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The Principles of Financial Management - Shin, Seungho

Part I

- Finance? it is a term describing the study and system of money, investment, and other financial instruments.

✓ Finance
- Corporate finance
- Investment (asset-pricing)
- Financial institutions/banking
- International finance/trade

- Types of Business Organization; ① Sole-proprietorship, ② Partnership, *③ Corporation

* Typical stages in the corporate life cycle!
many major firms such as Apple and Samsung began life in a garage or cave. How is it possible for such firms to grow into giants/monsters we see today?

① many firms begin as a sole-proprietorship, which is an unincorporated business owned by one individual.

② A partnership exists whenever two or more people/persons or entities associate to conduct a non-corporate business profit.

✓ Partnership
- General Partner (have unlimited liability)
- Limited Partner (only lose the amount of their investment in Partnership)
  - limited controls and returns

※ Good to know :) "F = Form"

① Proprietorship → F1040 (Sch. C)

② Partnership → F1065

③ Corporation
- F 1120 "C" corporation
- $\xrightarrow{\text{Form 2553}}$ F1120S "S" Corporation

L.L.C → all of above!

v LLC? LLP?

all partners enjoy limited liability with regard to the business's liabilities and their potential losses are limited to their investment in LLC/LLP. However, this arrangement increases the risk faced by an LLC's/LLP's lenders, customers, and suppliers.

- Pros and Cons of ① sole-proprietorships and ② partnerships?

v Pros

ⓐ it is easily and inexpensively formed,
ⓑ it is subject to few government regulations,
ⓒ it is not subject to corporate income taxes; it is taxed as part of the proprietor's personal income.

v Cons

ⓐ it is hard or may be difficult to obtain the capital needed for growth,
ⓑ he/she has unlimited personal liability for the business debts, which can result in losses that exceed the money invested in the firm (creditors may ever be able to seize a proprietor's house/car)
ⓒ the life of a proprietorship is limited to the life of its founder.

- Pros and Cons of ③ * corporation?

v Pros

ⓐ a corporation can continue after its original owners and founders are deceased,
ⓑ ownership interests are divided into shares of stock, which can be transferred far more easily than can proprietorship or partnership interests,
ⓒ losses are limited to the actual funds invested.

✓ Cons

Double taxation?

ⓐ the earnings of the corporation are taxed at the corporation levels, and then earnings paid out as dividends are taxed again as income to the stockholders,

ⓑ Setting up a corporation involves preparing a charter, writing a set of bylaws and filing the many required state/federal reports, which is complex and time-consuming.

- Growing and managing a corporation.

If the corporation continues to grow, it may become successful enough to attract lending from banks, or it may even raise additional funds through initial public offering (IPO) by selling stock to the public at large. After an IPO, corporations support their growth by borrowing from banks, issuing debts, or selling stocks. In short, a corporation's ability to grow depends on its interactions with the financial markets.

Part II

- *** What is management's primary goal? maximize shareholders' wealth subject to ethical constraints!

✓ the primary goal for financial managements or financial managers is to maximize the long-run value of the firm's common stock.

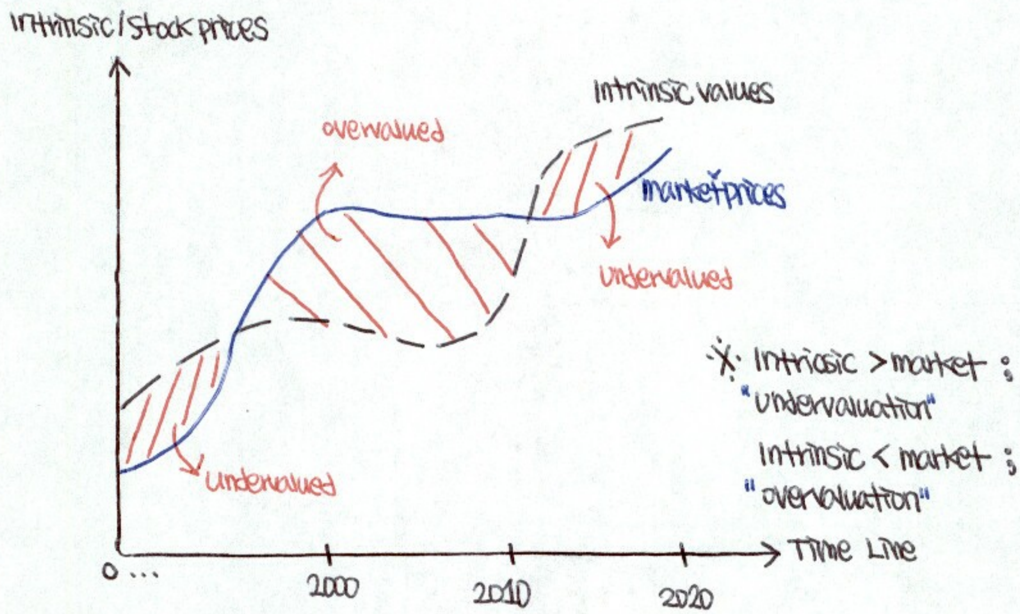
- * How to determine intrinsic (true) values and stock prices (market)?

✓ intrinsic values vs. market prices

ⓐ intrinsic values come from accurate risk and return data, and intrinsic values can be estimated, but not measured precisely.

ⓑ market prices are based on perceived, but possibly incorrect information as seen by the marginal investors.

∨ intrinsic values vs. market prices



∨ Financial management / managers should maximize the firm's intrinsic value, not its market price!

Part III

- Conflicting interests between financial managers, shareholders, and bondholders. (Agency Problem)
  - ∨ financial managers and shareholders
    - ⓐ financial managers are inclined to act in their own best interests, which are not always the same as the interest of shareholders.
    - ⓑ Some factors affect managerial behavior; compensation packages, threat of firing financial managers, and threat of hostile takeover.
  - ∨ shareholders and bondholders
    - ⓐ shareholders prefer riskier projects due to risk premium.
    - ⓑ bondholders receive fixed payments and more interesting in limiting risky projects.

Part IV "Concept flowchart"

Business Organization Forms

Proprietorship

Partnership

Corporation

- Separation between ownership and control
- determining goal of managers is very important
- goal is shareholder wealth maximization
- goal more comprehensive and long-term than profit maximization
- Agency problems
- *Role of ethics

Maximazation of shareholder's wealth

Managers cannot directly intervene in the market. They can only make right decisions in the firm to influence the share price

Categories of firm-level decisions

- investment (left-side of balance sheet)
- financing (right-side of balance sheet)
- dividend (income statement)

- capital budgeting
- cost of capital