Topics:

1. Why corporation is an efficient business form
2. Structure of Corporation
3. A = L + E
4. Define Finance
5. Goal of Corporate Financial Mgmt.
6. Why study Finance?
7. What are key questions in Finance
8. Financial Markets (primary & secondary)
9. Cash Flow
# Forms of Business

<table>
<thead>
<tr>
<th>Sole Proprietorship</th>
<th>Partnership</th>
<th>Corporation (separate legal &quot;person&quot;)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Easiest to start</td>
<td>Easy to start</td>
<td>C-corp (Big)</td>
</tr>
<tr>
<td>Least Regulated</td>
<td>somewhat regulated</td>
<td>S-corp (Small)</td>
</tr>
<tr>
<td>Hard to raise funds</td>
<td>somewhat hard to</td>
<td>Limited Liability Company (½ corp ½ partner)</td>
</tr>
<tr>
<td>unlimited liability</td>
<td>raise funds</td>
<td></td>
</tr>
<tr>
<td>can be sued and take bus. &amp; personal $</td>
<td>unlimited liability</td>
<td></td>
</tr>
<tr>
<td>single taxation</td>
<td>single taxation</td>
<td></td>
</tr>
<tr>
<td>Difficult to sell ownership</td>
<td>Difficult to sell ownership</td>
<td></td>
</tr>
</tbody>
</table>

**Reasons corporate form is efficient**

1. Easy to raise cash
2. Limited Liability for Debt
3. Ease of transferring ownership (stock sold to bus. not end)
4. Unlimited life (owner die, bus. not end)

The risk associated with implementing good ideas → Corp. Form
Structure Of Corporation

Owners' rights
Elect board of directors
Receive dividends
Preemptive right
Share in distribution of assets if corporation is liquidated

Stockholders

Manages corporation's affairs
Appoints officers
Declares dividends
Formulates policies

Board of directors

Officers
President
Secretary Treasurer
Vice President, Sales
Vice President, Production
Vice President, Finance

Employees
The Role Of The Financial Manager

- Board of Directors
  - Chairman of the Board and CEO
    - President and COO
      - VP Marketing
      - VP Finance CFO
        - Treasurer
          - Cash Manager
            - Capital Expenditures
          - Credit Manager
            - Financial Planning
        - Controller
          - Tax Manager
          - Cash Accounting Manager
            - Information Systems Manager
1. Things you own like, cash, truck, building, patent
2. Provide probable future economic benefit

4. Finance:
   How to allocate scarce resources across assets over time in order to earn a return
   - What should we invest in?
   - Should we use cash (equity) or incur debt?
   - The future is unknown so this makes finance difficult

Goal of Corporate Financial Manager:
"The goal of financial management is to maximize the current value per share of existing stock (market value of equity)"

- Theoretically this is a good goal since the owners own the company.
**Problem #1**

Agency Problem with Corporations

Stockholders own business = "Principal"
Managers run business = "Agent"

1. Agent works for Principal
2. Agent is supposed to act in best interest of principal
3. Agent is inside business & has custody of assets
4. Managers do not always act ethically or legally.

Examples:
- **Enron** - Andrew Fastow
- **World.com** - Bernard Ebbers
- **AIG** - Credit Default Swaps

Diagram:
- Inside Accounting
- Outside people
Agency Problem with Corporations

Stockholders own business. Stockholders are called principal. Managers run business & work for principal. Managers are called agents.

Q: If the principal is not watching the agent 100% of the time, how does principal get agent to act in the best interest of the principal?

A: 1) Pay managers based on stock value
    2) External Auditors Report to B. of D.
    3) Controls over assets & accounting
    4) Sarbanes Oxley Act
    5) Regulation (like on insurance)

Sometimes leads managers to "cook books."
Financial, Accounting, Management
Gurus invent ways to circumvent
or circumscribe laws that protect
owners

Example 1
- Lehman Brothers issued Debt
  (should be listed on Balance sheet
  as debt so investors (owners)
  can see that company has
  debt)
- Lehman Brothers then bought back
  Debt as Asset. (Hide Debt)

Example 2
- Financial Gurus invented Credit swap Defaults to allow
  companies to issue insurance
  polices without holding equity
  in case insurance had to be paid
  out.
- This is how AIG failed
Problem #3

The definition of finance depends on financial markets being efficient (accurately pricing assets), but as the Dot.Com Bubble (1995-2001) & the Housing Bubble (2003-2007) proved, financial markets are not always efficient.

If managers are doing things to maximize current market value, but "current market value" is not correct, the goal cannot be achieved because the mechanism to gauge whether a decision is good or bad is broken.
Example:

2000 - 2007 House Bubble


2009  2010

1. Markets said house worth a lot. This is price signal to buy house as investment.
2. Banks (make loans), individual (buy house), contractor (make house) react to price.
3. When market was incorrectly telling people to buy (most in market).
problem #4: (Banks only)

Alan Greenspan in Congressional testimony:

"Those of us who have looked to the self-interest of lending institutions to protect shareholder equity—myself especially—are in a state of shocked disbelief."

In a free market (self-interest), it was assumed that bankers would act in bank stockholder best interest, but bank managers ran the company until the bank went bankrupt, but managers still got bonus.
we will study Corporate Finance.

other areas of finance:

1. Investing
   - stockbroker
   - portfolio manager
   - security analyst
   - bond trader

2. Financial Institutions
   - Banks
   - Insurance

3. International Finance
why should we study Finance?

personal:
- Student loans
- Credit cards
- Investments
- Retirement savings
- Banking

careers:
- Marketing:
  Budgets, Analyze Market Plan
- Accounting:
  Accounting & Finance share a lot
- Management:
  Investing, what projects are best, job performance
- personal Finance

What Questions to Ask?

1. **Capital Budgeting Q:**
   - What long-term investments (projects) should corporation make? Equipment, Buildings, Investments

2. **Capital Structure Q:**
   - Where do we get long-term financing?
   - What mixture of Equity, Debt & Profits will we use?

3. **Working Capital Q:**
   - How do we collect from customers & pay our bills? Concerned with short-term assets & liabilities (Debt).
Financial Markets

- Primary Markets
  - Original sale of equity (stock) or debt.
  - The corporation issues "security"

- Secondary Markets
  - After the original sale, owners can buy or sell the equity or debt.
  - You sell/buy security.

Diagram:
- Primary market: buy stock → new owner
- Secondary market: sell stock to others
Figure 1.2

Cash Flow and Corporation and
Next 2 pages are about A1 G
1. Buy insurance in case of accident → Insurance Co. promises to pay if you get in accident.

2. Insurance Co. AIG
   - Spends your $100, but does not save any money in case you get in accident.

3. Insurance Co. AIG
   - AIG sells 1000 insurance policies to other people betting that you will get in accident.

4. 1000 × $100 = $100,000. AIG spends this $100,000 and does not put money aside in case you get in accident.

5. Government regulators do not force AIG to put money aside.

6. You get in accident

7. You ask AIG to pay the $100. The 1000 other investors ask for their $100. AIG has no money. They cannot pay.
1. AIG buys insurance in case Borrower does not pay.

2. 1000 other people buy insurance on ABC, even though they did not lend any money to ABC.

3. AIG spent all the money they got from the insurance policies.

4. AIG did not put any money aside in case the ABC Borrower does not pay.

5. ABC does not pay.

6. AIG has no money to pay.

7. Everyone is hurt. (Except Govt gives $ to AIG to pay off short contracts.)