**FI 393**

**Chapter 1—Introduction to Corporate Finance**

**Notes Outline**

1. Finance is the study of \_**applying specific value to: things we own, services we use, and decisions we make.** \_\_\_\_\_\_
2. Financial management focuses on valuing \_**Assets** and/or \_**investments\_**\_ from the perspective of a \_**Concepts**\_\_ rather than that of an \_\_**Individual**\_.
3. Finance focuses on \_\_\_\_**Cash Flow**\_. This is the process of \_\_**Spending** and **\_\_\_Receiving**\_\_ money.

* Much of this course will focus on \_\_\_\_**Valuing Cash Flows**\_\_.

1. Successful application of financial theories helps move \_**Money**\_ from people who want to \_**Save**\_ for the future to \_\_**Businesses\_**\_ that want to \_\_**Grow\_**.
   * Such \_\_\_**Cash Flow**\_\_ exchanges lead to growth of the economy and should increase households’ wealth.
2. What are the four basic areas of Finance?

* International
* Domestic
  + Corporate
  + Financial Institutions
  + Investments

1. **Financial markets and institutions** allow **\_Cash**\_\_ to flow from **\_\_Investors**\_\_\_ to **\_Businesses**\_.
   * \_**Cash**\_\_ then flows back to **\_\_\_Investors**\_ from \_\_**Businesses**\_\_.
   * \_\_\_**Investors-**\_ are those with extra \_\_\_**Cash**\_\_ who save and \_**Invest\_**\_ their money to earn a \_\_**Return**\_.
   * Businesses are those firms with viable and \_\_\_**Valuable**\_\_ ideas who lack the \_**Cash**\_\_ necessary to bring ideas to life.
2. **Investments** focuses on:
   * The \_**Methods**\_\_ and techniques for making decisions about what kinds of \_**Securities**\_ to own,
     1. Fundamental analysis vs. technical analysis
   * Deciding on which firm’s \_\_\_**Securities**\_\_ to buy,
   * And \_\_**How\_** firms pay the **\_\_Investors**\_\_ back (cash flow) in the form that the investor wishes.
3. **Corporate Finance (aka Financial Management)** focuses on a firm’s decisions in **\_\_Acquiring** \_ and \_\_**Using\_**\_ cash it receives from investors and retained earnings.
   * It is the study of the answers to the following questions:
   * *What long-term investments should we make?* – \_\_**Capital Budgeting\_**
   * *Where will we get the funds to pay for our investments?* – \_\_\_**Capital Structure**\_
   * *How will we collect from customers and pay our bills?* \_**Working Capital Management\_**
4. **International Finance** encompasses everything involved in investments, financial institutions & markets, and corporate finance, but in a \_**\_Global Environment**\_\_.
   * In addition, international finance is also concerned with:
   * Changing future \_\_**Exchange Rates.**
   * \_\_**Political**\_\_ risk
   * Changing \_**Business\_**\_ laws, and so on.
5. **Application & Theory for Financial Decisions.**

Cash flows are neither **\_Instantaneous**\_\_ nor \_\_**Guaranteed**\_.

* Keep in mind that there is \_**Uncertainty**\_\_ regarding the **\_Timing**\_\_ and \_\_**Size\_**\_ of future cash flows—we refer to this as \_\_**Risk**\_.
* \_**Risk -** \_ is defined as a potential future \_\_**Negative Impact**\_ to \_**Value**\_\_ and/or cash flows. It is often discussed in terms of the \_\_**Probability**\_\_ of \_**Loss**\_\_ and the expected \_\_**Magnitude**\_\_ of the loss.
  + Investors face risk about the \_\_**Return of their Capital**\_\_.
  + Firms face risk in \_**Funding\_** and operating business \_**Projects**\_.
* Most financial decisions involve \_\_\_\_**Decisions involve comparing risks**\_\_ and \_**Returns** and determining which outweighs the other.

