

Chapter 1

Introduction to Corporate Finance

Chapter Organization

- 1.1 Corporate Finance and the Financial Manager
- 1.2 Forms of Business Organization
- 1.3 The Goal of Financial Management
- 1.4 The Agency Problem and Control of the Corporation
- 1.5 Financial Markets and the Corporation
- 1.6 Financial Institutions

Chapter 1

Introduction to Corporate Finance

Chapter Organization (cont'd)

- 1.7 Trends in Financial Markets and Financial Management
- 1.8 Outline of the Text
- 1.9 Summary and Conclusions

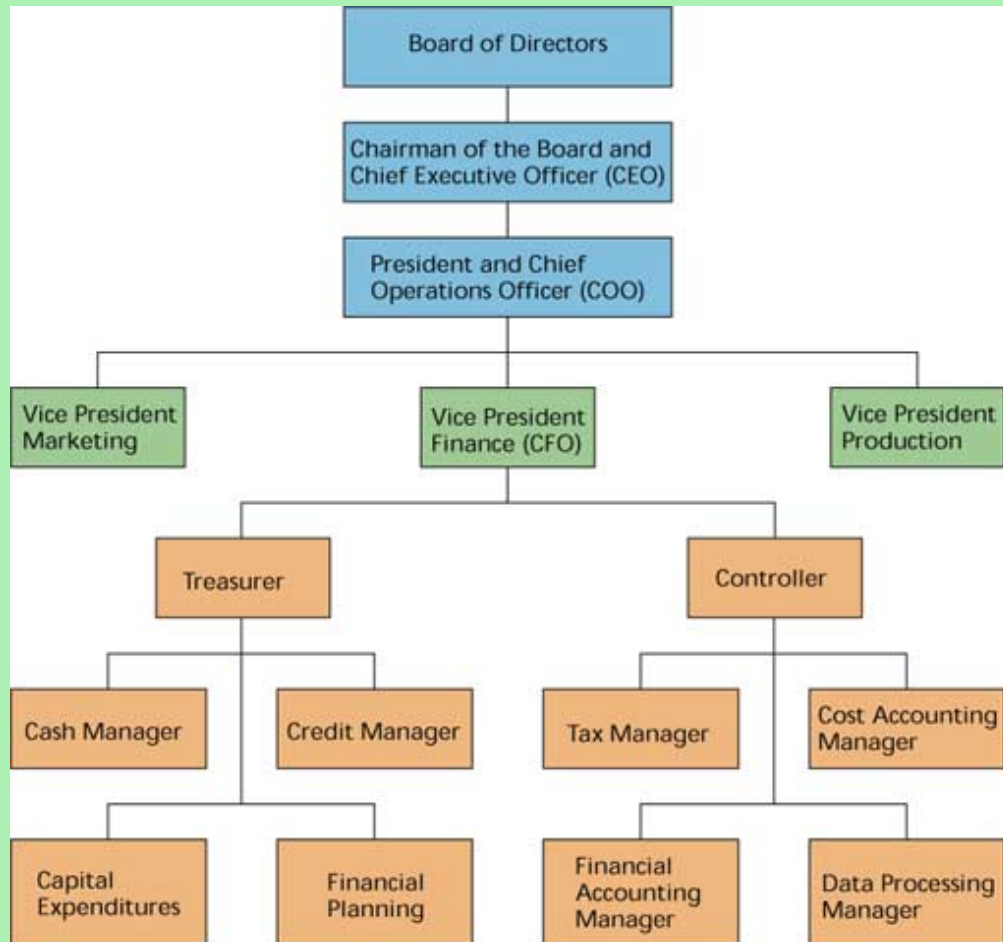
The Four Basic Areas of Finance

- **Corporate Finance**
- **Investments**
- **Financial Institutions**
- **International Finance**

Corporate Finance

- Long-term investments
 - ◆ Capital Budgeting
- Long-term financing
 - ◆ Capital Structure
- Short-term financing
 - ◆ Working Capital Management
- Risk management
 - ◆ Derivative securities

T1.3 A Simplified Organizational Chart (Figure 1.1)



T1.4 Forms of Business Organization

■ Organizational Forms

◆ Sole Proprietorship

◆ Partnership

General Partnership / Limited Partnership

◆ Corporation

Limited Liability Company

■ Legal Considerations

How do owners' roles differ across organizational forms?

■ Economic Considerations

Why are corporations generally larger than other forms of business?

T1.5 International Corporations (Table 1.1)

Company	Country of Origin	Type of Company	
		In Original Language	Translated
Bayerische Motorenwerke AG	Germany	Aktiengesellschaft	Corporation
Dornier GmbH	Germany	Gesellschaft mit Beschränkter Haftung	Limited liability co.
Rolls-Royce PLC	United Kingdom	Public limited company	Public limited co.
Shell UK Ltd.	United Kingdom	Limited	Corporation
Unilever NV	Netherlands	Naamloze Vennootschap	Joint stock co.
Fiat SpA	Italy	Societa per Azioni	Joint stock co.
Volvo AB	Sweden	Aktiebolag	Joint stock co.
Peugot SA	France	Societe Anonyme	Joint stock co.

T1.6 The Goal of Financial Management

The Goal of Financial Management

■ What are firm decision-makers hired to do?

“General Motors is not in the business of making automobiles.
General Motors is in the business of making money.”

--Alfred P. Sloan

■ Possible goals

■ Three equivalent goals of financial management:

Maximize shareholder wealth

Maximize share price

Maximize firm value

T1.7 The Agency Problem

The Agency Problem and Control of the Firm

- Agency Relationships and Management Goals
- Do managers Act in the Shareholders' interests?

