



Chapter 1 Introduction to Financial Management

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Key Concepts and Skills

After studying this chapter, you should be able to:

- Discuss the basic types of financial management decisions and the role of the financial manager.
- Identify the goal of financial management.
- Compare the financial implications of the different forms of business organizations.
- Describe the conflicts of interest that can arise between managers and owners.

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Chapter Outline

- 1.1 Finance: A Quick Look
- 1.2 Business Finance and The Financial Manager
- 1.3 Forms of Business Organization
- 1.4 The Goal of Financial Management
- 1.5 The Agency Problem and Control of the Corporation
- 1.6 Financial Markets and the Corporation

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Basic Areas of Finance

1. Corporate finance = Business finance
2. Investments
3. Financial institutions
4. International finance

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Investments

- Work with financial assets such as stocks and bonds
- Value of financial assets, risk versus return, and asset allocation
- Job opportunities
 - Stockbroker or financial advisor
 - Portfolio manager
 - Security analyst

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Financial Institutions

- Companies that specialize in financial matters
 - Banks—commercial and investment, credit unions, savings and loans
 - Insurance companies
 - Brokerage firms
- Job opportunities

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International Finance

- An area of specialization within each of the areas discussed so far
- May allow you to work in other countries or at least travel on a regular basis
- Need to be familiar with exchange rates and political risk
- Need to understand the customs of other countries; speaking a foreign language fluently is also helpful

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Basic Areas Of Finance

Traditionally, financial topics are grouped into four main areas:

1. Corporate finance
2. Investments
3. Financial institutions
4. International finance

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Why Study Finance?

- Marketing
 - Budgets, marketing research, marketing financial products
- Accounting
 - Dual accounting and finance function, preparation of financial statements
- Management
 - Strategic thinking, job performance, profitability
- Personal finance
 - Budgeting, retirement planning, college planning, day-to-day cash flow issues

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Business Finance

- Some important questions that are answered using finance:
 - What long-term investments should the firm take on?
 - Where will we get the long-term financing to pay for the investments?
 - How will we manage the everyday financial activities of the firm?

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Financial Manager

- Financial managers try to answer some, or all, of these questions.
- The top financial manager within a firm is usually the Chief Financial Officer (CFO).
 - Treasurer—oversees cash management, credit management, capital expenditures, and financial planning
 - Controller—oversees taxes, cost accounting, financial accounting, and data processing

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Corporate Organization Chart Figure 1.1

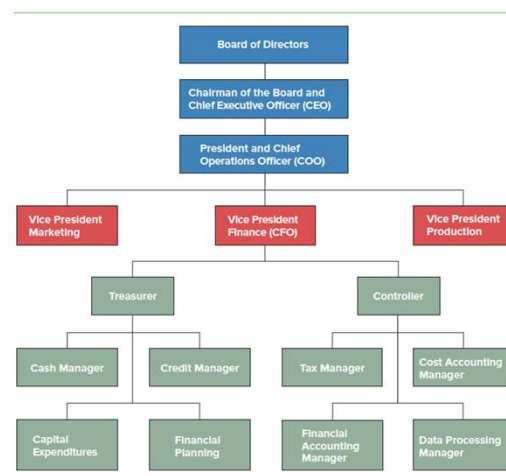


FIGURE 1.1

A simplified organizational chart. The exact titles and organization differ from company to company.

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Financial Management Decisions

- Capital budgeting
 - What long-term investments or projects should the business take on?
- Capital structure
 - How should we pay for our assets?
 - Should we use debt or equity?
- Working capital management
 - How do we manage the day-to-day finances of the firm?

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Forms of Business Organization

Three major forms in the United States

- Sole proprietorship
- Partnership
 - General
 - Limited
- Corporation
 - S-Corp
 - Limited liability company

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Sole Proprietorship

Business owned by one person

- Advantages
 - Easiest to start
 - Least regulated
 - Single owner keeps all of the profits
 - Taxed once as personal income
- Disadvantages
 - Limited to life of owner
 - Equity capital limited to owner's personal wealth
 - Unlimited liability
 - Difficult to sell ownership interest

Information about business structures can be found [at this link](#).

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Partnership

Business owned by two or more persons

- Advantages
 - Two or more owners
 - More capital available
 - Relatively easy to start
 - Income taxed once as personal income
- Disadvantages
 - Unlimited liability
 - General partnership
 - Limited partnership
 - Partnership dissolves when one partner dies or wishes to sell
 - Difficult to transfer ownership

Information about business structures can be found [at this link](#).

