BUSN 233
Chapter 1

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 Man.
⑥ why study Finance?
⑦ what are key questions in Finance
⑧ Financial Markets (primary & secondary)
⑨ Cash Flow

1 Forms of Business

2

Sole Proprietorship

- Easiest to start
- Least Regulated
- Hard to raise funds
- unlimited liability
  - Can be sued and take bus. & personal $
- single taxation
- Difficult to sell ownership

Partnership

- General
- Limited

- Easy to start
- somewhat Regulated
- somewhat hard to raise funds
- unlimited liability
  - Can be sued and take bus. & personal $ (also mutual agency)
- single taxation
- Difficult to sell ownership

Corporation (separate legal "person")

- C - corp (Big)
- S - Corp (small)
- Limited Liability company (½ corp ½ Partne

- Hard to start
- Regulated
- Easiest to Raise funds (Equity & Debt)
- Limited Liability
  - can be sued but can only take upto what was invested
- Double Taxation (Net Income & Dividen
- Easy to sell stock (because of separation of owners & managers & unlimited life of corporation).

If you have a Good Idea, the corporation is great because you have access to funds (Equity or Debt)

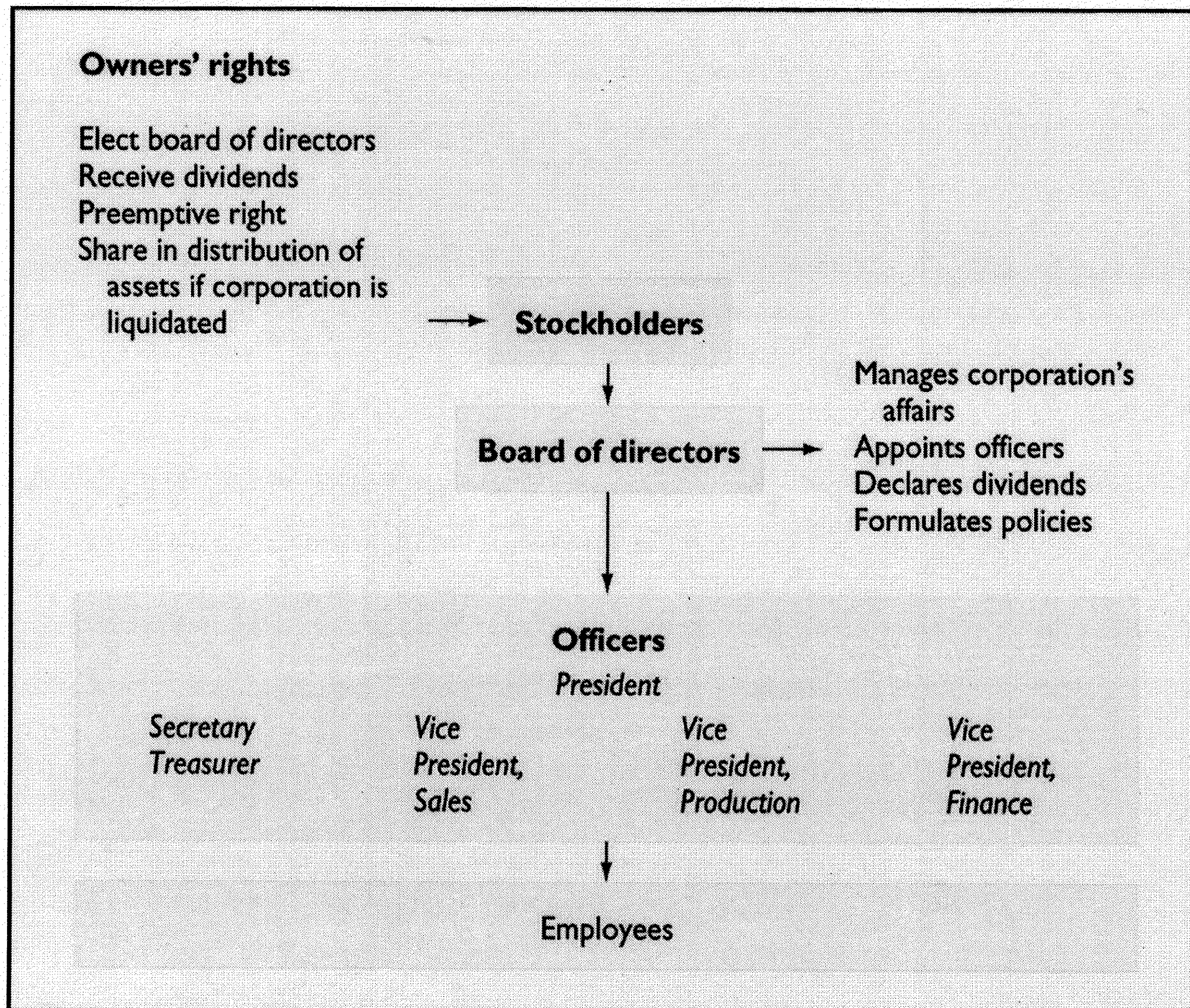
Reasons corporate Form is efficient

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

The risk associated with implementing good ideas → Corp. Form

4

Structure Of Corporation



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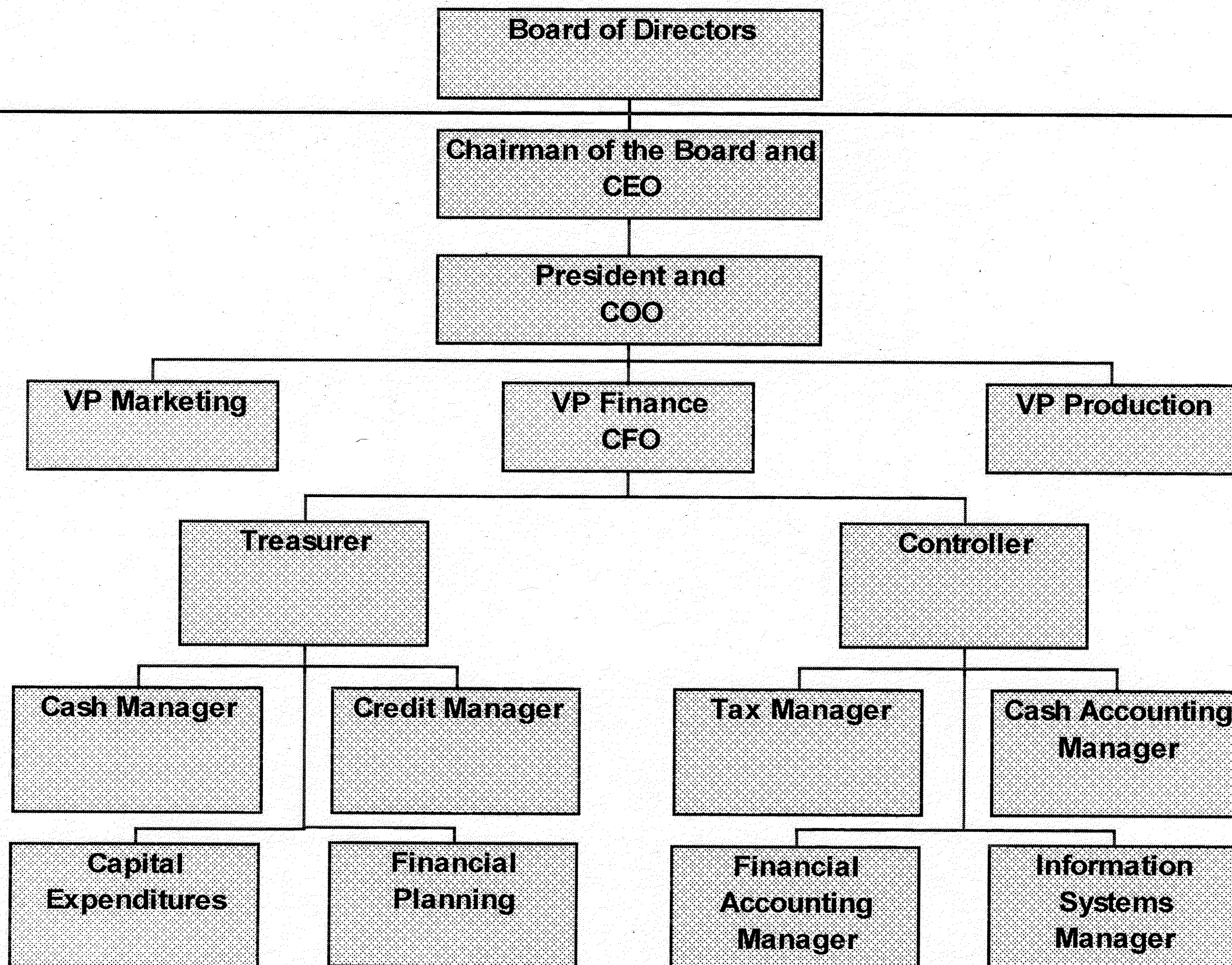
The Role Of The Financial Manager



A = D + E (5)

Fundamental Accounting Equation

3

Asset = Liabilities + Equity

= $\boxed{\text{Loan = Debt} \quad \text{owe = 150,000}}$ + $\boxed{\text{Down } 50,000}$

Asset:

1. Things you own like, cash, Truck Building, Patent
2. provide probable future economic Benefit

Liabilities:

1. D-E-B-T
2. contract to pay back loan + Interest
3. Bank gets paid before you when Bankrupt

Equity:

1. A - D = E
2. whatever is left over, is owners

4

Finance: How to allocate scarce resources across assets over time in order to earn a return

Individuals, corporations, Governments, ...

