FINANCIAL MANAGEMENT

CH I

Goals and Governance of the Corporation

Course Topics

- Goals and Governance of the Corporation
- Fundamental Financial Statement (Balance Sheet, Income Statement)
- Measuring Corporate Performance
- Interpreting Financial Ratios
- Applying Financial Statement Analysis
- Financial Planning – Estimation Methods
- Interpreting Cash Budgets
- Working Capital and Current Assets Management
- Current Liabilities Management
- Time Value of Money
- Investment Appraisal Methods
- Firm Valuation Techniques (Fundamental)

Required TextBooks:

Brealey, R. Myers, S. Marcus, A.; "Fundamentals of Corporate Finance; Special Edition for Turkey", McGraw Hill, 7th Edition, 2019.

Brigham, E.F. Houston, J.F. "*Fundamentals of Financial Management*", South-Western College Pub; 8th ed., 2017

Gitman, Lawrence J. Zutter, Chad J. "*Principles of Managerial Finance*", Published by Prentice, 2018

Learning Goals

Define finance and ***investment & financing decisions***

Identify the ***primary activities of the financial manager***

Describe the goal of the firm; ***maximizing shareholders' wealth***

Describe ***agency theory & corporate governance*** in finance

Learn ***legal forms*** of business organizations

Finance through the ages…

What is Finance?

Finance can be defined as the ***science and art of*** managing money.

Finance affects

- all individuals,
- businesses, and
- governments in the process of the transfer of money through institutions, markets, and instruments

What is Finance?

At the personal level, finance is concerned with individuals' decisions about;

- how much of their earnings they spend,
- how much they save, and
- how they invest their savings.

In a business context, finance involves the same types of decisions;

- how firms raise money from investors,
- how firms invest money in an attempt to earn a profit, and
- how they decide whether to reinvest profits in the business or distribute them back to investors.

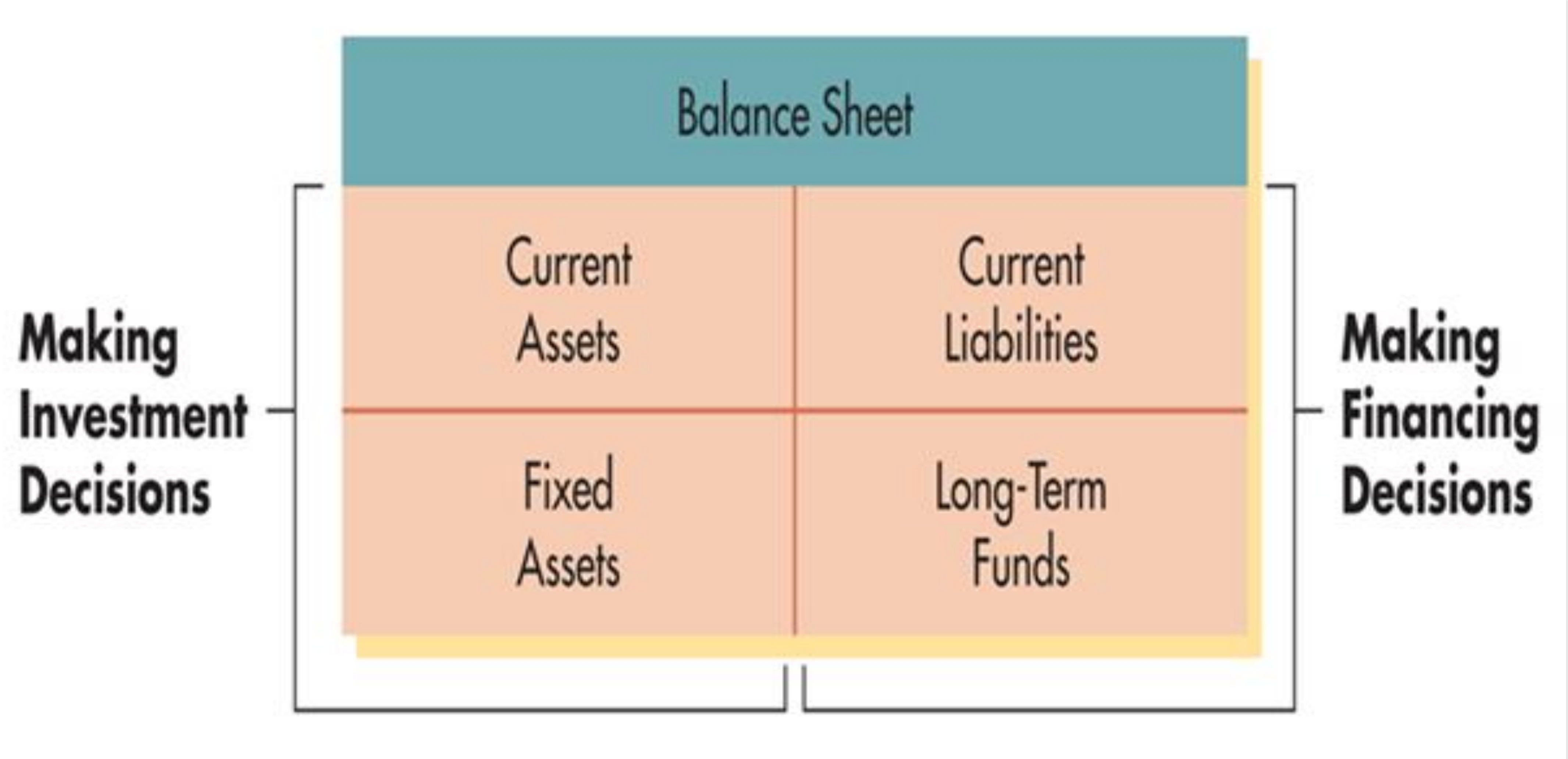
Invesment & Financing Decisions

Investment (Capital Budgeting) Decision

- These decisions are often called ***capital budgeting*** or ***Capital Expenditure*** (***CAPEX***) decisions.
- Decision to invest in tangible or intangible assets.
- **REAL ASSET**; assets used to produce goods & services

Financing Decision

- The form and amount of financing of a firm’s investments
- **FINANCIAL ASSET**; non-physical asset whose value is derived from a contractual claim, such as bank deposits, bonds, and stocks.



