Week 1 - Lecture 1

McGraw-Hill/Irwin

Key Concepts and Skills

- Know the basic types of financial management decisions and the role of the Financial Manager
- Know the financial implications of the various forms of business organization
- Know the goal of financial management
- Understand the conflicts of interest that can arise between owners and managers

1.1 What Is Corporate Finance?

Finance addresses the following three questions:

1. What long-term investments should the firm choose? – CAPITAL BUDGETING
2. How should the firm raise funds for the selected investments? – CAPITAL STRUCTURE
3. How should short-term assets be managed and financed? – NET WORKING CAPITAL

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

Current Liabilities

Long-Term Debt

Fixed Assets

1 Tangible

2 Intangible

What long-term investments should the firm choose?

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

Net Working Capital

Current Liabilities

Long-Term Debt

Fixed Assets

1 Tangible

2 Intangible

How should short-term assets be managed and financed?

Shareholders' Equity

onlinepoll.ucla.edu

111S20Q1 balance

1.2 The Corporate Firm

- The corporate form of business is the standard method for solving the problems encountered in raising large amounts of cash.
- However, businesses can take other forms.

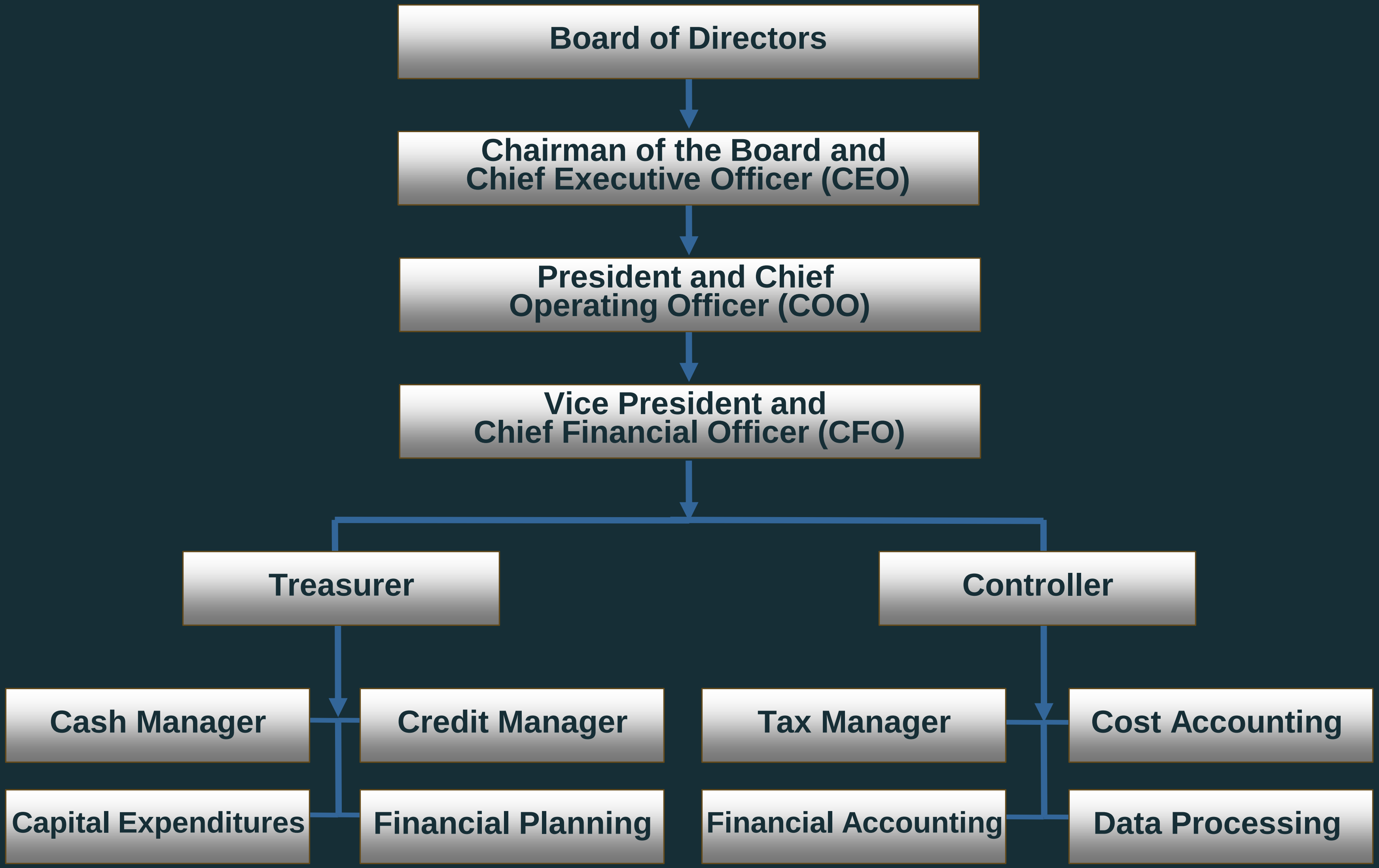
Forms of Business Organization

- The Sole Proprietorship
- The Partnership
  - General Partnership
  - Limited Partnership
- The Corporation
  - Private
  - Public
  - Companies with more than $10 million in assets whose securities are held by more than 500 owners must file annual and other periodic reports. These reports are available to the public through the SEC's EDGAR database.
  - More info: http://www.sec.gov/about/laws.shtml

A Comparison

	Corporation	Partnership
Liquidity	Shares can be easily exchanged	Subject to substantial restrictions
Voting Rights	Usually each share gets one vote	General Partner is in charge; limited partners may have some voting rights
Taxation	Double	Partners pay taxes on distributions
Reinvestment and dividend payout	Broad latitude	All net cash flow is distributed to partners
Liability	Limited liability	General partners may have unlimited liability; limited partners enjoy limited liability
Continuity	Perpetual life	Limited life