- what should we invest in?
- should we use cash (equity) or incur Debt?
- The future is unknown so this makes finance difficult

5

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.

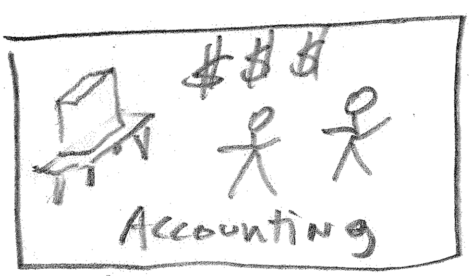
...>

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.



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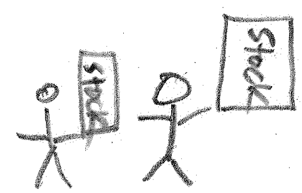


outside

Think of:
ENRON - Andrew Fastow
World.com - Bernard Ebbers
AIG - Credit Default swaps

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?

works inside corp.
has custody of assets

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 • Makes managers personally responsible for financial statements.
⑤ Regulation (like on Insurance)

sometimes leads managers to "cook books"

Problem # 2

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 issurance had to be paid out.
- This is how AIG failed

Both practices were legal, both AIG & Lehman Brothers are dead

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 gage whether a decision is good or bad is broken.

Example:

2000 – 2007 House Bubble

1) Markests 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

6 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

7 what Questions to Ask?

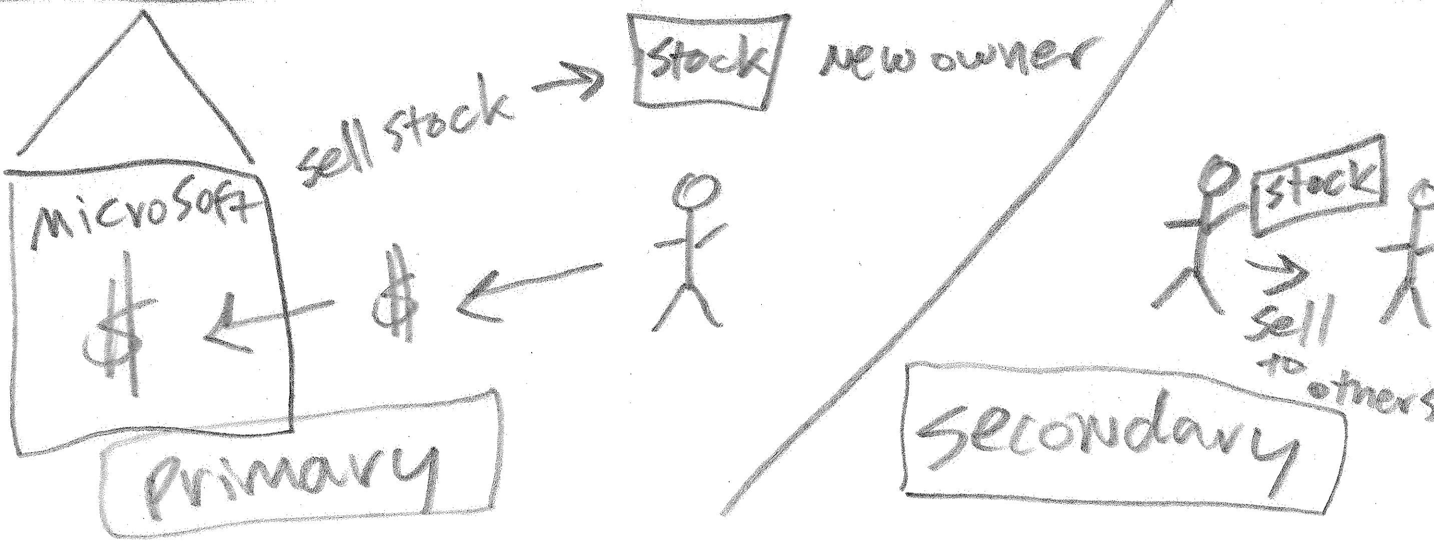
1. **Capital Budgeting Q:**
   what long-term investments (projects) should corporation make? Equipment, Buildings, Investments

2. **capital structure Q:**
   where do we get long-term financing? What Mixture of Equity, Debt & Profits will we use?

