Chapter 1: Introduction

Introduction

Finance is about financial decisions; this book focuses on how people in corporations make financial decisions. The financial decisions, in your personal life and inside a business, are tied together in the Valuation Principle. This principle shows how to make the costs and benefits of a decision comparable so that we can weigh them properly.

The four types of firms

There are four major types of firms that financial managers run:

1. Sole proprietorships

A sole proprietorship is a business owned and run by one person. This type of firm is usually very small with few of none employees and is the most common type in the world.
Key features:

1. Easy to set up;
2. No separation between the firm and the owner (one owner who runs the business);
3. Owner has got unlimited personal liability for any of the firm's debts;
4. Life of the firm is limited to the life of the owner.

2. Partnerships

A business owned and run by more than one owner is called a *partnership.*
Key features:

1. All partners are liable for the firm's debt;
2. Death or withdrawal of any single partner means the end of the partnership;
3. If the partnership agreement provides for alternatives (e.g. buyout) partners can avoid liquidation.

When the partnership has got two kinds of owners, general partners and limited partners, the partnership is called a *limited partnership*. The general partners have the same rights and privileges as partners in any general partnership (personal liability). The liability of limited partners is limited to their investment, they have *limited liability.* Their private property is safe. The death or withdrawal of a limited partner does not mean the end of the partnership, and the interest of a limited partner is transferable. Limited partners have no management authority.

3. Limited liability companies

A *limited liability company or corporation* (LLC) is a limited partnership without a general partner. The owners' liability is limited to their investment in shares. All the owners have limited liability, but they can run the business. There are two types of limited liability companies: private companies and public companies.

4. Corporations

A *corporation* is a legally defined, artificial being (a legal entity), separate from its owners. A corporation is solely responsible for its own obligations, this means: the owners of a corporation are not liable for any obligations the corporation enters into. The corporation is the most important type of firm.

Setting up a corporation is more costly, because a corporation must be legally formed. The number of owners is unlimited. The entire ownership stake or equity of a corporation is the *stock*, which is divided into shares. The *equity* is the collection of all outstanding shares of a corporation.

An owner of a share of stock is called a *shareholder, stockholder or equity holder.* Shareholders receive *dividend payments*: payments made at the discretion of the corporation to its equity holders. There is no limitation on who can own the stock. This is a unique feature of a corporation and this characteristic allows free trade in shares. Because corporations can sell ownership shares to anonymous outside investors, corporations can raise great amounts of capital.

An important difference among the types of corporate organizational forms is the way they are taxed. A corporation pays a tax on its profits. When the remaining profits are distributed to the shareholders, the shareholders pay their own personal tax over this income. In this way there is double taxation.

An alternative system to use is the imputation system:
S corporations: Corporations that elect subchapter S tax treatment and are allowed an exception from double taxation. Only the shareholders have to pay income taxes.
C corporations: Corporations that have no restrictions on who owns their shares or the number of shareholders; therefore, they cannot qualify for subchapter S treatment and are subject to direct taxation.

Table 1.1 (page 9) shows a brief overview of the characteristics of the different types of firms explained.

Financial Manager

The financial manager of a corporation makes the financial decisions of the business for the stockholders. He has got three tasks:

1. Making investment decisions: The financial manager must weigh the costs and benefits of all the investments/projects and decide which of them qualify as good use of the money stockholders have invested in the firm. It is the most important task of a financial manager.

2. Making finance decisions: The financial manager has to decide how to pay for an investment. Large investments may require raising additional money. Then the manager must decide whether to borrow the money or to raise money from new and existing owners by selling more shares.

3. Managing cash flow from operations activities: The financial manager must ensure that the firm has enough cash on hand to meet its obligations. This is also called managing working capital. It may seem straightforward but it can mean the difference between success and failure especially in young, growing firms.

The overall goal of the financial manager is to maximize the wealth of the owners; the shareholders (maximize the stock price). The financial manager is a caretaker of the stockholders' money, making decisions in their interests.

