

Chapter 1: The Corporation and the Financial Manager**INTRODUCTION**

Financial Management is an important part of the decision making process in the firm. Daily, managers face questions such as:

- Will this project be successful?
- Do we have enough cash?
- How are we going to raise funds?
- How much does it cost to raise fund?
- Is there a cheaper way to do that?
- How much inventory should we carry?
- How risky is the project and does it earn enough return to make it worth the risk we take?

Financial managers in large businesses also deal with more dramatic decisions like mergers and acquisitions, going public, distributing dividends.

THE GOAL OF THE FIRM

What goal should guide the decision-making processes in the firm? What should managers try to achieve for the owners of the firm?

- Is it to maximize sales or market share?
Maximizing sales require more spending on advertising or reducing the price of the product for example.
- Is it to maintain the highest quality product or services in the industry?
This also requires more spending! (Example: car manufacturers and zero-defect policy).

- Is it to maximize the profit?
 - No time dimension: Do you mean profit in the long-term or profit in the short term? (Drug companies and cutting R&D expenses)
 - Different methods of accounting can make a losing firm profitable and vice versa. (Depreciation methods, off balance sheet items, and adding revenue accrued).
 - No specific definition of profit: is it Total profit, ROE, or EPS?
 - No risk element considered. EPS can increase by issuing more debt and less shares.

The most appropriate goal is to

MAXIMIZE SHAREHOLDERS' WEALTH

Shareholders' wealth is measured as (Stock Price * the number of shares). Therefore, managers should maximize the stock price, which is the market value of the common stock.

The stock price or the value of any assets is determined by the three elements:

- 1- *Magnitude* of the cash flow (the larger the cash flow the higher the stock price)
- 2- *Timing* of the cash flow (the sooner the cash flow the higher the stock price)
- 3- *Riskiness* of the cash flow (the more certain the cash flow the higher the stock price)

What is cash flow?

Cash flow relates to the actual cash generated by the firm. It is the difference between the cash inflow (from sales) and cash outflow (to suppliers, employees, taxes, raw material and equipments).

- The market price of the stock is supposed to be an unbiased objective and managers cannot control it!

DO MANAGERS ALWAYS MAXIMIZE SHAREHOLDER’S WEALTH? (AGENCY PROBLEM)

The managers (agents) are *supposed* to represent stockholder’s (principal) interests. However, managers may sometimes act in their *own* interests.

Managers may be tempted to...

- Increase their own job security by trying to reduce risk which lead to unsuccessful acquisitions or unwillingness to expand business (Nortel bought 19 companies for 33 billion dollars then went bankrupt”.
- Excessive spending “perks” luxurious office, corp. jets, travels, birthday parties (Dennis Kozlowski, former CEO of Tyco”.

Motivating factors that can influence managers to act in the interest of stockholders:

- **Properly structured compensation package**
 - Annual salary
 - Bonus depending on profitability
 - Performance shares and/or executive stock options “Ford forces managers to own stock in the firm”
- **Monitoring by the board of directors:** The shareholders (principals) elect the board of directors. The board of directors hires and fires the managers (agents).
- **Threat of hostile takeovers:** Most likely to occur when stock is undervalued due to poor management “If you want to keep your job, don’t let your stock sell at a bargain price.”

BUSINESS ETHICS AND FINANCIAL MANAGEMENT

- Maximizing shareholders wealth should be through ethically and legally accepted standards.
- At least, managers must operate within the confines of what is legal. However, being ethical might require more than that. Managers should be honest and fair when dealing with customers, employees, government, suppliers, and the society.
- Keeping the good reputation of the firm among its stakeholders and in the society pays off financially. “Examples: environment, lay-offs and downsizing, labor union”.

FORMS OF BUSINESS ORGANIZATION

Sole Proprietorships

- Unincorporated
- Owned by one individual
- Used primarily as small business operations
- The vast majority of businesses operate as sole proprietorships.

Advantages:

- Easy and inexpensive to form
- Few government regulations
- No corporate income taxes

Disadvantages:

- Difficult to obtain much capital
- Unlimited liability
- Limited life of business

Partnerships

- Unincorporated
- Owned by two or more persons
- Partnerships can be either general or limited.

General partnership: each partner has unlimited liability.

Limited partnership: at least one of the owners must be a *general partner*, while some or all of the others can be *limited partners*. The differences are outlined below:

- General partners
 - Unlimited liability
 - Has control over the company
- Limited partners
 - Limited liability
 - Gives up some control in the company

Advantages:

- Easy and inexpensive to form
- Few government regulations
- No corporate income taxes

Disadvantages:

- Difficult to obtain much capital
- Unlimited liability
- Limited life of business

Corporations

- Legal entity created by a state (Incorporated)
- Separate from its owners
- The owners are the *stockholders* (also called *shareholders*).
- The vast majority of large businesses are corporations.

Advantages:

- Unlimited life of business
- Easy to transfer ownership
- Limited liability
- Easier to raise capital

Disadvantages:

- Double taxation: Business pays corporate income tax, and then shareholders pay personal income tax on dividends.
- More complicated to organize.
- Subject to more regulation.

Hybrid Forms of Organization

Limited Liability Partnership (LLP) and Limited Liability Company (LLC)

- All partners enjoy limited liability.
- Avoids double taxation
- Less restrictions than S corporation

Professional Corporation Limited Liability Partnership (PLL)

- Partnership formed to provide professional service, like legal, accounting and investment banking services and other. (Example, Goldman Sachs)

	Sole Proprietorship	Partnership	Corporation
Who owns the Business?	The manager	Partners	Shareholders
Are managers and owner(s) separate?	No	No	Usually
What is the owner's liability?	Unlimited	Unlimited	Limited
Are the owner and business taxed separately?	No	No	Yes

How severe is the agency problems among the different types of business organizations?

FINANCIAL MANAGEMENT FUNCTIONS

VP of finance or CFO is the direct boss of the *Controller* and the *Treasurer*

Controller's Activities: Financial accounting, Cost accounting, Taxes, Data processing

Treasurer's Activities: Management of cash and marketable securities, Capital budgeting, financial planning, Credit analysis, Investors relations, Pension fund management.

In large firms Treasurer also deals with risk management in general and currency risk management.

Exciting Career Opportunities

VP of Finance, Director Investor Relations, Assistant Treasurer, Tax Manager, Financial Analyst, Account Executive Security Broker, Mortgage Analyst
Banking

Professional Financial Affiliations

Institute of Chartered Financial Analysis (CFA), Financial Management Association (FMA).