1. Comparing risks and returns typically involves assessing the \_\_**Value Today**\_\_ of \_**Cash Flows**\_ that we expect to receive in the \_**Future**\_.
   * Stocks’, bonds’ and other assets’ \_**Price**\_\_ should be based on the \_**Cash Flows**\_\_ you expect to receive in the **\_\_Future**\_\_\_.
     1. Which should be more valuable today? Answer: **A stock that is expected to return high cash flows in the future or one that is expected to return lower cash flows.**
   * \_Time Value\_ of \_Money\_\_ concepts allow us to determine the value today (\_\_Present Value\_\_) of future cash flows (CFs), based on the expected \_\_Risks\_\_ of those CFs.
2. **The Finance Function in Business.**

\_Financial Manager - \_\_ makes decisions regarding capital structure, capital budgeting, and working capital management.

* The highest-level financial manager within a firm us usually the \_CFO (chief financial officer\_.

1. What is the definition of **capital budgeting**?

* **Process of planning an managing a firm’s investments in fixed assets.**

1. What are the three **key concerns of capital budgeting**?

* **Size, timing, and riskiness of cash flows**

1. What is the definition of **capital structure**?

* **Mix of debut and equity used by a firm.**

1. What are the financial manager’s **three concerns regarding capital structure**?
2. What are the least \_\_Expensive\_\_ sources of \_\_Funds\_\_?
3. Is there a \_Best Mix\_\_?
4. \_When\_\_ and \_Where\_\_ to raise funds?
5. What is **working capital management**?

* **Managing short-term assets and liabilities.**

1. What are three questions that must be answered regarding working capital?
2. How much \_**Cash**\_ and \_\_**Inventory**\_\_ to keep?
3. What is our \_**Credit**\_\_ policy?
4. How/where will we obtain \_**Short - Term**\_ financing?
5. Who ultimately controls a firm?

* **Shareholders**

1. **Finance in Your Personal Life.**

A better understanding of finance will help you make better decisions regarding the following activities:

* \_**Borrowing money**\_ to buy a car.
* \_\_**Refinancing**\_ your home \_**mortgage**\_\_ at a lower \_**rate**\_\_.
* Making \_**credit card**\_ or \_\_**student**\_ loan payments.
* Saving for \_\_**retirement**\_.

1. What are the four major forms of business organization in the U.S.?
2. **Sole Proprietorship**
3. **Partnership**
   1. **General or Limited**
4. **Corporation**
5. **Hybrid Organization**
7. What is a **sole proprietorship**?

* **Owned by one or few people.**

1. What are the major **advantages of a sole proprietorship**?

* **Easiest to start**
* **Least regulated**
* **Sole Owner(s) maintains complete control over firm**
* **Owner keeps all the firm’s profits**
* **Profits are taxed once as personal income**

What are the **disadvantages**?

* **Limited to the life of the owner.**
* **Equity capital is limited to owner’s personal wealth**
* **Unlimited Liability**
* **Sole owner responsible for all of firm’s losses**
* **Difficult to obtain capital**

1. What is a **partnership**? What are two kinds of partnerships?

* **Business owned by two or more people.**

1. What are the main **advantages of a partnership**?

* **Two or more owners**
* **More capital available**
* **Easier to obtain debt**
* **Easy to start**
* **Income taxed once as personal income**

What are the **disadvantages**?

* **Unlimited Liability**
  + **General Partnership**
  + **Limited Partnership**
* **All partners are obligated to contracts agreed to by any one of the partners**
* **Difficult to transfer ownership**

1. What is a **corporation**?

* **A legal “person” distinct from owners and a resident of a state**

1. What are the main **advantages of a corporation**?

* **Limited Liability**
* **Unlimited Life**
* **Separation of ownership and management**
* **Transfer of Ownership is easy**

What are the **disadvantages**?