Dividend Decisions???

Invesment & Financing Decisions

Investment decisions:

- ➨Should a new computer be purchased?
- ➨Should the firm develop a new drug?
- ➨Should the firm shut down an unprofitable factory?

Financing decisions:

- ➨Should the firm borrow money from a bank or sell bonds?
- ➨Should the firm issue preferred stock or common stock?
- ➨Should the firm buy or lease a new machine that it is committed to acquiring?

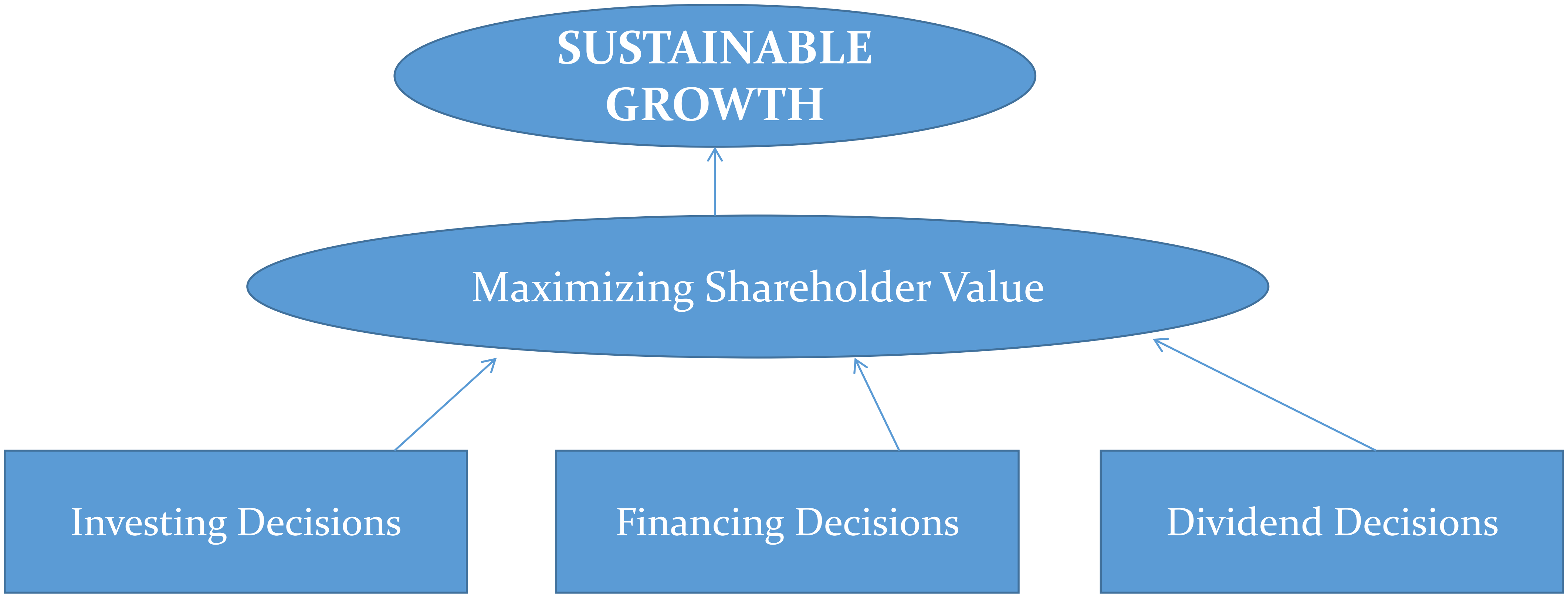
Company (revenue in billions, 2010)	Recent Investment Decisions	Recent Financing Decisions
GlaxoSmithKline (£28 billion)	Spent £3.7 billion in 2009 on research and development of new drugs.	Financed R&D expenditures with reinvested cash flow generated by sales of pharmaceutical products.
Boeing ($64 billion)	Completed testing of its 787 Dreamliner aircraft, developed at a cost of more than $10 billion.	Bolstered its cash position by borrowing nearly $6 billion.
Walmart ($405 billion)	Planned in 2011 to open more than 150 stores in the U.S. and more than 600 overseas.	Repaid over $6 billion of long-term debt, bought back $7 billion of its shares, and paid a dividend to shareholders of $4 billion.
Union Pacific ($17 billion)	Acquired 127 new locomotives in 2009 at a cost of $287 million.	Financed many of the new locomotives by long-term leases.
Banco Santander (€42 billion)	Acquired Sovereign Bank for $1.9 billion.	Financed the acquisition by an exchange of shares.
Ford Motor Company ($121 billion)	Announced $2.3 billion investment in U.K. manufacturing facilities over the next 5 years to support production of low-carbon emission vehicles.	Paid off $7 billion in automotive debt in the second quarter of 2010.
LVMH (€20 billion)	Engaged in capital expenditures of €729 million, including new store openings for Louis Vuitton and new production facilities for Christian Dior, Hennessy, and Veuve Clicquot.	Issued a 3-year bond in 2008, raising 200 million Swiss francs.
Honda (¥10,011 billion)	Invested ¥90 billion to develop new motorcycle models and modernize production facilities.	Issued $1 billion of debt maturing in 3 and 5 years.
Chevron ($171 billion)	Announced plans to invest with its partners in the Gorgon liquefied natural gas project in western Australia. The total cost of the project is forecast at more than A$40 billion.	Arranged credit facilities with various banks that would allow it to borrow $5.1 billion.

