Fundamentals of Corporate Finance

Week 1

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The Finance Manager's Role

The Finance Manager bridges the gap between the firm's operations and the financial markets. Every business journey starts by answering three fundamental financial questions.

- **Investment Decisions — Capital Budgeting:** What long-term investments or assets should you buy?
- **Financing Decisions — Capital Structure:** How will you pay for those investments,how to raise funds?
- **Working Capital Management:** How will you manage day-to-day cash and inventory?

Business Entity Forms

The legal structure impacts liability, taxation, and access to capital.

Form	Liability	Taxation
Sole Proprietorship	Unlimited	Personal Income Tax
Partnership	Unlimited	Personal Income Tax
Corporation	**Limited**	**Double Taxation**

Corporations are legal entities distinct from their owners, allowing for easier transfer of ownership and infinite life. It is also the superior structure for raising large amounts of cash, albeit with the disadvantages of double taxation.

Double taxation means that companies should pay taxes on their profit, and then when those profits are paid out to investor, those investors would pay the income tax.

Objectives of Financial Management

The Primary Goal

To **Maximize the current value per share** of existing stock.

- **Why not profit maximization?** Profit ignores the timing of returns, cash flows, and risk.
- **Shareholder Wealth:** Represents the long-term strategy, day-to-day health, and market consensus of the firm's value.

The Agency Problem

Conflict of interest between **Principals** (Stockholders) and **Agents** (Managers).

- **Agency Costs:**
  - Direct: Corporate jets, perks, expense of monitoring management such as audit fees.
  - Indirect: Lost opportunities due to management being "too safe" and leaning toward securing their job rather than taking risky but valuable project.
- **Mitigation:**
  - Management compensation (Stock Options).
  - Corporate control (Threat of takeover).

Financial Markets - where the money comes from

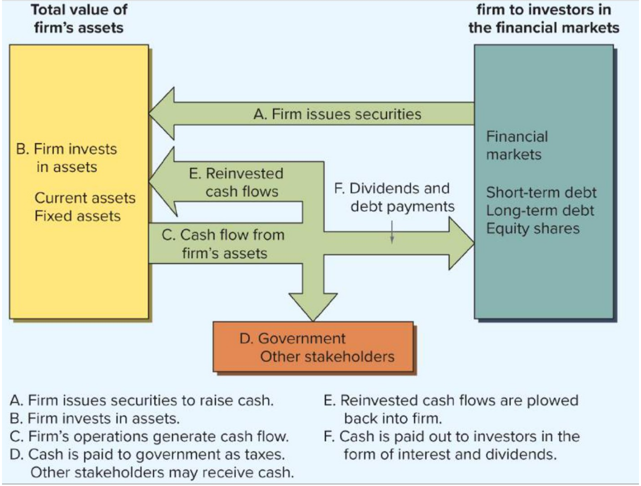
- **Money Markets:** Short-term debt securities (maturity < 1 year).
  - Example: Treasury Bills, Commercial Paper.
- **Capital Markets:** Long-term debt and equity (maturity > 1 year).
  - Example: Stocks and Bonds.
- **Primary vs. Secondary:** Primary is the original sale from the issuer; Secondary is trading between investors.

  Why does secondary market is matter when the company does not get money from this market?
  Because without a healthy secondary market, where investors could sell the investment easily later, no body would buy in the market to begin with, i.e., it is the source of liquidity.

The Flow of Cash

- **Step 1: Raise Cash** Firm issues securities to investors in financial markets (capital structure).
- **Step 2: Invest** Firm invests the cash in its operation (working capital) and assets (capital budgeting).
- **Step 3: Generate Cash** Firm's operations generate cash flow (working capital).
- **Step 4: Return/Reinvest** Cash is returned to investors or reinvested in the firm (payout policy).

The Flow of Cash



Key Financial Concepts

1. **Book Value vs. Market Value**
   - **Book Value:** Historical cost on the balance sheet.
   - **Market Value:** Current price at which assets/liabilities can be sold. *Finance focuses on Market Value.*
2. **Average vs. Marginal Tax Rates**
   - **Average:** Total tax paid / Total taxable income. It is calculated using financial statement figures.
   - **Marginal:** Tax rate on the **next dollar** earned. Used for project evaluation. It is come from applied tax law.

Profit vs. Cash Flow

- **Net Profit:** An accounting measure based on the *accrual principle* (Revenue recognized when earned).
- **Net Cash Flow:** The actual "green stuff" moving in and out of the bank.

Cash Flow Calculation

$$\text{Cash Flow} = \text{Net Income} + \text{Depreciation} \pm \Delta\text{Working Capital}$$

Preparing the Statement of Cash Flows

Organizes sources and uses of cash into three categories:

1. **Operating Activities:** Adjusting Net Income for non-cash items and changes in Current Assets/Liabilities: Core business (Net income + Depr. - Δ NWC)
2. **Investing Activities:** Changes in long-term assets (buying/selling equipment).
3. **Financing Activities:** Changes in notes payable, long-term debt, and equity (dividends, issuing stock).