Chapter 1

Introduction to Corporate Finance

Acknowledgement

- This work is reproduced, based on the book [Ross, Westerfield, Jaffe and Jordan “Core Principles and Applications of Corporate Finance”].
- This work can be used in the financial management course with the original text book.
- This work uses the figures and tables from the original text book.

Chapter Outline

1.1 What is Corporate Finance?

1.2 The Corporate Firm

1.3 The Goal of Financial Management

1.4 The Agency Problem and Control of the Corporation

1.5 Financial Markets

1.1 What is Corporate Finance?

Corporate Finance addresses the following three questions:

1. What long-term investments should the firm choose?(Capital budgeting): long-term investment opportunity
2. How should the firm raise funds for the selected investments?(Capital structure): Financing, raise fund, debt and equity.
3. How should short-term assets be managed and financed?(Working Capital management): Daily operating activities, transaction.

Figure 1.1
The Balance Sheet Model of the Firm

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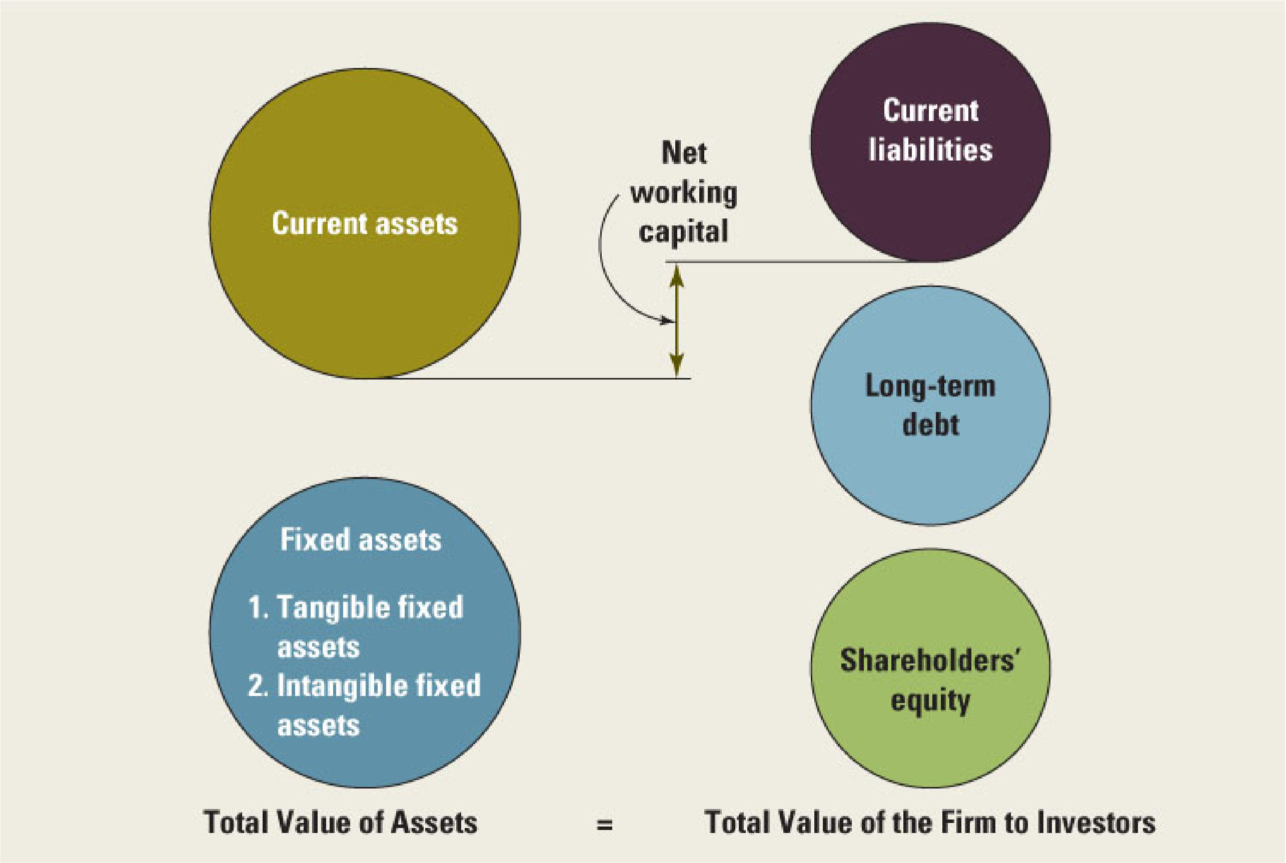
The Balance Sheet Model of the Firm



Cited by the text book (p. 36)

The Capital Budgeting Decision

Current Assets

Fixed Assets

1 Tangible

2 Intangible

- What long-term investments should the firm choose?
- Long term investment
- Decision to invest in tangible or intangible assets

Current Liabilities

Long-Term Debt

Shareholders' Equity

The Capital Structure Decision

Current Assets

Fixed Assets

1 Tangible

2 Intangible

How should the firm raise funds for the selected investments? Current Liabilities, Long-term Debt and Equity

Current Liabilities

Long-Term Debt

Shareholders' Equity

Short-Term Asset Management

Current Assets

Short-term cash flow problems

Current Liabilities

Net Working Capital

Long-Term Debt

Fixed Assets

1 Tangible

2 Intangible

How should short-term assets be managed and financed?