Financial Assets vs Real Assets

Which of the following are real assets, and which are financial assets?

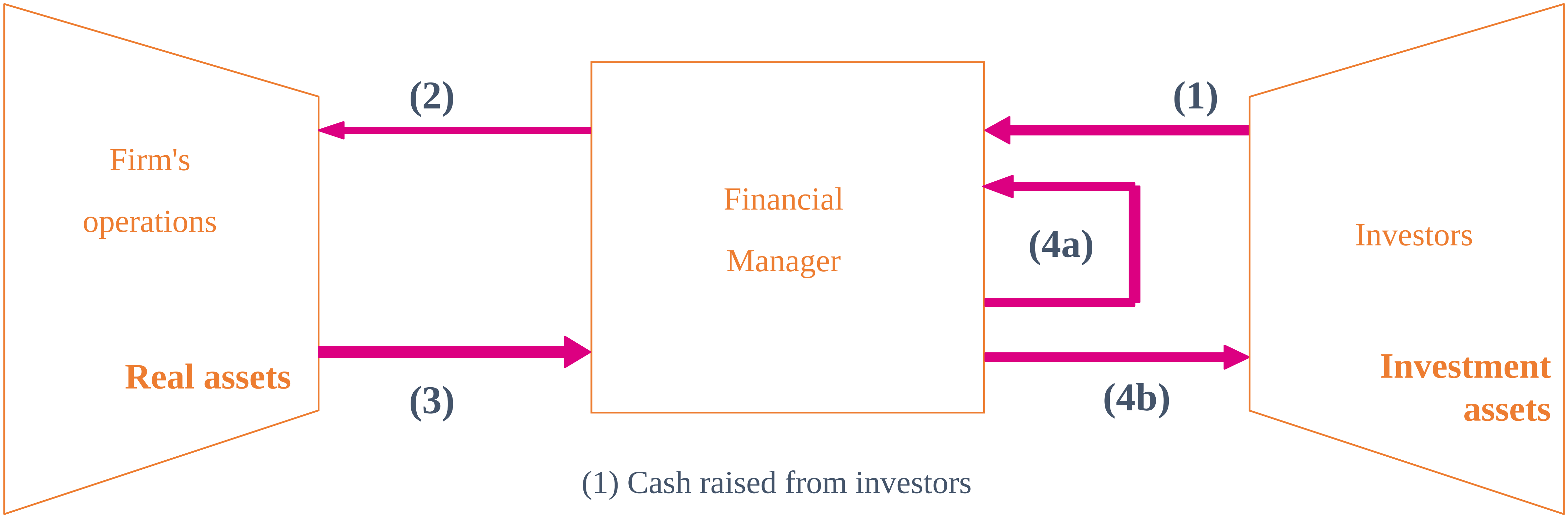
- A patent.
- A share of stock issued by Bank of New York.
- A blast furnace in a steel-making factory.
- A mortgage loan taken out to help pay for a new home.
- An IOU ("I owe you") from your brother-in-law.

Goals of the Corporation



Max (V) = f (I,F,D)

The Role of the Financial Manager?



(1) Cash raised from investors

(2) Cash invested in firm

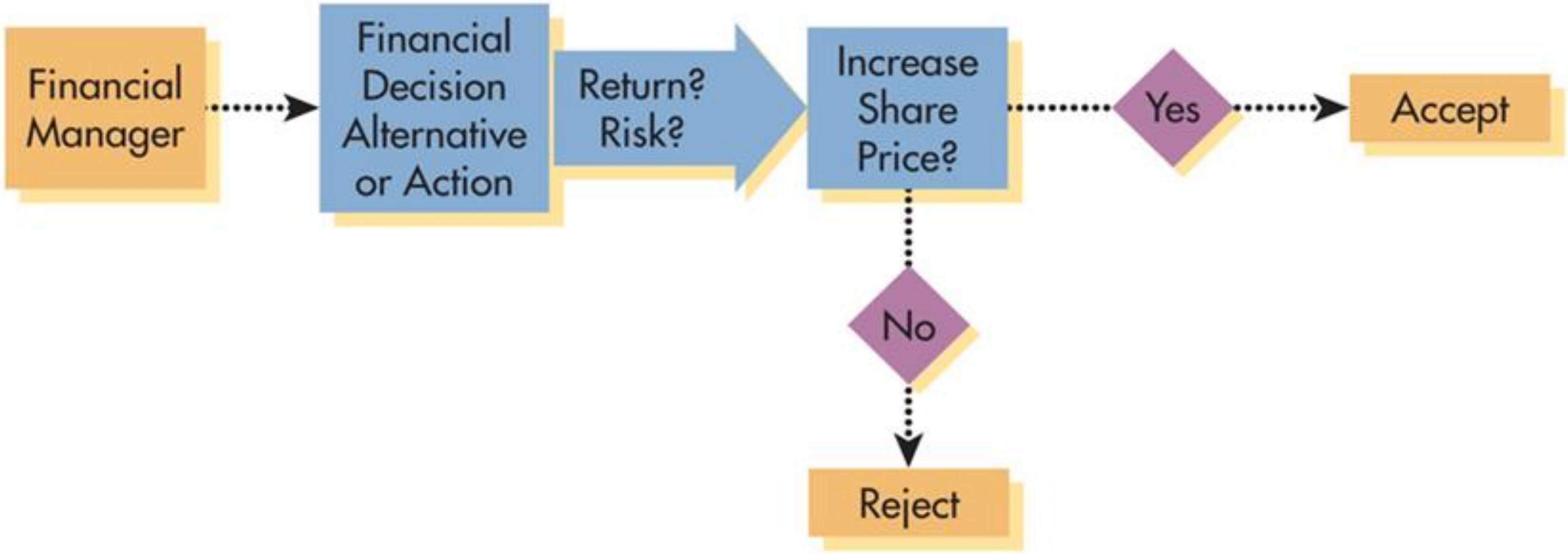
(3) Cash generated by operations

(4a) Cash reinvested

(4b) Cash returned to investors

The Role of the Financial Manager?

