Financial Management

Chapter ONE

INTRODUCTION

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1. Whose financial management?

- A business can be organized in one of several ways, and **the form its owners choose will affect the company's and owners' legal liability and income tax treatment**.

1. Whose financial management?

- several business organization forms:

First Type:

Sole proprietorships: a business owned by one person

- Good news: keep all the profits
- Bad news: unlimited liabilities for business debts and all the losses

Sole proprietorships

Advantages	Disadvantages: Unlimited and limited
Easiest to start	Owners must bear all costs and Unlimited liability for debts
Least regulated	No others to share burden or add expertise and malpractice
ease with business decision	limited to the owner's life span
the profits	Amount of equity that can be raised is limited to the amount of the owner's personal wealth
Taxed once as personal income	Difficult to sell ownership interest
	not ideal for high-risk businesses

1. Whose financial management?

□ several business organization forms:

✓ Second Type:

- Partnership: similar to a proprietorship (not independent legal entity) except that: Owners: 2～50
  - General Partnerships (GP): all the partners can
    - be held totally responsible for the business
    - run the business and make decisions that affect the whole business

1. Whose financial management?

several business organization forms:

Second Type:

•Partnership: similar to a proprietorship (not independent legal entity) except that: Owners: 2～50

- •Limited Partnerships (LP) : must have one or more General Partners and limited partners will
  - not actively participate in the business
  - have limited liability, limited to the extent of their invested capital
  - most commonly used by professionals such as doctors and lawyers, and VC industry.

Partnership

Advantages	Disadvantages: unlimited and limited
Relatively easy to start	general partner has unlimited liability for debt
Pooled expertise and resources	Amount of equity that can be raised is limited to the amount of the partners' combined wealth
More capital available	GP: difficult to transfer ownership to form a new partnership LP: sold without dissolving the partnership but difficult to find a buyer
Income taxed **once** as personal income	Bad sustainability: Partnership dissolves when one partner dies or wishes to sell

1. Whose financial management?

Third type: Corporation

Advantages	Disadvantages
Limited liability for debts and malpractice	Separation of ownership and management
Separation of ownership and management	Double taxation (income taxed at the corporate rate; dividends taxed at personal rate)
Easier to raise capital	Responsible to shareholders
Transfer of ownership is easy	Requires and attorney to establish

1. Whose financial management?

- The most common economic organization structure
  - almost all large and medium-sized businesses are organized as corporations.

- In each case the firm is owned by stockholders
  - Closely held company vs. Public company

1. Whose financial management?

Other forms as the hybrids of partnership and corporation:

- Limited Liability Company(LLC)
- S corporation in U. S.

Similarities:

- Personal income tax
- Limited liability

Differences:

	Limited Liability Company(LLC)	S corporation in U. S.
Business Formality	•use an informal operating agreement	•involves setting up business filings as C corporation
Shareholder	• No restrictions	• ≤ 100 shareholders, only domestic owners.
Income Allocation	• allocated disproportionately	• strictly based on their pro-rata shares of ownership.
Class of Stock	•Allowed all types	•only one: voting and non-voting
VC Funding	•Expensive	•Easy and cheap

1. Whose financial management?

□ Knowledge background summary:

□ Forms of Business Organization

- ✓ Sole proprietorship
- ✓ Partnership
- ✓ Corporation

□Focus on Corporation's Financial Management

□However, businesses of all types and sizes need financial management, so the majority of the subjects we discuss bear on any form of business.

2. What is FINANCIAL MANAGEMENT ?

FINANCIAL MANAGEMENT

Anagram game:

"Finance" → money → Net cash flow

"Management" → decision + plan

Definition

- ***Financial management*** **entails planning for the future** of a business enterprise **with the aim of ensuring a positive net cash flow**.

To entail planning for the future?

Corporation Operations (Real Assets) ⇄ Financial Management ⇄ Financial Markets (Investors)

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?

