Overview and Learning Objectives

Overview

This chapter provides an overview of financial management and the primary goal of a company. It discusses issues related to the principal-agent relationship that is resulted from the separation of ownership and management in corporations. This chapter also covers issues regarding various forms of business organizations and different types of securities issued by a company in financial markets.

Learning Objectives

After reading course materials on this chapter, students should be able to:

- Explain what financial management is, and the three key types of financial decisions – capital budgeting, capital structure, and net working capital investment, and their desirable outcomes.
- Explain how payoffs to debt holders and equity holders are contingent on firm value under different financial conditions.
- Discuss the advantages and disadvantages of each of the three basic forms of business organizations:
  - sole proprietorship
  - partnership (general versus limited)
  - corporation
- Explain why firm value (or shareholders' wealth or stock price) maximization is the most comprehensive objective of a corporation.
- Explain and identify the principal-agent relationship, the key condition for agency problem, the different forms of agency costs, and the approaches used to mitigate agency problems.
- Summarize the basics of financial markets and regulations.

Financial Management I (FIN 531)

What is Corporate Finance? (Section 1.1)

Most people like money and they associate 'finance' with money. To them, corporate finance is about managing money for corporations. That is true. When asked, people give different answers to why they like money. My favorite response is that money represents the claim on, or control of, resources. And we will use this approach in examining various corporate finance issues in this course.

Corporate finance is about the management and valuation of resources. We can consider a company as a black box that brings in resources as input, makes right decisions on the use of resources to produce output that generate more resources than what it brings in. By doing so, this company creates value to its owners – stockholders.

Management of resources involves three major types of decisions:

1. How should the firm utilize the resources?
2. How should the firm raise the resources?
3. How much short-term cash flow does a company need to pay its bills?

These decisions will be further explained on the next page.

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see full course sequence

What is Corporate Finance? (cont'd.)

How should the firm utilize the resources? (Slide)

What projects should the firm invest in? This refers to the **investment or capital budgeting decision** of the firm. The fixed assets section on the left-hand side of the balance sheet of a firm reflects the cumulative effect of its past capital budgeting decisions.

The desirable outcome of the capital budgeting decision is to invest in projects that generate more resources for the firm than the amount committed. These projects add value to the firm and its owners.

How should the firm raise the resources? (Slide)

What types of securities, debt or equity, should the firm use in raising capital? This refers to the **financing or capital structure decision** of the firm. The long-term debt and shareholders' equity sections on the right-hand side of the balance sheet of a firm reflect the cumulative effect of its past capital structure decisions.

The desirable outcome of the capital structure decision is to be able to raise more resources from the capital providers than what it will cost the firm to repay them. Although the capital structure decision can also potentially help create value for the firm, its main role is to determine how firm value should be distributed among various stakeholders of the firm.

How much short-term cash flow does a company need to pay its bills? (Slide)

This is the financial decision at the operational level, and is also known as the **net working capital investment decision**. The net working capital (NWC) is defined as current assets minus current liabilities. This type of decision, which is a natural byproduct of investment and financial decisions discussed above, is reflected in the current assets and current liabilities sections on the top of the two sides of the balance sheet of a firm. This short-term cash flow problem is resulted from the uncertainty in the size and timing of cash inflows and cash outflows during the course of operation.

In this course, our primary focus is on the capital budgeting decision, i.e., how to utilize the resources to create value for the firm and its owners. In FIN 581, you will be introduced to issues regarding the capital structure decision and the net working capital investment decision.

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The Corporate Firm (Section 1.2)

There are three basic forms of business organizations – sole proprietorship, partnership, and corporation. For the discussion in this course, we assume that the firm takes the corporate form, which allows the separation of the firm from its ownership, a common practice in corporate America.

The corporate form of business is the standard method for solving the problems encountered in raising large amounts of cash.

Corporation is a legal entity (that allows its owners, i.e., shareholders, to enjoy the benefit of limited liabilities).

- Assets are what a corporation owns.
- Liabilities and Equity are what a corporation owes to its various stakeholders.

Other business forms:

- Sole Proprietorship
- Partnership

Please refer to the text for further information on the three basic forms of business organizations.

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Partnerships and Corporations Comparison

In reading the materials presented in your textbook for details on this topic, please pay close attention to the characteristics, advantages and disadvantages of each of these three forms of business organization. The table below provides a useful comparison between corporations and partnership for your reference on this topic.

	Corporation	Partnership
Liquidity & Marketability of Ownership	Shares can easily be exchanged.	Subject to substantial restrictions.
Voting Rights (Control)	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	Broad latitude	All net cash flows are distributed to partners.
Liability	Limited liability	General partners may have unlimited liability. Limited partners enjoy limited liability.
Continuity of Existence	Perpetual life	Limited life

Financial Management I (FIN 531)

The Importance of Cash Flows and Corporate Securities as Contingent Claims (Section 1.3)

Firms issue debt and equity securities (i.e., bond and stock), in the financial market to raise cash for investing in value creating projects and repay the investors (i.e., bondholders and stockholders) later (Slide). As such, one can consider a firm as a pie. While the investment decision determines the size of the pie, the financing decision determines how the pie is shared among various stakeholders (or resource providers) such as bondholders and stockholders (Slide). In this section, we examine how payoffs to debt (or bond) holders and equity (or stock) holders depend on firm value.