Decision rule for managers: ***only take actions that are expected to increase the share price*.**



Who is the Finance Manager?

Chief Financial Officer (CFO)

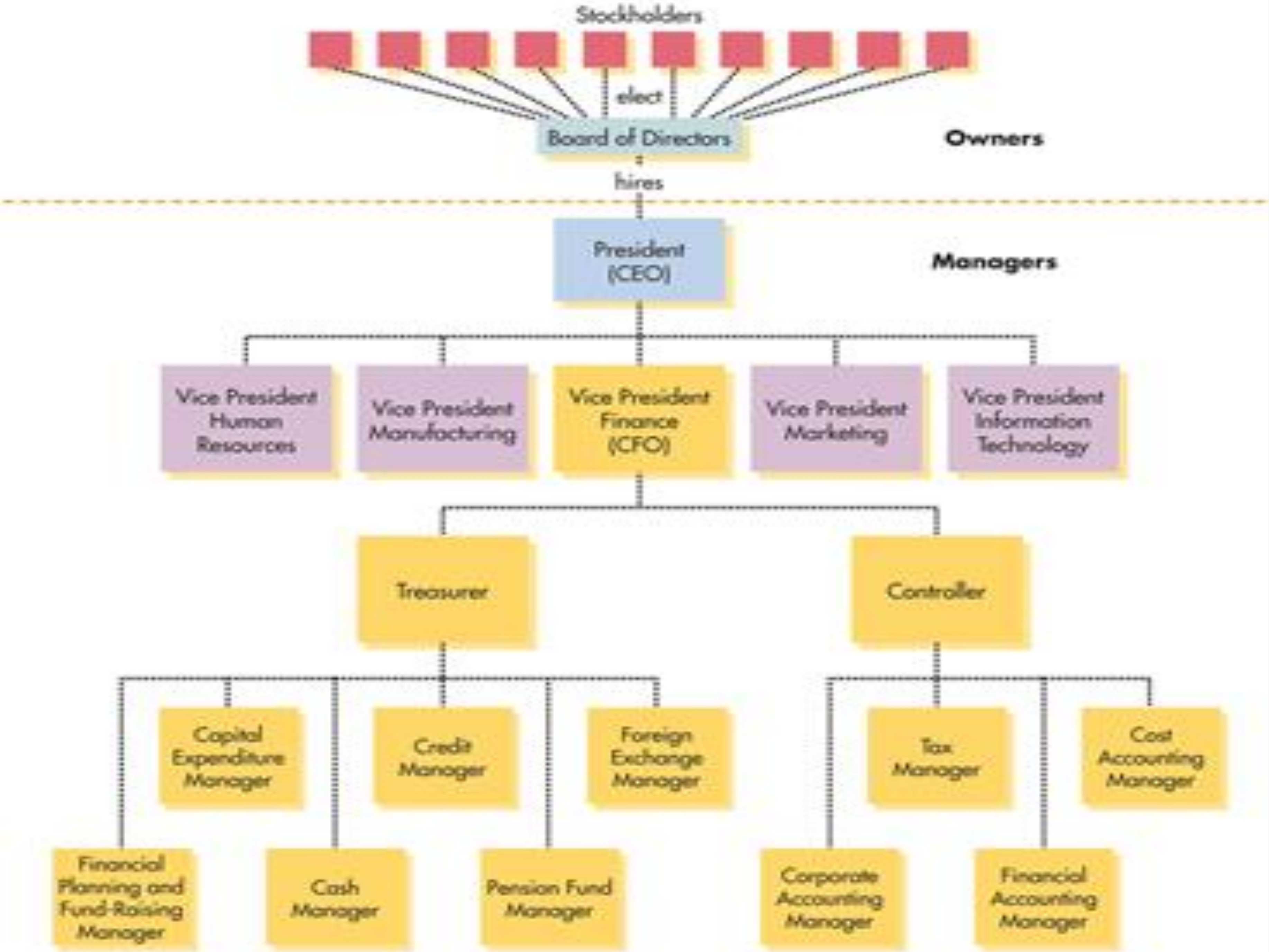
Oversees the treasurer and controller and sets overall financial strategy

Treasurer

Responsible for financing, cash management, and relationships with banks and other financial institutions

Controller

Responsible for budgeting, accounting, and taxes.



Stockholders
elect
Board of Directors
Owners
hires
President (CEO)
Managers
Vice President Human Resources
Vice President Manufacturing
Vice President Finance (CFO)
Vice President Marketing
Vice President Information Technology
Treasurer
Controller
Capital Expenditure Manager
Credit Manager
Foreign Exchange Manager
Tax Manager
Cost Accounting Manager
Financial Planning and Fund-Raising Manager
Cash Manager
Pension Fund Manager
Corporate Accounting Manager
Financial Accounting Manager

Goals of the Corporation

For small corporations,
shareholders and management may be one and the same.

For large corporations,
separation of ownership and management is a practical necessity.

- *Walmart has over 300,000 shareholders. There is no way that these shareholders can be actively involved in management*

Do Managers really Maximize Shareholders' Wealth?

Owner-managers have no conflicts of interest in their management of the business.

In most large corporations the managers are not the owners, and so managers may be tempted to act in ways that are not in the best interests of shareholders.

- For example, they might buy luxurious corporate jets or overindulge in expense-account dinners.

Do Managers really Maximize Shareholders' Wealth?

Agency problems:Managers are agents for stockholders, but the managers may act in their own interests rather than maximizing value.

When Dennis Kozlowski, the CEO of Tyco, threw a $2 million 40th birthday for his wife, he charged half of the cost to the company.