Balance Sheet Model of the Firm

Total Value of Assets:

Current Assets

Fixed Assets

1 Tangible

2 Intangible

Total Firm Value to Investors:

Current Liabilities

Long-Term Debt

Shareholders' Equity

The Capital Budgeting Decision

Current Assets

Fixed Assets

1 Tangible

2 Intangible

What long-term investments should the firm choose?

Current Liabilities

Long-Term Debt

Shareholders' Equity

The Capital Structure Decision

Current Assets

Fixed Assets

1 Tangible

2 Intangible

How should the firm raise funds for the selected investments?

Current Liabilities

Long-Term Debt

Shareholders' Equity

Short-Term Asset Management

Current Assets

Current Liabilities

Net Working Capital

Long-Term Debt

Fixed Assets

1 Tangible

2 Intangible

How should short-term assets be managed and financed?

Shareholders' Equity

To entail planning for the future?

Financial Management

Profitability

Daily

Credit management
Inventory control
Receipt and disbursement of fund

Occasional

Stock issue
Bond issue
Capital budgeting
Dividend decision

Trade-off

Risk

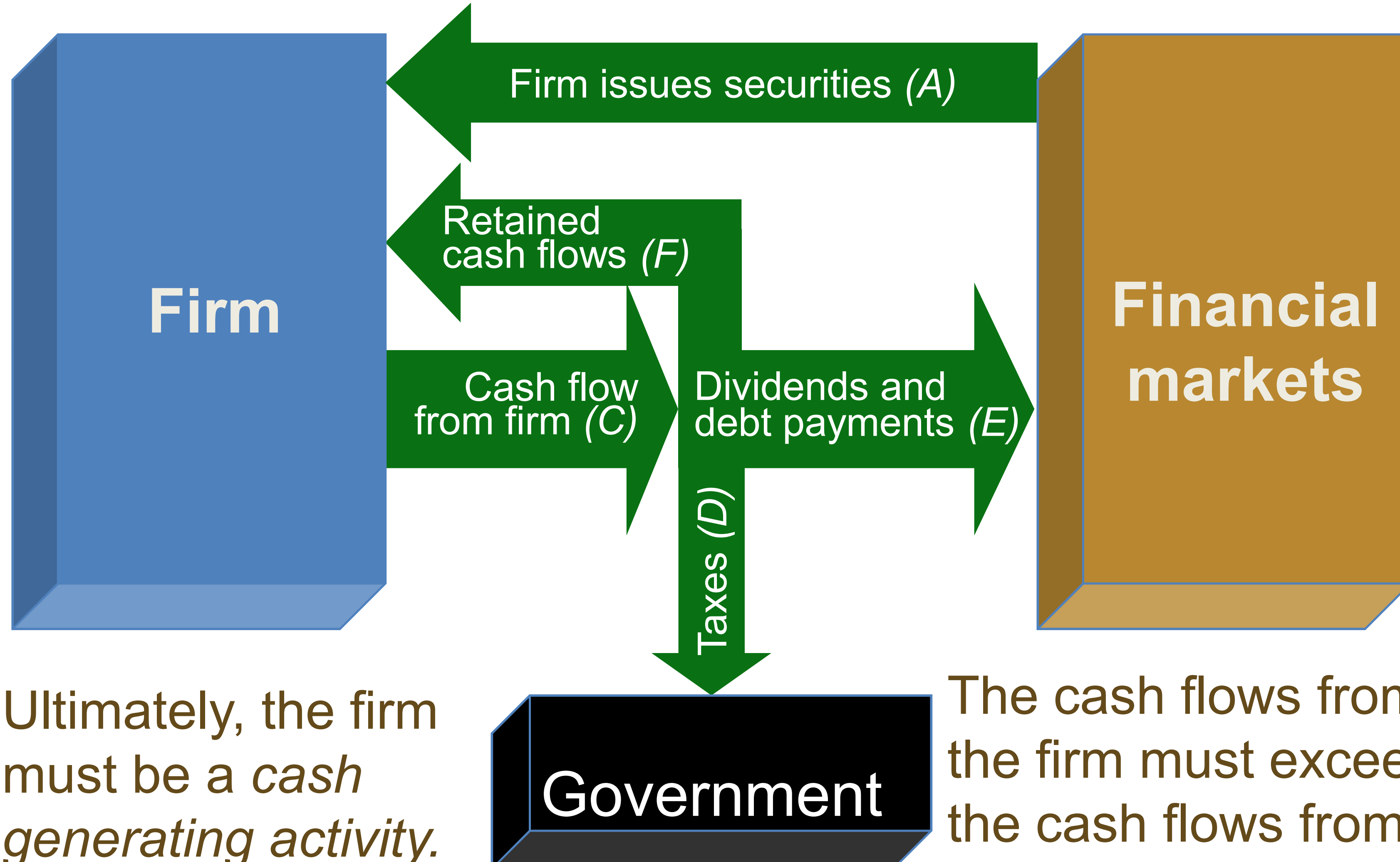
2. What is FINANCIAL MANAGEMENT ?