Hypothetical Organization Chart



Pros and cons of going public

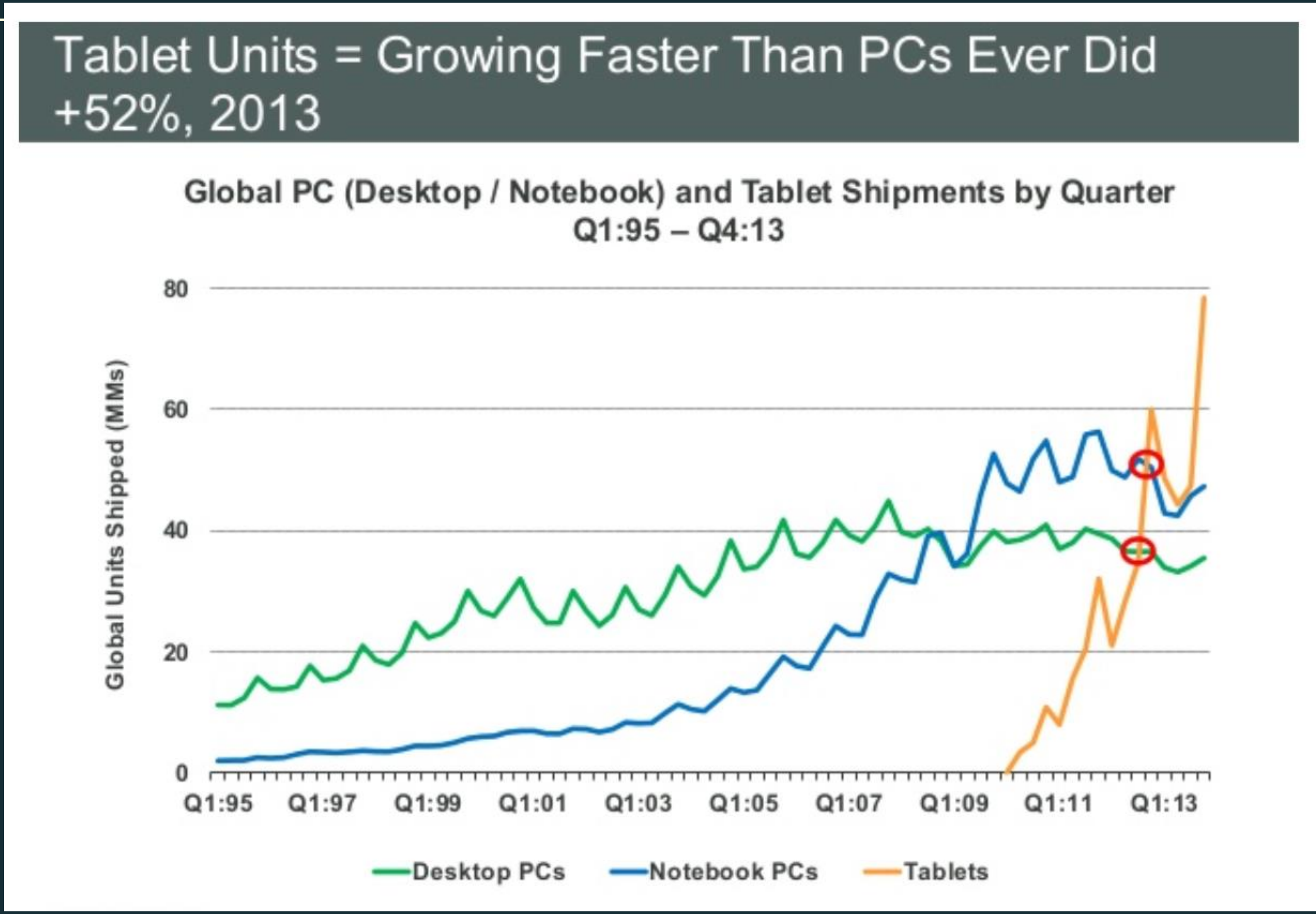
PROS

- Obtain money that does not have to be repaid
- Increased visibility
- Market valuation