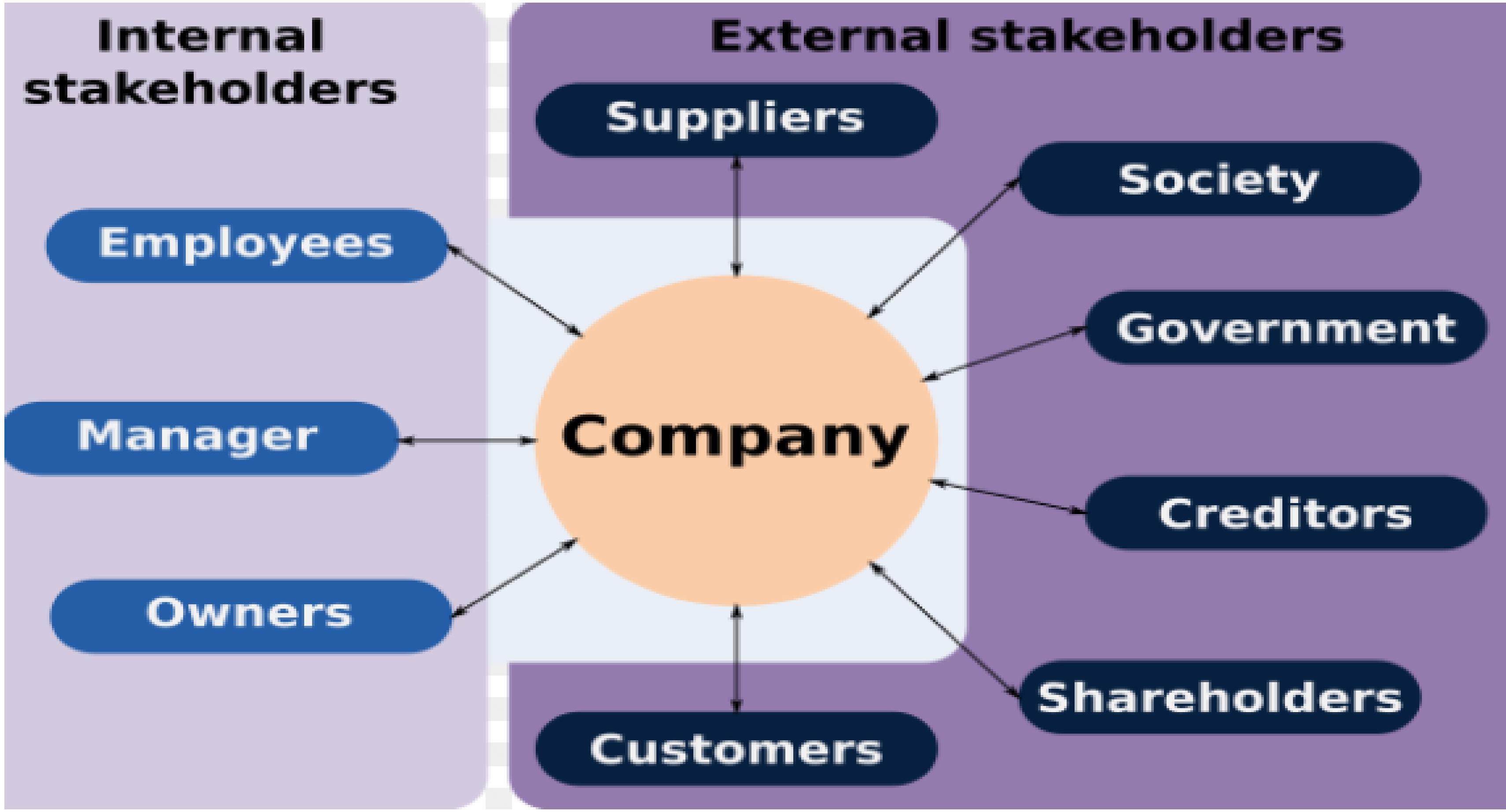
Conrad Black, the boss of Hollinger International, used the company jet for a trip with his wife to Bora Bora.

Agency Problems

Managers, acting as agents for stockholders, may act in their own interests rather than maximizing value.

Stakeholder

Anyone with a financial interest in the firm.



The Agency Issue

A ***principal-agent relationship*** is an arrangement in which an agent acts on the behalf of a principal. For example, shareholders of a company (principals) elect management (agents) to act on their behalf.

- Agency problems arise when managers place personal goals ahead of the goals of shareholders.
- Agency costs arise from agency problems that are borne by shareholders and represent a loss of shareholder wealth.

