they need to pay particular attention to the owners of the corporation i.e. shareholders.

- If managers fail to pursue shareholder wealth maximization, they will lose the support of investors and lenders. The business may cease to exist and ultimately, the managers will lose their jobs!

Agency Considerations in Corporate Finance

- **Agency relationship** exists when one or more persons (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** 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, stealing, expensive perks.

- All else equal, agency problems will reduce the 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 will help to reduce agency problems/costs.

**Agency/Conflict of Interest Relationships**

- Manager vs. Shareholder Interests
- Manager vs. Bondholder (lender) Interests
- Bondholder (lender) vs. Shareholder Interests

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**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. In the future, you will have more than one dollar. 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. (Conservative view)

- **Profit** 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. (Conservative view is that “you can’t spend profits” but you can spend cash)
  - For example, if all sales are on credit, the firm may report profits even though no cash is being generated.
- **Pragmatic view** is that Cash flow and Profits are highly correlated and both create value.
**Incremental Cash Flows**

- Financial decisions in a firm should consider “incremental cash flow”
  - i.e. the difference between the cash flows the company will produce with the potential new investment it’s thinking about making and what it would make without the investment.

  - Later, we will use this concept to derive capital budgeting decision criteria.

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**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.
The goal of the firm should be:

- 1) maximization of profits.
- 2) maximization of shareholder wealth.
- 3) maximization of consumer satisfaction.
- 4) maximization of sales.