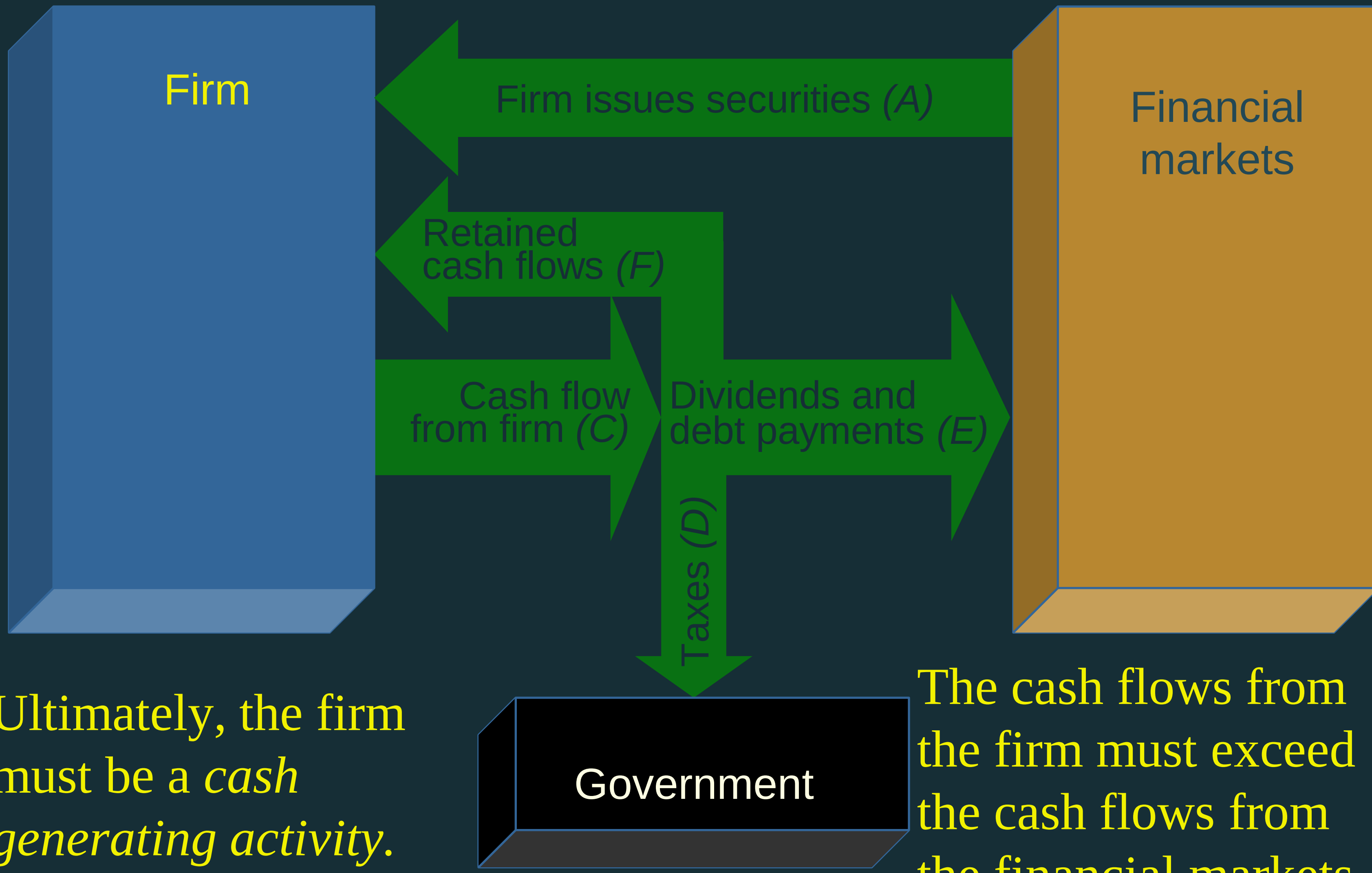
CONS

- Going public is costly
- Management loses some of its freedom to act without board approval
- Open to scrutiny
- Public reporting
- Company maybe taken over

DELL


Tablet Units = Growing Faster Than PCs Ever Did
+52%, 2013
Global PC (Desktop / Notebook) and Tablet Shipments by Quarter
Q1:95 – Q4:13
Global Units Shipped (MMs)
0
20
40
60
80
Q1:95
Q1:97
Q1:99
Q1:01
Q1:03
Q1:05
Q1:07
Q1:09
Q1:11
Q1:13
Desktop PCs
Notebook PCs
Tablets

1.3 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.

1.4 The Goal of Financial Management

- What is the correct goal?
  - Maximize profit?
  - Minimize costs?
  - Maximize market share?
  - **Maximize shareholder wealth?**

1.5 The Agency Problem

- Agency relationship
  - Principal hires an agent to represent his/her interest
  - Stockholders (principals) hire managers (agents) to run the company
- Agency problem
  - Conflict of interest between principal and agent

Managerial Goals

- Managerial goals may be different from shareholder goals
  - Expensive perquisites
  - Survival
  - Independence
- Increased growth and size are not necessarily equivalent to increased shareholder wealth

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 intended goal
- Corporate control
  - The threat of a takeover may result in better management

2.1 The Balance Sheet

- An accountant's snapshot of the firm's accounting value at a specific point in time
- The Balance Sheet Identity is:

Assets $\equiv$ Liabilities + Stockholder's Equity

U.S. Composite Corporation Balance Sheet

	2019	2018
Current assets:		
Cash and equivalents	$140	$107
Accounts receivable	294	270
Inventories	269	280