Agency Problem Solutions

1 - Legal and Regulatory Requirements

2 - Board of Directors

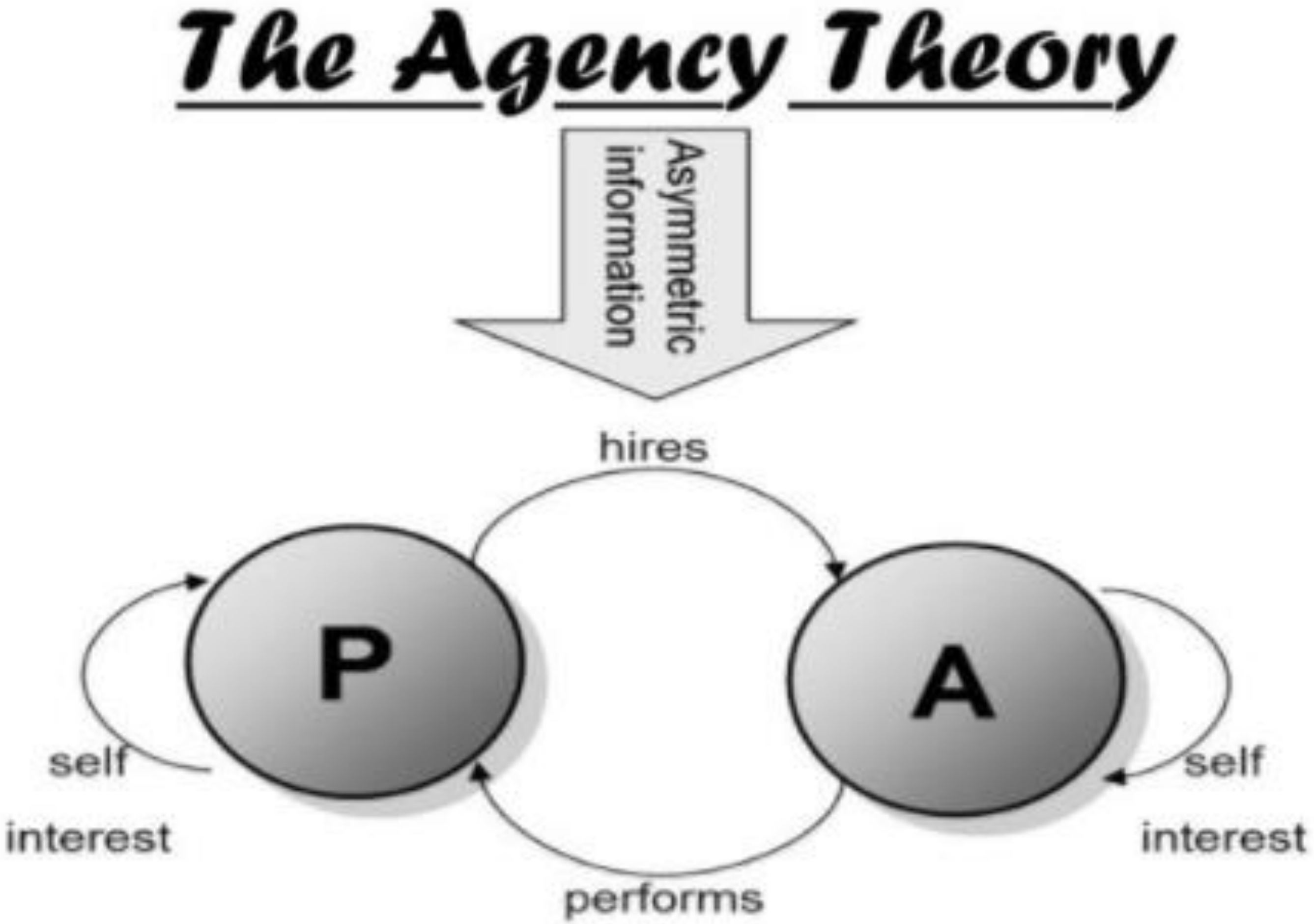
3 - Blockholders

4 - Specialist Monitoring

5 – Compensation Plans

6 – Takeovers

7 – Shareholder Pressure



The Agency Issue:

Management Compensation Plans

Are they effective tool to overcome that problem?

- In addition to the roles played by corporate boards, institutional investors, and government regulations, corporate governance can be strengthened by ensuring that managers' interests are aligned with those of shareholders.
- A common approach is to structure management compensation to correspond with firm performance

Matter of Fact – Forbes.com

CEO Performance vs Pay

Forbes.com CEO Performance vs. Pay				
Efficiency ranking	Chief executive officer	Company	Compensation	Compensation rank
1st	Jeffery H. Boyd	Priceline.com	$7.49 mil.	135th
2nd	Jeffrey P. Bezos	Amazon.com	$1.28 mil.	463rd
3rd	Leonard Bell	Alexion Pharmaceuticals	$4.26 mil.	286th
90th	H. Lawrence Culp Jr.	Danaher Corp.	$141.36 mil.	1st
82nd	Lawrence J. Ellison	Oracle Corp.	$130.23 mil.	2nd
163rd	Aubrey K. McClendon	Chesapeake Energy Corp.	$114.29 mil.	3rd

Agency & Corporate Governance

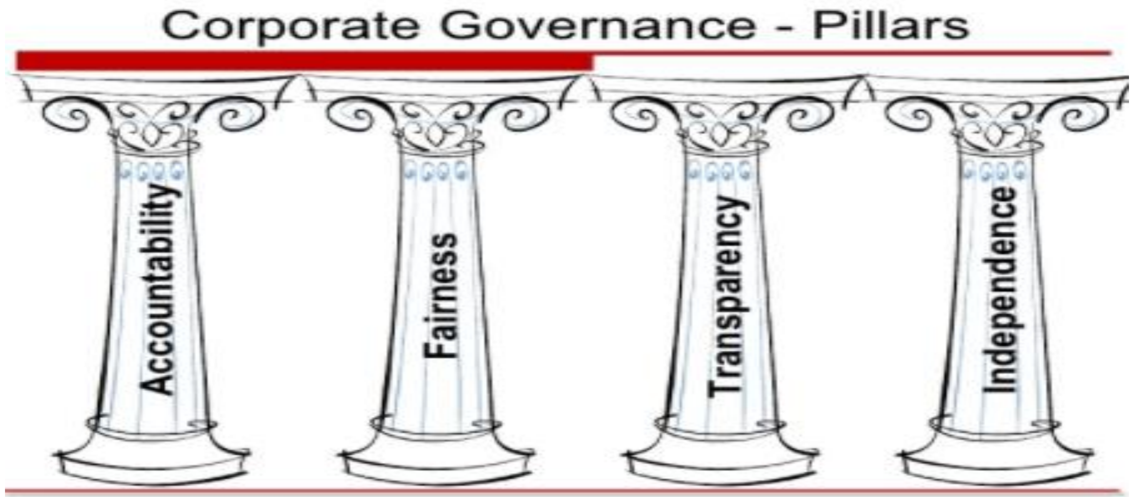
Corporate governance refers to the rules, processes, and laws by which companies are operated, controlled, and regulated.