3. **Working Capital Q:** (current Assets - current Liab.)
   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.



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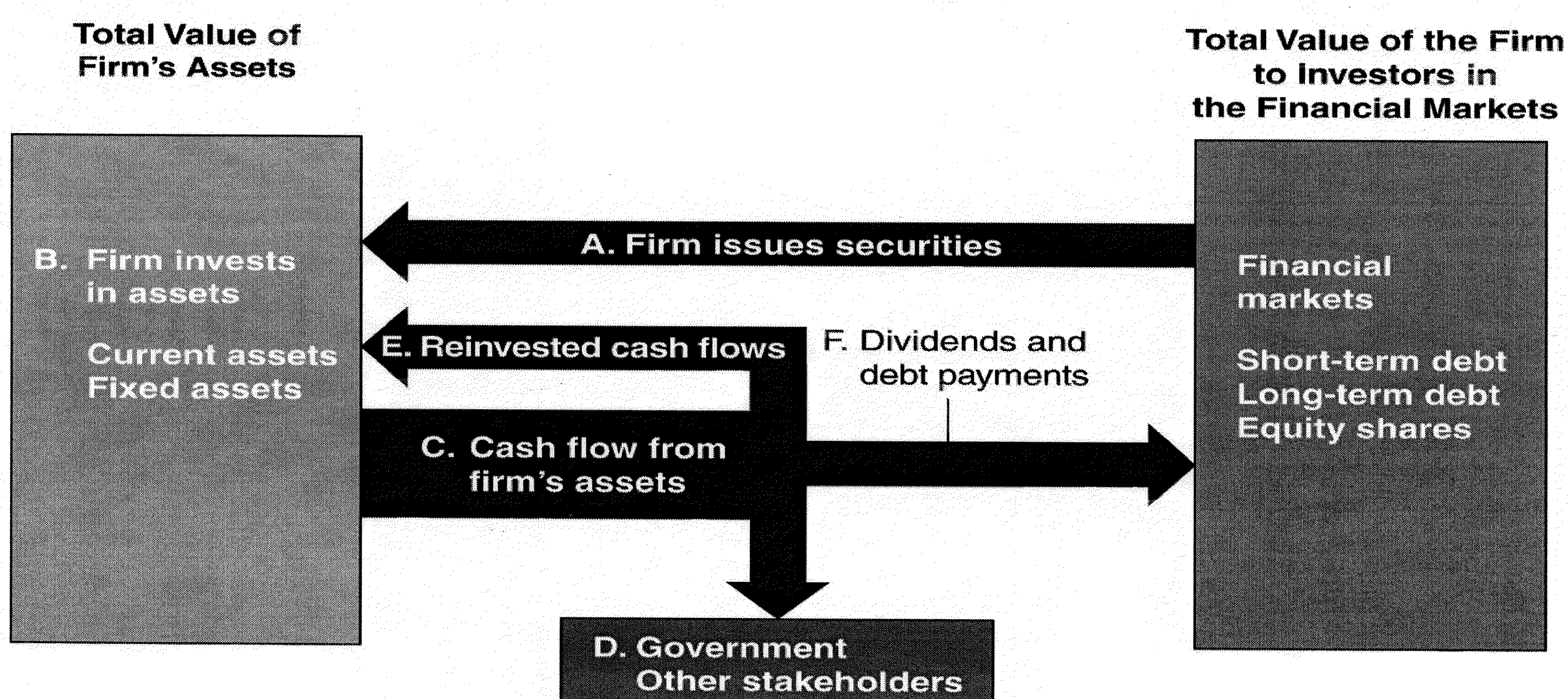
Corporation and Cash Flow