Debt gives its holders higher seniority in claiming the firm's cash flows, under normal circumstance, and assets, upon liquidation, than equity holders.

When the firm is solvent, the payoffs to debt holders are the promised amount, F (Slide). But when the firm is insolvent, i.e., firm value, V, is less than the promised amount (V<F), payoffs to debt holders are contingent on firm value because that is the most they can receive from the firm. For equity holders, their payoffs are always contingent on firm value, and are whatever remains after paying the debt holders. When the firm is insolvent, equity holders receive nothing. Note that payoffs to equity holders are always nonnegative even when the firm is insolvent. This is because the corporate form of a firm gives equity holders the benefit of limited liabilities, i.e., they are not required to 'guarantee' that debt holders receive the full promised amount. In a perfect world where there is no government or any transaction costs, the sum of the payoffs to debt holders and equity holders is equal to the value of the firm (Slide).

In Finance, we focus on cash flows in our analysis because the value of a firm is determined by the amount, riskiness and timing of cash flows generated by the firm.

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Goals of the Corporate Firm and Agency Problem (Sections 1.4 and 1.5)

In this section, we discuss the most important topic in this chapter and the related issues – the objective of the firm and the agency problems in pursuing this objective.

Among typical responses to the question of what should be the primary objective of the firm, the most appropriate and comprehensive one is the maximization of long-term firm value, and equivalently, stock value maximization or shareholders' wealth maximization. The long-term firm value maximization objective takes into consideration all three factors of valuation, namely, the size, timing, and riskiness of expected future after-tax cash flows. As owners of the firm, shareholders surely prefer the maximization of firm value, and hence stock value, to other goals because they can be directly benefited. When you invest in stocks, don't you like its value to be maximized such that you can maximize the capital gain, and at worst minimize capital loss, in your investment? But, would you share the same view when you were the management team of the company?

Please reference the text for the discussion on the shortfall of other possible goals, especially the impreciseness of the popular one - profit maximization.

Agency Problem

When shareholders, the owners, let the management team run the company on their behalf, i.e., the common practice of separation of ownership and control in corporate America, a principal-agent relationship is established (Slide). Conflicts arise when the goals of the agent (the management team), such as their preferences for excessive perk consumption and the maximization of corporate wealth that provides survival, independence and self-sufficiency of management, differ from the primary goal of the principal (shareholders), the maximization of long-term firm value. The conflict in the interests of the agent (management) and the principal (owners/shareholders) is the primary condition for the agency problem that results in potentially substantial agency costs.

Agency costs refer to the costs of resolving the conflicts of interest between managers and shareholders. Agency problems are "costly" because shareholders have to expense resources (either in the form of direct monitoring, or providing incentives such as stock options) to motivate management to act in shareholders' best interests. In addition, agency costs also include the residual losses resulting from unresolved agency problems.

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Goals of the Corporate Firm and Agency Problem (cont'd.)

Mechanisms to Mitigate Agency Problem

Listed below are various approaches that can mitigate agency problems by aligning the goals of management with the primary goal of shareholders/owners.

Managerial Incentives

Compatible incentives such as performance plans linked to accounting income (or, even better, cash flow) or equity participation through stock options help to bring the objectives of the management team more in line with those of the shareholders. This is a **constructive** approach that brings the management team into the ownership group.

The Voting Mechanism and Corporate Governance

The corporate charter often determines how difficult it is to replace the management team through the board of directors. Also, the board brings in more independent members that represent shareholders' interests. This is an example of rising activism among (institutional) investors.

Takeovers

Takeovers can be a shareholder's best friend if they (or the threat of their existence) force the management team to work in the shareholders' interests, i.e., the **capital market discipline**.

The Labor Market for Managers

Managers have a strong incentive to work in the shareholders' interests if they can be easily replaced and such an outcome can have an adverse impact on their reputation in the labor market, i.e., the **labor market discipline**.

These various approaches to mitigate agency problems motivate managers to act in the shareholders' interest – the maximization of long-term firm value.

Financial Markets and Regulations (Section 1.6)

This section provides basic information about financial markets and regulations(Slide).

Primary markets

- When a corporation issues new securities, cash flows from investors to the firm.
- Usually an underwriter is involved.

Secondary markets

- Involve the sale of seasoned securities from one investor to another.
- Securities may be traded in an organized exchange such as NYSE, or traded over-the-counter in a dealer market.

Regulations

- Please reference the text for an introduction to the regulations concerning financial reporting of public corporations and public trading of securities. Major regulations include -

- Securities Act of 1933 (the 1933 Act) on the information disclosure requirements concerning primary market activities.

- Securities Exchange Act of 1934 (the 1934 Act) on secondary market activities; and establishment of Securities and Exchange Commission (SEC).

- Sarbanes-Oxley Act of 2002 (Sarbox) on audit guidelines and ethical standards to mitigate corporate abuses; and establishment of Public Companies Accounting Oversight Board (PCAOB).

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Self-Assessment

This content element contains information that is regularly updated by McGraw-Hill.

To view this content, follow this link.

Financial Management I (FIN 531)

Chapter Quiz

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