INTRODUCTION TO MANAGERIAL FINANCE

An Overview of Managerial Finance (Chapter 1)

- What is Finance?
  - Finance deals with decisions concerning cash inflows (financing) and cash outflows (investing); thus, nearly every decision made in the firm is somehow related to finance.
  - *Everything else equal*, you should prefer (1) more value to less, (2) to receive cash sooner rather than later, and (3) less risk to more.

- <u>General Areas of Finance</u>
  - Financial Markets and Institutions—the financial marketplace and the relationships of banking, insurance, estate planning, and so forth.
  - Investments—evaluating financial assets, such as stocks and bonds, and determining which investments to include in a portfolio of financial assets.
  - Financial Services—service organizations and mechanisms related to the management of money.
  - Managerial Finance—often called corporate finance, includes decisions regarding types of real investments (i.e., plant and equipment) that should be made and how such investments should be financed (i.e., stocks or bonds), whether dividends should be paid, and so forth.

- <u>The Importance of Finance in Nonfinance Areas</u>—regardless of the area of business you study, an understanding of finance is crucial; decisions about money are commonplace in every area of business, thus financial decisions are required.

- <u>Alternative Forms of Business Organization</u>
  - Proprietorship—single owner who is personally responsible for all liabilities of the firm; proprietorships represent about 70-75 percent of all businesses.
    - Advantages:
      - easy and relatively inexpensive to form
      - affected by few regulations
      - business is taxed as an individual rather than a corporation
    - Disadvantages
      - owner has unlimited personal liability for debts of the firm
      - firm's life is limited
      - ownership transfer is similar to selling a house, which can be difficult
      - firm's credit and its ability to raise funds is dependent on the financial strength of the owner
  - Partnership—two or more owners who are personally responsible for all liabilities of the firm; advantages and disadvantages of a partnership are the same as for a proprietorship; partnerships represent about 8-10 percent of all businesses.

  - Corporation—a legal entity in which owners have limited responsibility for the liabilities of the firm; corporations represent about 20 percent of all businesses, but generate nearly 85 percent of all sales.

- Advantages:
  - unlimited life
  - transfer of ownership is relatively simple—stock represents ownership
  - limited liability of owners—generally limited to an investor's initial investment in the stock of the firm
- Disadvantages:
  - earnings are can be taxed twice, once at the corporate level and once when (if) distributed to stockholders as dividends
  - establishing a corporation is more complex than for a proprietorship or a partnership
    - Corporate charter—information about the corporation, including its name, type of business, amount of stock, and so forth.
    - Bylaws—how the corporation will be governed

- <u>Hybrid Business Forms</u>
  - Limited liability partnership (LLP)—a partnership where at least one partner is fully liable—the general partner—for the firms debts, but the liability of the other partners' generally is limited to the amount they invest in the business.
  - Limited liability corporation (LLC)—a business that offers limited liability to its owners like a regular corporation, but its income is taxed like a partnership; the structure of an LLC is very flexible with regard to ownership, governance, and so forth; unlike an S corporation, an LLC can have more than 100 stockholders and still be taxed like a partnership. In some states, only certain types of businesses can be formed as LLCs.
  - S Corporation—a corporation that has fewer than 100 stockholders can elect to be taxed as a partnership such that the income "passes through" to the stockholders and is not taxed at the corporate level.

- <u>Primary Goal of the Corporation</u>
  - Maximize wealth—should be the primary goal of the financial manager. Unlike profit (earnings per share, EPS) maximization, wealth maximization considers the impact of current decisions on the long-term financial health of the firm.
  - Social Responsibility—firms should be socially responsible at the same time they earn "normal" profits; otherwise they probably will go out of business.
  - Wealth Maximization and Social Responsibility—actions that maximize the value of the firm also are beneficial to society; wealth maximization improves the standard of living.

- <u>Shareholder Wealth Maximization</u>—make decisions that maximize the current value of the cash flows that will be received in the future; the value of a firm can be computed as follows:

Value = Current (present) value of expected cash flows ($\hat{CF}$s) based on the return demanded by investors (r)

$$= \frac{\hat{CF}_1}{(1+r)^1} + \frac{\hat{CF}_2}{(1+r)^2} + \cdots + \frac{\hat{CF}_N}{(1+r)^N}$$

Decisions that affect cash flows affect the value of the firm. Financial decisions are based on the impact a behavior will have on the firm's expected future cash flows. Such decisions include determining how to finance the firm (capital structure decisions), what assets to purchase (capital budgeting decisions), and whether to pay stockholders dividends or reinvest earnings in the firm (dividend policy decisions).

- <u>Agency Relationships</u>—persons who make decisions that affect the firm are "agents" who are responsible for acting in the best interests of the owners (stockholders) of the firm.
  - Agency problems arise when managers satisfy their own interests rather than the interests of the owners—that is, the common stockholders. Methods that help managers act in the best interests of owners include:
    - Managerial compensation (incentives)—reward managers for acting in the best interests of owners
    - Shareholder intervention—suggest remedies to problems, sponsor proposals/ changes to the governance of the firm, threaten to change the board of directors
    - Takeover threat—upper management generally is "let go" when a firm is taken over by another firm
  - There is no agency problem/relationship in a proprietorship form of business, because the firm's owner also makes the firm's decisions; thus, he or she will make decisions that are in his or her best interest

- <u>Business Ethics</u>—"Standards of conduct or moral behavior"; "ethical" businesses "act" morally; generally "ethical" businesses are valued higher than similar business that are perceived to be unethical.

- <u>Corporate Governance</u>—how the firm is run/managed when doing business; the "rules" that the corporation follows when conducting business

- <u>Forms of Business in Other Countries</u>
  - Foreign businesses are generally more closed than U.S. businesses—that is, foreign businesses are generally owned by fewer stockholders than U.S. businesses; ownership is more closely held
  - Industrial groups—businesses in different industries that have common ownership; often the businesses complement each other—e.g., financing and marketing organizations might be aligned with manufacturers; in some cases suppliers, manufacturers, distributors, and retailers have common ownership.

- <u>Multinational Corporations</u>—firms that operate in more than one country
  - Firms become more global to:
    - seek new markets
    - seek new sources of raw materials
    - seek new technological advances
    - seek more efficient production opportunities
    - avoid political and regulatory hurdles that apply to foreign manufacturers

- Factors that differentiate managerial finance in purely domestic firms and in multinational organizations include:
  - different currency denominations
  - economic and legal ramifications
  - language differences
  - cultural differences
  - government involvement
  - political risk

- Chapter 1 Summary Questions—You should answer these questions as a summary for the chapter and to help you study for the exam.
  - What is finance?
  - What are the basic forms of business? What are the advantages and disadvantages of each?
  - What should be the primary goal of a financial manager? Why?
  - What is an agency relationship? How can shareholders reduce the potential for agency problems?
  - How do businesses in the United State differ in general from businesses in other countries? Why do firms "go global?"