Chapter 1

Introduction to Financial Management
Basic Areas Of Finance

- Corporate finance
- Investments
- Financial institutions
- International finance
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
Financial Institutions

• Companies that specialize in financial matters
  – Banks – commercial and investment, credit unions, savings and loans
  – Insurance companies
  – Brokerage firms

• Job opportunities
International Finance

• This is an area of specialization among all of the areas discussed so far
• It 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 and speaking a foreign language fluently is also helpful
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 investment?
  – How will we manage the everyday financial activities of the firm?
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
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?
Forms of Business Organization

• Three major forms in the United States
  – Sole proprietorship
  – Partnership
    • General
    • Limited
  – Corporation
    • S-Corp
    • Limited liability company
Sole Proprietorship

- **Advantages**
  - Easiest to start
  - Least regulated
  - Single owner keeps all 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
Partnership

• 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
Corporation

• 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
  – Double taxation (income taxed at the corporate rate and then dividends taxed at personal rate)
Goal Of Financial Management

• What should be the goal of a corporation?
  – Maximize profit?
  – Minimize costs?
  – Maximize market share?
  – Maximize the current value of the company’s stock?

• Does this mean we should do anything and everything to maximize owner wealth?
The Agency Problem

- Agency relationship
  - Principal hires an agent to represent their interest
  - Stockholders (principals) hire managers (agents) to run the company

- Agency problem
  - Conflict of interest between principal and agent

- Management goals and agency costs
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 goal
- Corporate control
  - The threat of a takeover may result in better management
- Other stakeholders
Financial Markets

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