That defines the rights and responsibilities of the corporate participants such as the shareholders, board of directors, officers and managers, and other stakeholders, as well as the rules and procedures for making corporate decisions.

- ***FAIRNESS***
- ***TRANSPARENCY***
- ***ACCOUNTABILITY***
- ***RESPONSIBILITY***

Four Pillars of CG

- ***Transparency***; timely, accurate disclosure on all material matters, including the financial situations, performance, ownership and corporate governance.
- ***Accountability***; management is accountable to the board – board is accountable to stakeholders.
- ***Responsibility***; free from the influence of others, avoid completely conflicts of interests
- ***Fairness***; shareholder rights. Treat all shareholders including minorities equitably.



Government Regulations

Government regulation generally shapes the corporate governance of all firms.

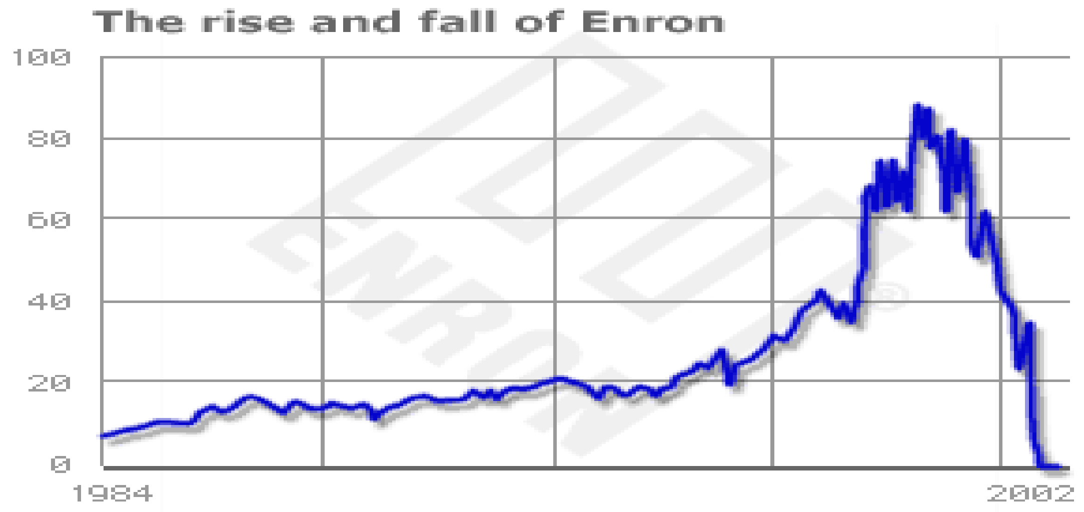
During the recent decade, corporate governance has received increased attention due to several high-profile corporate scandals.

Corporate Scandals;

- ***Enron, Tyco, Parmalat….***

Enron Case

- 7th largest company in US and largest buyer/seller of natural gas and electricity
- Heavily involved in Energy brokering, Electronic energy trading and energy services
- Awarded "America's most innovative company" for six consecutive years
- Enron's stock was priced at $83.13 in 2000
- Market capitalization exceeded $60 billion



What constitutes *fair* behavior by companies? One survey asked a number of individuals to state whether they regarded a particular action as acceptable or unfair. Before we tell you how they responded, think how *you* would rate each of the following actions:

1a. A small photocopying shop has one employee who has worked in the shop for 6 months and earns $9 per hour. Business continues to be satisfactory, but a factory in the area has closed and unemployment has increased. Other small shops in the area have now hired reliable workers at $7 an hour to perform jobs similar to those done by the photocopying shop employee. The owner of the photocopying shop reduces the employee's wage to $7.

1b. Now suppose that the shop does not reduce the employee's wage but he or she leaves. The owner decides to pay a replacement $7 an hour.

2. A house painter employs two assistants and pays them $9 per hour. The painter decides to quit house painting and go into the business of providing landscape services, where the going wage is lower. He reduces the workers' wages to $7 per hour for the landscaping work.

3a. A small company employs several workers and has been paying them average wages. There is severe unemployment in the area and the company could easily replace its current employees with good workers at a lower wage. The company has been making money. The owners reduce the current workers' wages by 5 percent.

3b. Now suppose instead that the company has been losing money and the owners reduce wages by 5 percent.

4. A grocery store has several months' supply of peanut butter in stock on shelves in the storeroom. The owner hears that the wholesale price of peanut butter has increased and immediately raises the price on the current stock of peanut butter.

5. A hardware store has been selling snow shovels for $15. The morning after a large snowstorm, the store raises the price to $20.

6. A store has been sold out of the popular Beanie Baby dolls for a month. A week before Christmas a single doll is discovered in a storeroom. The managers know that many customers would like to buy the doll. They announce over the store's public address system that the doll will be sold by auction to the customer who offers to pay the most.

Source: Adapted from D. Kahneman, J. L. Knetsch, and R. Thaler, "Fairness as a Constraint on Profit Seeking: Entitlements in the Market," *American Economic Review* 76 (September 1986), pp. 728–741. Reprinted by permission of American Economic Association and the authors.

THINGS ARE NOT ALWAYS
FAIR IN
LOVE & ECONOMICS ????

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Now compare your responses with the responses of a random sample of individuals:

	Percent Rating the Action As:	
Action	**Acceptable**	**Unfair**
1a	17	83
1b	73	27
2	63	37
3a	23	77
3b	68	32
4	21	79
5	18	82
6	26	74

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Things are not always fair in economics

Question 5. A hardware store has been selling snow shovels for $15. The morning after a large snowstorm, the store raises the price to $20.

Please rate this action as:

Acceptable or Unfair???