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Corporation

A legal “person” distinct from owners and a resident of a state

- Advantages
 - Limited liability
 - Unlimited life
 - Separation of ownership and management
 - Transfer of ownership is easy
 - Easier to raise capital
- Disadvantages
 - Separation of ownership and management (agency problem)
 - Double taxation (income taxed at the corporate rate and then dividends taxed at personal rate, while dividends paid are not tax deductible)

Information about business structures can be found [at this link](#).

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International Corporate Forms

- All of these forms feature public ownership and limited liability

Company	Country of Origin	Type of Company	Translation	TABLE 1.1
Bayerische Motoren Werke (BMW) AG	Germany	Aktiengesellschaft	Corporation	International corporations
Montblanc GmbH	Germany	Gesellschaft mit beschränkter Haftung	Company with limited liability	
Rolls-Royce PLC	United Kingdom	Public limited company	Public limited company	
Shell UK Ltd.	United Kingdom	Limited	Corporation	
Unilever NV	Netherlands	Naamloze Vennootschap	Limited liability company	
Fiat SpA	Italy	Società per Azioni	Public limited company	
Saab AB	Sweden	Aktiebolag	Joint stock company	
Peugeot SA	France	Société Anonyme	Joint stock company	

More information on publicly traded companies can be found [at this link](#).

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Goal of Financial Management (1 of 2)

- What should be the goal of a corporation?
 - Maximize profit?
 - Minimize costs? ← Return to Quick Quiz
 - Maximize market share?
 - **Maximize the current value per share of the company's existing stock**
 - *Maximize the market value of the existing owners' equity*

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Goal of Financial Management (2 of 2)

- Does this mean we should do anything and everything to maximize owner wealth?
 - Outsourcing?
 - Off-shoring?
 - Enron?
 - Corporate support of charities?

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Sarbanes-Oxley Act (SarBox, 2002)

- Driven by corporate scandals
 - Enron, Tyco, WorldCom, Adelphia
- Intended to strengthen protection against accounting fraud and financial malpractice
- Compliance very costly
 - Firms driven to:
 - Go public outside the U.S.
 - Go private (“go dark”)

More information about the Sarbanes-Oxley Act can be found [at this link](#).

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The Agency Problem

- Agency relationship
 - Principal hires an agent to represent its interests
 - Stockholders (principals) hire managers (agents) to run the company.
- Agency problem
 - Conflict of interest between principal and agent
- Management goals and agency costs

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Do Managers Act in the Shareholders' Interests?

- Managerial compensation
 - Incentives can be used to align management and stockholder interests.
 - Incentives need to be carefully structured to ensure that they achieve their goal.
- Corporate control
 - Threat of a takeover may result in better management
- Other stakeholders

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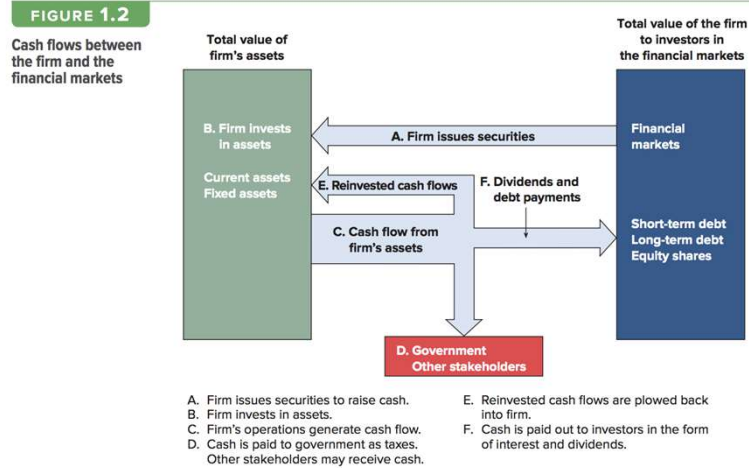
Example: Work the Web

- The Internet provides a wealth of information about individual companies.
- “Finance.yahoo.com” is an excellent site.
- Examples:
 - Southwest Airlines (LUV)
 - Harley-Davidson (HOG)
 - American Express (AXP)

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Cash Flows Between the Firm and the Financial Markets



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Financial Markets

- Cash flows to the firm
- Primary vs. secondary markets
 - Dealer vs. auction markets
 - Listed vs. over-the-counter securities
 - NYSE
 - NASDAQ

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Quick Quiz

- What are the four basic areas of finance? (Slide 1.4)
- What are the three types of financial management decisions, and what questions are they designed to answer? (Slide 1.13)
- What are the three major forms of business organization? (Slide 1.14)
- What is the goal of financial management? (Slide 1.19)
- What are agency problems, and why do they exist within a corporation? (Slide 1.22)

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Chapter 1

END

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