The financial manager's place in the corporation

The ownership and control of a corporation are separate. The shareholders exercise their control by electing the board of directors. *The board of directors* is defined as a group of people elected by shareholders who have the ultimate decision-making authority in the corporation. This board of directors makes the rules, sets the policy and monitors the performance. The board delegates tasks to its management.

The *chief executive officer (CEO*) is the person charged with running the corporation by instituting the rules and policies set by the board of directors.

Agency problems

Because of the separation of ownership and control in a corporation, the *agency problem* may occur. There is an agency problem when managers, despite being hired as the agents of shareholders, put their own self-interest ahead of the interests of those shareholders. There is a conflict of interests; the self-interest of managers against the interest of the shareholders. A given solution for this problem is providing bonuses to managers, thus the compensation is connected to the performance. But, by tying compensation too closely to performance, the shareholders might be asking managers to take on more risk.

Shareholders can also encourage managers to work in their interest, by disciplining them if they do not. The shareholders have the possibility to pressure the board to oust the CEO if they are unhappy with his performance.

However, more common is to sell your shares when you're unhappy. If enough shareholders are dissatisfied, the price of shares will fall because this is the only way to entice investors to buy. When investors see a well-managed corporation, the stock price will rise because investors want to purchase them. Therefore, the stock price is a barometer for corporate leaders that continuously gives them feedback on the opinion of the shareholders of their performance.

In corporations in which the CEO is doing a poor job, the expectation of continued poor performance will cause the stock price to be low. This creates a profit opportunity. In a *hostile takeover,* an individual or organization, sometimes known as corporate rider, can purchase a large fraction of the equity and acquire enough votes to replace the board of directors and the CEO.

The stock market

Corporations can be private or public. A private corporation has got a limited numbers of owners and there isn't an organized market for its shares. A public corporation has got many owners and its shares trade on an organized market: the stock market (or stock exchange or bourse). The stock market is defined as an organized market on which the shares of many corporations are traded. The market price of shares is determined on this market. These markets provide liquidity for a company's shares. An investment that can easily be turned into cash because it can be sold immediately at a competitive market price is called *liquid.*

There is a difference between primary markets and secondary markets.

- The trade in shares starts at the *primary market,* when a corporation issues new shares of stock and sells them to investors.
- *Secondary markets* are markets where shares of a corporation are traded between investors without the involvement of the corporation (NYSE, NASDAQ).

A secondary market can be a physical market or an electronic market. The NYSE is an example of a physical market. In this kind of market, the *market makers* match the buyers with the sellers. They post two prices for every stock they make a market in: the bid price and the ask price. The *bid price* is the price at which a market maker or specialist is willing to buy a security. The *ask price* is the price at which a market maker is willing to sell a security.

Ask prices exceed the bid prices, this difference is called the bid-ask spread. The *bid-ask spread* is a transaction cost the investors have to pay in order to trade.

The NASDAQ is an example of an electronic stock market. These markets are called *over-the-counter (OTC) markets*. This are markets without a physical location and it is a collection of dealers connected by a network of computers and telephones. On NASDAQ, stocks can have multiple market makers. These market makers compete with each other.

Each exchange has its own *listing standards;* outlines of the requirements a company must meet to be traded on the exchange. These standards usually require a certain amount of shares outstanding a company must have.

Financial Institutions

Since the financial crisis of 2008 people pay more attention to financial institutions and their role in the economy. *Financial institutions* are entities that provide financial services, such as taking deposits, managing investments, brokering financial transactions or making loans. The role of financial institutions is to move funds from those who have extra funds (savers) to those who need funds (borrowers and firms). They also move funds through time.

The major categories of financial institutions are:

- Banks and credit unions
- Insurance companies
- Mutual funds
- Pension funds
- Hedge funds
- Venture capital funds
- Private equity funds