Chapter 1

What is Finance?

Four Basic Areas

Corporate Finance

Investments

Financial Institutions

International

What are the duties of the financial manager?

| What long-term investments should the firm make? | Capital budgeting  
The process of planning and managing long-term investments |
|-------------------------------------------------|---------------------------------------------------------------|
| How will we pay for these investments?           | Capital Structure  
The mixture of debt and equity                                    |
| How will we manage our day-to-day operations?   | Working Capital Management                                    |

A financial manager is responsible for deciding whether an investment in new manufacturing equipment should be financed with debt, preferred stock, or common stock. Which of the following financial management areas would be involved in the decision process?

I. Capital budgeting
II. Capital structure management
III. Working capital management

A) I only
B) II only
C) III only
D) I and III only
E) I, II and III
Which of the following is an answer to “What are the duties of a financial manager?”

I. Deciding how much interest to pay the holders of the corporation’s bonds.
II. Deciding the mix of long-term debt and equity.
III. Deciding which projects a firm should undertake.
IV. Deciding how much short-term debt to use.
A) I and II only
B) I, II, and III only
C) II and III only
D) II, III, and IV only
E) I, II, III, and IV

The process of planning and managing a firm’s long-term investments is called:

A) Working capital management.
B) Financial depreciation.
C) Agency cost analysis.
D) Capital structure.
E) Capital budgeting.
### Types of Businesses

<table>
<thead>
<tr>
<th></th>
<th>Sole Proprietorship</th>
<th>Partnership</th>
<th>Corporation</th>
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<tbody>
<tr>
<td>Is it easy to start?</td>
<td>Yes</td>
<td>Generally</td>
<td>Not Generally</td>
</tr>
<tr>
<td>Access to capital?</td>
<td>Limited</td>
<td>Limited</td>
<td>Easy</td>
</tr>
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<td>What is the life of the business?</td>
<td>Limited</td>
<td>Limited</td>
<td>Unlimited</td>
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<td>Who owns the business?</td>
<td>The Manager</td>
<td>Partners</td>
<td>Shareholders</td>
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<td>Are managers and owners separate?</td>
<td>No</td>
<td>No</td>
<td>Usually</td>
</tr>
<tr>
<td>What is the owner’s liability?</td>
<td>Unlimited</td>
<td>Unlimited (exceptions)</td>
<td>Limited</td>
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<tr>
<td>Are owners &amp; the business taxed separately?</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
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Which of the following statements is true regarding the corporate form of organization compared to that of the sole proprietorship?

- The owners of the sole proprietorship have limited liability for the firm's debts.
- **The sole proprietorship is the simplest business form to start-up.**
- The corporation has a limited life.
- Dividends received by the corporation's shareholders are tax-exempt.
- Dividends are paid with a corporation's pre-tax income.
- It is more difficult to transfer ownership in a corporation.
- The owners of the corporation have unlimited liability for the firm's debts.
- It is the simplest to start.
Goal of Corporation

What should be the goal of a corporation?

Maximize profit?

Minimize costs?

Maximize market share?

Maximize the current value of the company’s stock?

Maximizing shareholder wealth is the guiding principle for all decisions.

A financial manager of a corporation is considering different operating strategies for the coming year. From a financial management standpoint, which of the following would be her optimal strategy?

A) Undertake the plan that would reduce the overall riskiness of the firm.
B) Undertake the plan that would lead to the most stable stock price for the year.
C) Undertake the plan that would result in the largest profits for the year.
D) Undertake the plan that would maximize her personal wealth.
E) Undertake the plan that would maximize the current stock price.
Agency Costs

Definition - Agency costs arise when one party (principal) pays another (agent) to represent them. The conflicts of interest which arise are agency problems and the subsequent costs to reduce this divergence of agent action from the best interest of the principal.

Agency costs are the costs of the conflict of interest between stockholders and management

Examples - Company car, company jet, company sports tickets monitoring and suboptimal investment, hiring an outside auditor to check financial records

In finance, a major issue is the possibility of conflict of interest between the stockholders and management. This is an agency problem.

Stock Markets - Important as a source of cash flows to firm

Types of Markets

Primary - Firm sells stock directly to buyers or the market where the original sale of securities by government and corporations occur.

Cash from sale goes to firm

Actual sale is not generally directly from the company to the individual, but rather through an underwriter or investment banker who buys shares from the company and sells them to the public on a given day

Secondary - Stockholder sells ownership to another individual

Firm receives no cash

Important since secondary markets allow transfer of ownership, individuals are willing to buy stock

Dealer vs. Auction

Dealer market - NASDAQ

Dealer buys and sells stock, individuals buy stock directly from a dealer
Auction market - no dealer involved - individuals buy and sell from each other - sometimes (NYSE) involve a market maker who is responsible for maintaining an orderly market

**Continuous vs. Call**

Continuous - operates every second - if you want to sell you name a price and broker attempts to sell at that price

Call - Orders and sales with prices are submitted and they are matched at the price that clears the market

**Bond Markets**

**Primary and Secondary**

Primary - works through underwriters much the same as stocks, although there are more direct sales to buyers

Secondary - Many bonds are listed on an exchange, however little trading takes place there. On a given day, 2/3 of the bonds on the NYSE do not trade and the average trade is 15 bonds. Most of the secondary market is OTC since most bondholders are institutions such as insurance companies, mutual funds and banks.

Which of the following markets is considered an auction market?

A) The New York Stock Exchange  
B) The over-the-counter (OTC) market  
C) NASDAQ

The original sale of securities by governments and corporations occurs in the:

A) Primary market.  
B) Secondary market.  
C) Dealer market.  
D) Auction market.  
E) Liquidation market.