Agency costs

Direct agency costs

Indirect agency costs

- Mechanisms to ensure Managers are acting in shareholders' interest

Managerial compensation

Proxy Contest

Board of directors

Institutional Investors

Takeover activity

Financial Markets

- **What is the role of financial markets in corporate finance?**

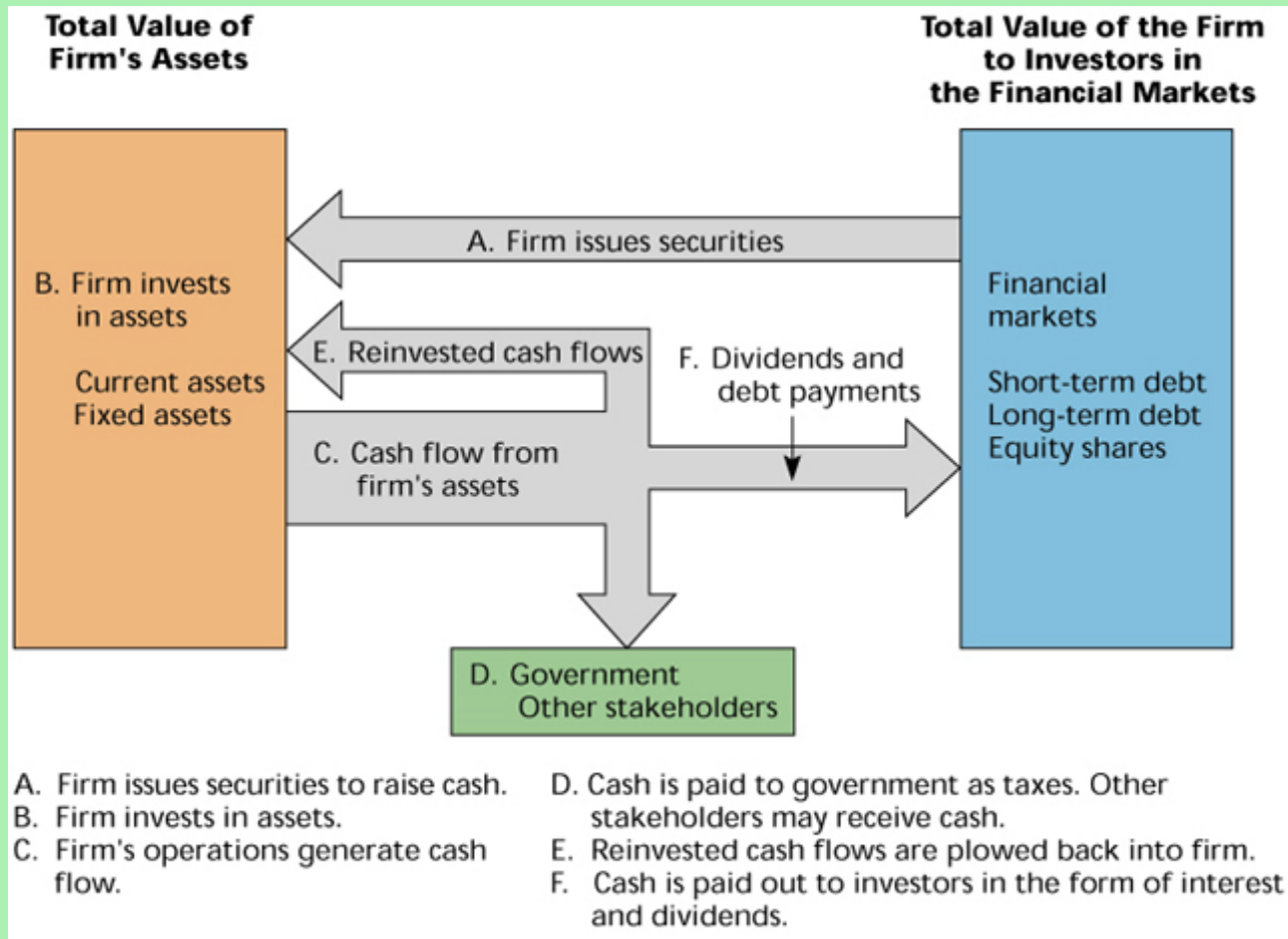
Cash flows to and from the firm

Money markets and capital markets

Primary versus Secondary markets

- **How do financial markets benefit society?**

T1.9 Cash Flows Between the Firm and the Financial Markets (Figure 1.2)



Banks are Intermediaries

- Intermediaries provide scale economies in services
- This allows them to earn income on services provided:
 - Earn interest on the spread between loans and borrowings
 - Service fees (e.g. bankers acceptance, stamping fee)
 - Direct finance - services to clients without holding funds
- The 10 largest Canadian financial institutions are:
 - 6 chartered banks, 2 financial holding companies,
 - 1 credit union, 1 pension fund (see Table 1.4 in the text)

Trends in Financial Markets and Management

- Derivative securities and financial engineering
 - ◆ Long-Term Capital Management
- Information technology
- Regulation
- Demutualization

Quick Quiz

1. Who performs the financial management function in the typical corporation?
2. What are the major advantages and disadvantages of the corporate form of organization?
3. Why is shareholder wealth maximization a more appropriate goal than profit maximization?

Quick Quiz

1. Who performs the financial management function in the typical corporation?

Treasurer, CFO, Vice-President of Finance

2. What are the major **advantages** and **disadvantages** of the corporate form of organization?

Pros: limited liability, raising capital, unlimited life, ease of ownership transfer

Cons: expensive to form, double taxation, agency problems

3. Why is shareholder wealth maximization a more appropriate goal than profit maximization?

It takes time and risk into account