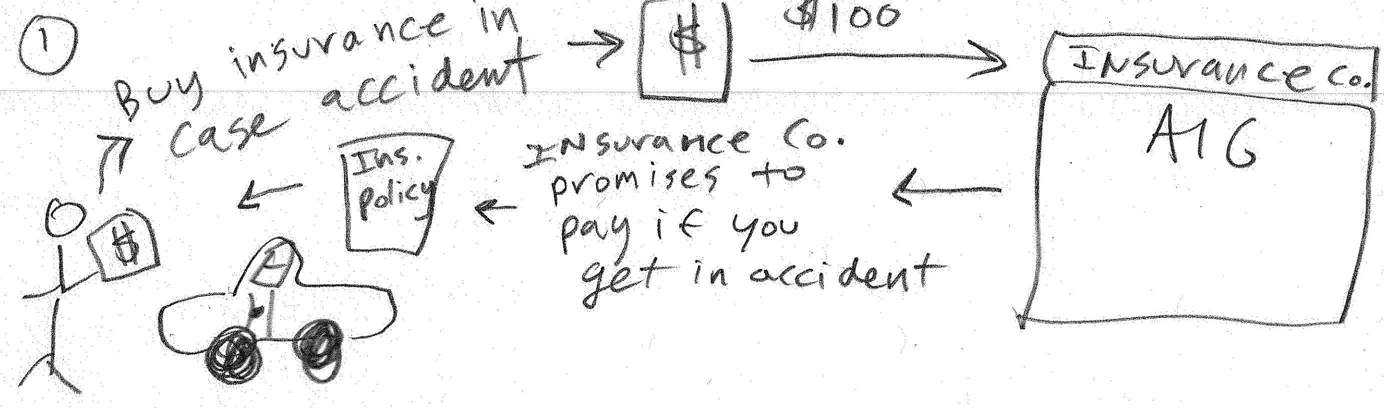
Figure 1.2



A. Firm issues securities to raise cash.
B. Firm invests in assets.
C. Firm's operations generate cash flow.
D. Cash is paid to government as taxes. Other stakeholders may receive cash.
E. Reinvested cash flows are plowed back into firm.
F. Cash is paid out to investors in the form of interest and dividends.

Next 2 pages are
about AIG

1



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2 Insurance AIG

spends your $100 $ does not save any money in case you get in accident

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3 Insurance AIG

AIG sells 1000 Insurace policies to other people betting that you will get in accident

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

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5 Government regulators do not force AIG to put money aside

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6 you get in accident

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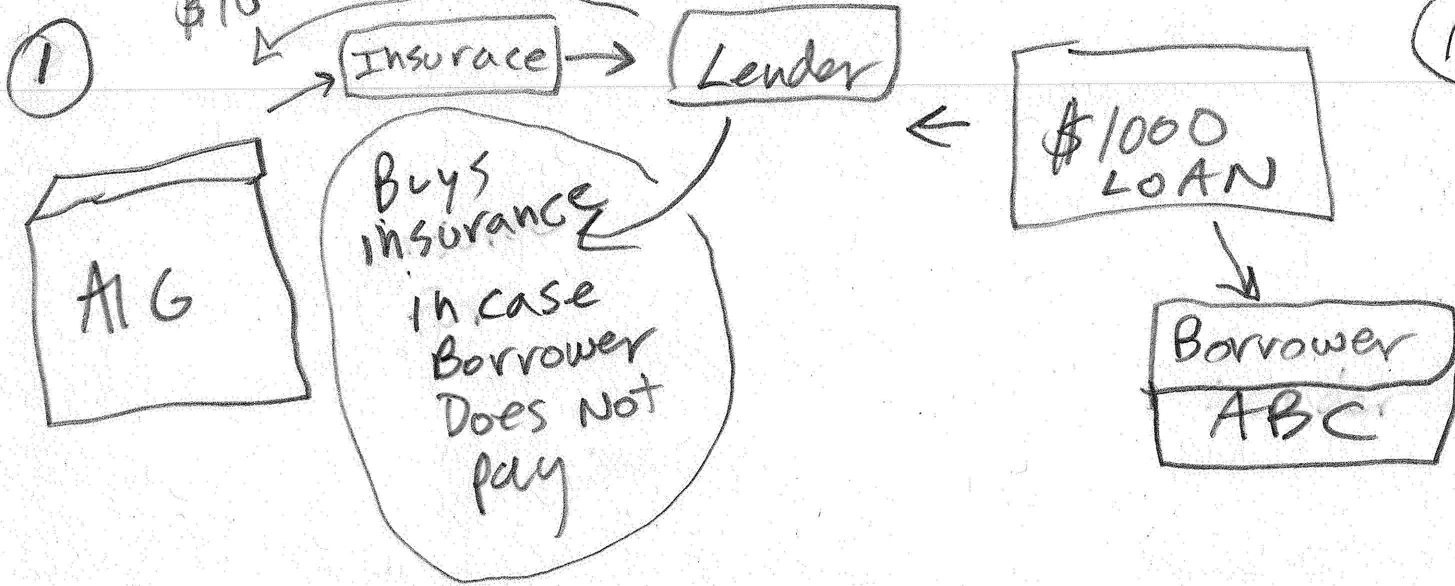
7 (A) you ask AIG to pay the $100.

(B) The 1000 other investors ask for their $100.

(C) AIG has no money. They cannot pay

1



2 1000 other people buy insrrance 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 Borrow does Not pay

5 ABC does Not pay.

6 AIG has no Money to pay

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