Definition

- ***Financial management*** **entails planning for the future** of a business enterprise **with the aim of ensuring a positive net cash flow**.

How to understand "the aim of ensuring a positive net cash flow"?

The Importance of Cash Flow



Ultimately, the firm must be a *cash generating activity.*

The cash flows from the firm must exceed the cash flows from the financial markets.

2. What is FINANCIAL MANAGEMENT ?

Structure of this Course

- financial accounting
- financial analysis
- Financial planning &budgeting
- Long-term financing
- Working capital management
- Short-term Financial decision-making and action

3. What Are the Goals of Financial Management?

Discussion: What should be the goal of a corporation?

- –Maximize profit (all of the corporations)
- –Minimize costs (some)
- –Maximize market share (some)
- –Maximize the current value of the company’s stock
- –Maximize the social value of the company

Good side? Bad side?

3. What Are the Goals of Financial Management?

- **The goals:**

  - □Survive
  - □Bankruptcy avoidance
  - □Stability, maintain steady earnings growth

This group relates to controlling risk.

  - –Maximize profit (all of the corporations)
  - –Minimize costs (some)
  - –Maximize market share (some)

This group relates to profitability.

It isn't really possible to maximize both safety and profit. What we need is a goal that encompasses both factors.

3. What Are the Goals of Financial Management?

Goal: Maximizing shareholder wealth, which is maximizing the current value or price of the firm's common stock.

Good side:

- **This goal directly copes with the Shareholders' goal:**

  Shareholders are the residual owners of a corporation. This means that they have a residual claim, they are entitled to only what is left after employees, suppliers, and creditors are paid their due.
- **A more precise definition without short-run or long-run issue.**

Bad side:

Much of what affects stock price is beyond management's direct control.

- **Stock prices are affected by many factors, such as expectations of the future, the economic environment, etc.**

4. The Agency Problem

- **Agency relationship**

  Definition: **Principal hires an agent to represent their interest**

  Example: **Stockholders (principals) hire managers (agents) to run the company. In most cases, shareholders elect the board of directors , who then hire managers to run the corporation on a day-to-day basis.**

- **Managers' goal should be consistent with Shareholders':**

  Since managers are working on behalf of shareholders, so they should maximizing the shareholder wealth.

4. The Agency Problem

Agency problem (Principal-Agency problem):

- **Definition:** Conflict of interest and goal between principal and agent.
- **Example:** Managers are naturally inclined to act in their own best interests.
- **Cause:** Management goals and agency costs
- **Effect:** lead to higher employee turnover , so greatly hamper organizational efficiency and decrease the agency's productivity.

What are ways of resolving agency problem?

A. Use of incentives

- ✓Managerial compensation
  - ✓ Extrinsic reward
  - ✓Intrinsic motivation

B. Use of stockholders

- ✓ Corporate control
  - ✓proper share centrality
  - ✓The threat of a takeover may result in better management
- ✓ Other stakeholders：
  - ✓Powerful institutional investors