Kahneman, Kentsch, Thaler (1986) Fairness as a constraint on profit seeking. Entitlements in the market, American Economic Review, pp.728-741 (18A-82U)

Things are not always fair in economics

Question 6. A store has been sold out of the popular Cabbage Patch dolls for a month. A week before Christmas a single doll is discovered in a storeroom. The managers know that many customers would like to buy the doll. They announce over the store's public address system that the doll will be sold by auction to the customer who offers to pay the most.

Please rate this action as:

Acceptable or Unfair???

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Legal Forms of Business Organizations

Sole Proprietorships

- A sole proprietorship is a business owned by one person and operated for his or her own profit.

Partnerships

- A partnership is a business owned by two or more people and operated for profit.

Corporations

- A corporation is an entity created by law. Corporations have the legal powers of an individual in that it can sue and be sued, make and be party to contracts, and acquire property in its own name.

Organizing a Business

	Sole Proprietorship	Partnership	Corporation
Who owns the business?	The manager	Partners	Stockholders
Are managers and owners separate?	No	No	Usually
What is the owner's liability?	Unlimited	Unlimited	Limited
Are the owner and business taxed separately?	No	No	Yes

A corporation's owners are called as ***stockholders***

Corporate Structure

Sole Proprietorships → Unlimited Liability; Personal tax on profits

Partnerships → Unlimited Liability; Personal tax on profits

Corporations → Limited Liability; Corporate tax on profits + Personal tax on dividends

Double taxation; a corporation's income is taxed first at the corporate tax rate, and then, when the income is distributed to shareholders as dividends, the income is taxed again at each shareholder's personal tax rate

SWOT Analysis

	Sole proprietorship	Partnership	Corporation
Strengths	• Owner receives all profits (and sustains all losses) • Low organizational costs • Income included and taxed on proprietor's personal tax return • Independence • Secrecy • Ease of dissolution	• Can raise more funds than sole proprietorships • Borrowing power enhanced by more owners • More available brain power and managerial skill • Income included and taxed on partner's personal tax return	• Owners have *limited liability*, which guarantees that they cannot lose more than they invested • Can achieve large size via sale o ownership (stock) • Ownership (stock) is readily transferable • Long life of firm • Can hire professional managers • Has better access to financing
Weaknesses	• Owner has *unlimited liability*—total wealth can be taken to satisfy debts • Limited fund-raising power tends to inhibit growth • Proprietor must be jack-of-all-trades • Difficult to give employees long-run career opportunities • Lacks continuity when proprietor dies	• Owners have *unlimited liability* and may have to cover debts of other partners • Partnership is dissolved when a partner dies • Difficult to liquidate or transfer partnership	• Taxes generally higher because corporate income is taxed, and dividends paid to owners are also taxed at a maximum 15% rate • More expensive to organize than other business forms • Subject to greater government regulation • Lacks secrecy because regulations require firms to disclose financial results

Snippet of Finance History

- ***c. 1800 B.C. Interest Rates***. In Babylonia Hammurabi's Code established maximum interest rates on loans
- ***c. 1000 B.C. Options***. One of the earliest recorded options is described by Aristotle. The philosopher Thales knew by the stars that there would be a great olive harvest, so, having a little money, he bought options for the use of olive presses.
- ***15th century*** International Banking
- ***1650 Futures***. Futures markets allow companies to protect themselves against fluctuations in commodity prices.

Cont'd

- ***17th century Joint Stock Corporations***:the modern corporation with a large number of stockholders originates with the formation in England of the great trading firms like the East India Company (est. 1599).
- ***1792 Formation of the New York Stock Exchange***.The New York Stock Exchange (NYSE) was founded in 1792 when a group of brokers met under a button wood tree and arranged to trade shares with one another at agreed rates of commission
- ***1929 Stock Market Crashes***. Common stocks are risky investments.
- ***1960s Eurodollar Market***. In the 1950s the Soviet Union transferred its dollar holdings from the United States to a Russian-owned bank in Paris
- ***1972 Financial Futures***. Financial futures allow companies to protect themselves against fluctuations in interest rates, exchange rates, and so on
- ***1988 Mergers***. The 1980s saw a wave of take over
- ***1999 The Euro***. Large corporations do business in many currencies. In 1999 a new currency came into existence, when 11 European countries adopted the euro in place of their separate currencies
- ***2008 Global Financial Crises***

Financial Services

Financial Services is the area of finance concerned with the design and delivery of advice and financial products to individuals, businesses, and governments.

- Career opportunities include;
  - banking,
  - personal financial planning,
  - investments,
  - real estate, and
  - insurance.

Position	Description
Financial analyst	Prepares the firm's financial plans and budgets. Other duties include financial forecasting, performing financial comparisons, and working closely with accounting.
Capital expenditures manager	Evaluates and recommends proposed long-term investments. May be involved in the financial aspects of implementing approved investments.
Project finance manager	Arranges financing for approved long-term investments. Coordinates consultants, investment bankers, and legal counsel.
Cash manager	Maintains and controls the firm's daily cash balances. Frequently manages the firm's cash collection and disbursement activities and short-term investments and coordinates short-term borrowing and banking relationships.
Credit analyst/manager	Administers the firm's credit policy by evaluating credit applications, extending credit, and monitoring and collecting accounts receivable.
Pension fund manager	Oversees or manages the assets and liabilities of the employees' pension fund.
Foreign exchange manager	Manages specific foreign operations and the firm's exposure to fluctuations in exchange rates.

Relationship to Economics

- The field of finance is closely related to economics.
- Financial managers must understand the economic framework and be alert to the consequences of varying levels of economic activity and changes in economic policy.
- They must also be able to use economic theories as guidelines for efficient business operation.

Relationship to Accounting

- The firm's finance and accounting activities are closely-related and generally overlap.
- In small firms accountants often carry out the finance function, and in large firms financial analysts often help compile accounting information.
- One major difference in perspective and emphasis between finance and accounting is that accountants generally use the accrual method while in finance, the focus is on cash flows.