* **Separation of ownership and management (agency problem)**
* **Double taxation**
  + **Income tax at the co. rate and then dividends taxed at personal rate, while dividends paid are not tax deducted**

1. What is a **hybrid organization**?

* **Businesses that offer single taxation and limited liability to all owners**

1. What are the main **advantage of a hybrid organization**?

* **Limited liability**
* **Single taxation at personal income tax rate**

What are the **disadvantages**?

* **Must be a small firm**
* **Ex; S-corp may only have 100 shareholders**

1. What are **examples of hybrid organizations**?

* S-Corporation
* B-Corps

1. What should be the **goal of a corporation**?

* Maximize Net Income (EPS)?
* Minimize costs?
* Maximize market share?
* Maximize shareholder wealth.
  + Maximize the current value per share of the company’s stock
  + Maximize the market value of the existing owners’ equity

1. **Agency Theory.** An agency relationship occurs when a principal hires an agent to represent its interests. Name a specific agency relationship that occurs in a corporation.

* EX: Stockholders (principles) hire managers (agents) to run the company

1. What is an **agency problem**?

* Difficulties that arise when a principle hires an agent and cannot fully monitor the agent’s actions.

1. Give an example where management goals and interests might differ from what’s in the best interest of shareholders.

* CEO needs a new vehicle and buys a Ferrari going over company budget.

1. What are the three main approaches to minimize agency problems? Briefly explain each.
   * Monitor Managers
     1. Accounting Audits
     2. Concentrated ownership by institutional investors, large block holders or debt holders provides incentive for these parties to monitor manager actions.
     3. Board of directors have a responsibility to monitor managers on behalf of all shareholders.
     4. Legislation has been passed by Congress to reduce conflicts of interest on corporate boards – Sarbanes Oxley Act of 2002.
   * Ignore It
     1. If the amount of money is small enough, shareholders might be best served it overlook the problem.
     2. Cost time and money to prevent agency problems
     3. Some perks may motivate managers productivity.

* + Make managers owners
    1. Managers are offered equity stake in the firm
    2. Managers directly benefit from actions taken to maximize shareholder wealth.

1. **Corporate governance** is the process of \_\_Monitoring managers and aligning their incentives with shareholders goals\_\_.
2. Who/what is the main **inside monitor** of a firm?

* Board of Directors
  + Hire and fire CEO
  + Evaluated management
  + Design compensation plans

1. **Outside monitors** include each of the following. Briefly explain *how* each monitor the firm.

* Auditors – Examine the firms accounting systems and comment on whether financial statements are accurate.
* Analysts – Follow a firm, analyze its business prospects, and give options of future success.
* Banks – Monitor firm performance to ensure that the firm can repay loans
* Credit rating agencies – Analyze the firm’s ability to repay debts and report the findings as a grade.
* US government (SEC) – Requires publicly-traded firms to file reports that disclose financial statements, ownership stakes, and management roles.

1. **The Financial Crisis.**

Between 2002 and mid-year 2006, the US experienced an economic boom. What were the two main contributors to this boom?

* Rise in housing prices and Stock prices rose rapidly

1. In the second half of 2006, the **financial crisis began** as housing prices began to \_\_Fall\_ and \_\_Defaults\_\_ by \_\_Subprime\_ mortgage borrowers increased.
2. There are **three reasons that the financial crisis got worse**:
   1. \_\_\_Financial\_\_ institutions were severely damaged by the collapse of the \_\_\_Housing Bubble\_ and tightened \_\_Lending Standards\_, making \_Money difficult to obtain.
   2. \_\_\_\_\_\_\_\_\_\_ prices began to fall in October 2007 and plunged during 2008.
   3. \_\_Businesses\_\_\_ responded by cutting back on \_\_Employment\_\_ and unemployment rates reached \_10\_%.
3. On February 13, 2009, the US government intervened in the resulting recession when Congress passed the American Recovery and Reinvestment Act.
   * Generally speaking (you do not have to write down the dollar figures for each category), *how* did this Act intend to pull the economy out of the Great Recession?
     1. Immediate Relief for Families
     2. Modernize Federal Infrastructure

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