Other	58	50
Total current assets	$761	$707
Fixed assets:		
Property, plant, and equipment	$1,423	$1,274
Less accumulated depreciation	(550)	(460)
Net property, plant, and equipment	873	814
Intangible assets and other	245	221
Total fixed assets	$1,118	$1,035
Total assets	$1,879	$1,742

Total liabilities and stockholder's equity	$1,879	$1,742

The assets are listed in order by the length of time it would normally take a firm with ongoing operations to convert them into cash.

Clearly, cash is much more liquid than property, plant, and equipment.

Balance Sheet Analysis

- When analyzing a balance sheet, the Finance Manager should be aware of three concerns:
  1. Liquidity
  2. Debt versus equity
  3. Value versus cost
  4. Balance Sheet does NOT include some of the most valuable things that a company has

Liquidity

- Refers to the ease and quickness with which assets can be converted to cash—without a significant loss in value
- Current assets are the most liquid.
- Some fixed assets are intangible.
- The more liquid a firm’s assets, the less likely the firm is to experience problems meeting short-term obligations.
- Liquid assets frequently have lower rates of return than fixed assets.

Debt versus Equity

- Creditors generally receive the first claim on the firm’s cash flow.
- Shareholder’s equity is the residual difference between assets and liabilities.

Value versus Cost

- Under Generally Accepted Accounting Principles (GAAP), audited financial statements of firms in the U.S. carry assets at cost.
- Market value is the price at which the assets, liabilities, and equity could actually be bought or sold, which is a completely different concept from historical cost.