Chapter 1
Introduction to Financial Management

Key Concepts and Skills
- Know the basic types of financial management decisions and the role of the financial manager
- Know the financial implications of the different forms of business organization
- Know the goal of financial management
- Understand the conflicts of interest that can arise between owners and managers

Basic Areas Of Finance
- Corporate finance
- Investments
- Financial institutions
- International finance

Investments
- Work with financial assets such as stocks and bonds
- Value of financial assets, risk versus return and asset allocation
- Job opportunities
  - Stockbroker or financial advisor
  - Portfolio manager
  - Security analyst

Financial Institutions
- Companies that specialize in financial matters
  - Banks – commercial and investment, credit unions, savings and loans
  - Insurance companies
  - Brokerage firms

International Finance
- This is an area of specialization within each of the areas discussed so far
- It may allow you to work in other countries or at least travel on a regular basis
- Need to be familiar with exchange rates and political risk
- Need to understand the customs of other countries and speaking a foreign language fluently is also helpful
**Why Study Finance?**

- **Marketing**
  - Budgets, marketing research, marketing financial products
- **Accounting**
  - Dual accounting and finance function, preparation of financial statements
- **Management**
  - Strategic thinking, job performance, profitability
- **Personal finance**
  - Budgeting, retirement planning, college planning, day-to-day cash flow issues

**Business Finance**

- Some important questions that are answered using finance
  - What long-term investments should the firm take on?
  - Where will we get the long-term financing to pay for the investment?
  - How will we manage the everyday financial activities of the firm?

**Financial Manager**

- Financial managers try to answer some or all of these questions
- The top financial manager within a firm is usually the Chief Financial Officer (CFO)
  - Treasurer – oversees cash management, credit management, capital expenditures, and financial planning
  - Controller – oversees taxes, cost accounting, financial accounting, and data processing

**Financial Management Decisions**

- **Capital budgeting**
  - What long-term investments or projects should the business take on?
- **Capital structure**
  - How should we pay for our assets?
  - Should we use debt or equity?
- **Working capital management**
  - How do we manage the day-to-day finances of the firm?

**Forms of Business Organization**

- Three major forms in the United States
  - **Sole proprietorship**
  - **Partnership**
    - General
    - Limited
  - **Corporation**
    - S-Corp
    - Limited liability company

**Sole Proprietorship**

- **Advantages**
  - Easiest to start
  - Least regulated
  - Single owner keeps all the profits
  - Taxed once as personal income
- **Disadvantages**
  - Limited to life of owner
  - Equity capital limited to owner's personal wealth
  - Unlimited liability
  - Difficult to sell ownership interest
### Partnership

**Advantages**
- Two or more owners
- More capital available
- Relatively easy to start
- Income taxed once as personal income

**Disadvantages**
- Unlimited liability
- General partnership
- Limited partnership
- Partnership dissolves when one partner dies or wishes to sell
- Difficult to transfer ownership

### Corporation

**Advantages**
- Limited liability
- Unlimited life
- Separation of ownership and management
- Transfer of ownership is easy
- Easier to raise capital

**Disadvantages**
- Separation of ownership and management (agency problem)
- Double taxation (income taxed at the corporate rate and then dividends taxed at personal rate)

### Goal Of Financial Management

- **What should be the goal of a corporation?**
  - Maximize profit?
  - Minimize costs?
  - Maximize market share?
  - Maximize the current value of the company’s stock?
- **Does this mean we should do anything and everything to maximize owner wealth?**
- **Sarbanes-Oxley Act**

### The Agency Problem

- **Agency relationship**
  - Principal hires an agent to represent their interest
  - Stockholders (principals) hire managers (agents) to run the company
- **Agency problem**
  - Conflict of interest between principal and agent
- **Management goals and agency costs**

### Managing Managers

- **Managerial compensation**
  - Incentives can be used to align management and stockholder interests
  - The incentives need to be structured carefully to make sure that they achieve their goal
- **Corporate control**
  - The threat of a takeover may result in better management
- **Other stakeholders**

### Financial Markets

- **Primary vs. secondary markets**
  - Dealer vs. auction markets
  - Listed vs. over-the-counter securities
    - **NYSE**
    - **NASDAQ**