Short-term activitites

Shareholders' Equity

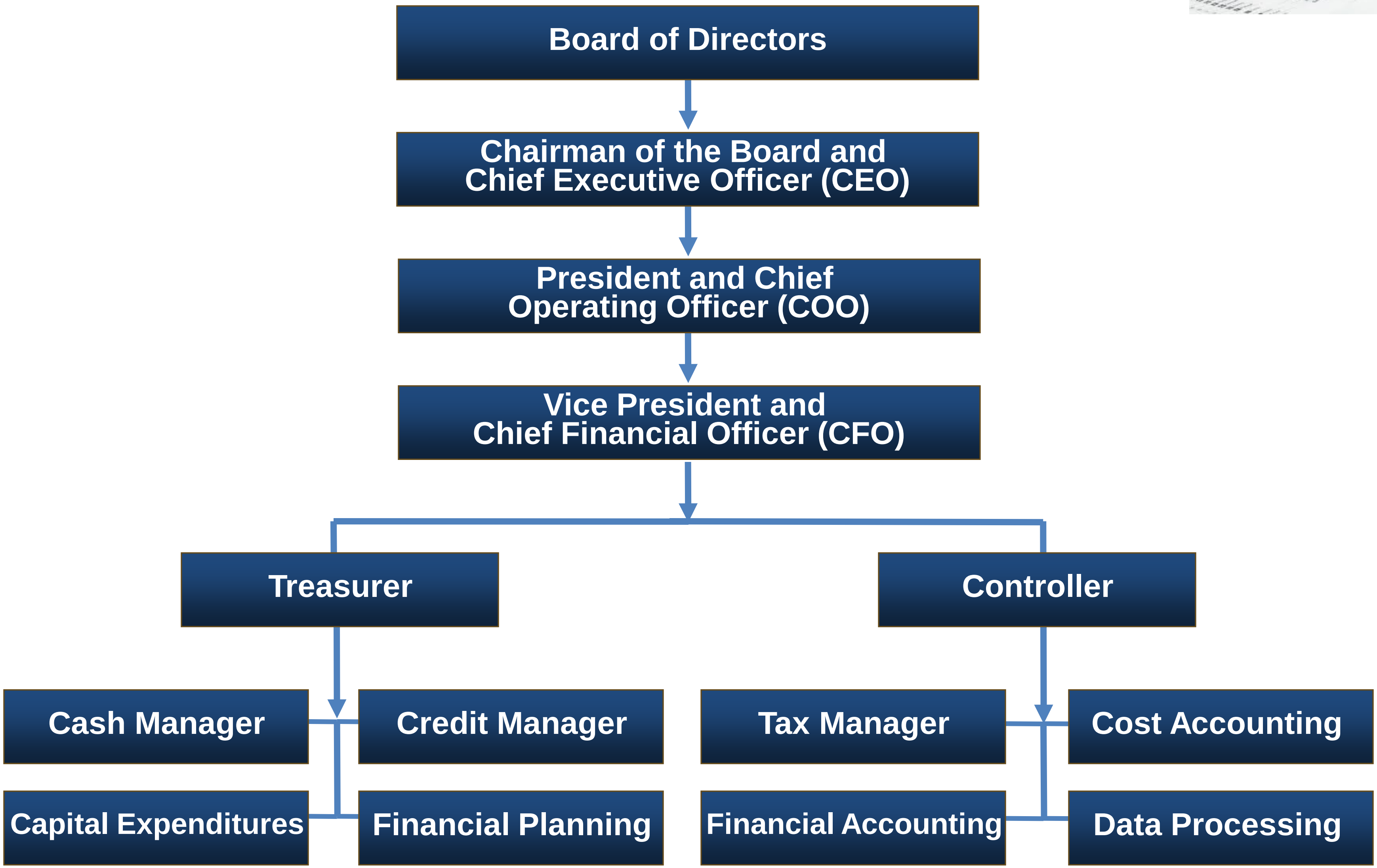
The Role of Financial Manager

The Financial Manager's primary goal is to increase the value of the firm by:

1. Make investment decisions
2. Make financing decisions
3. Manage cash flow from operating activities

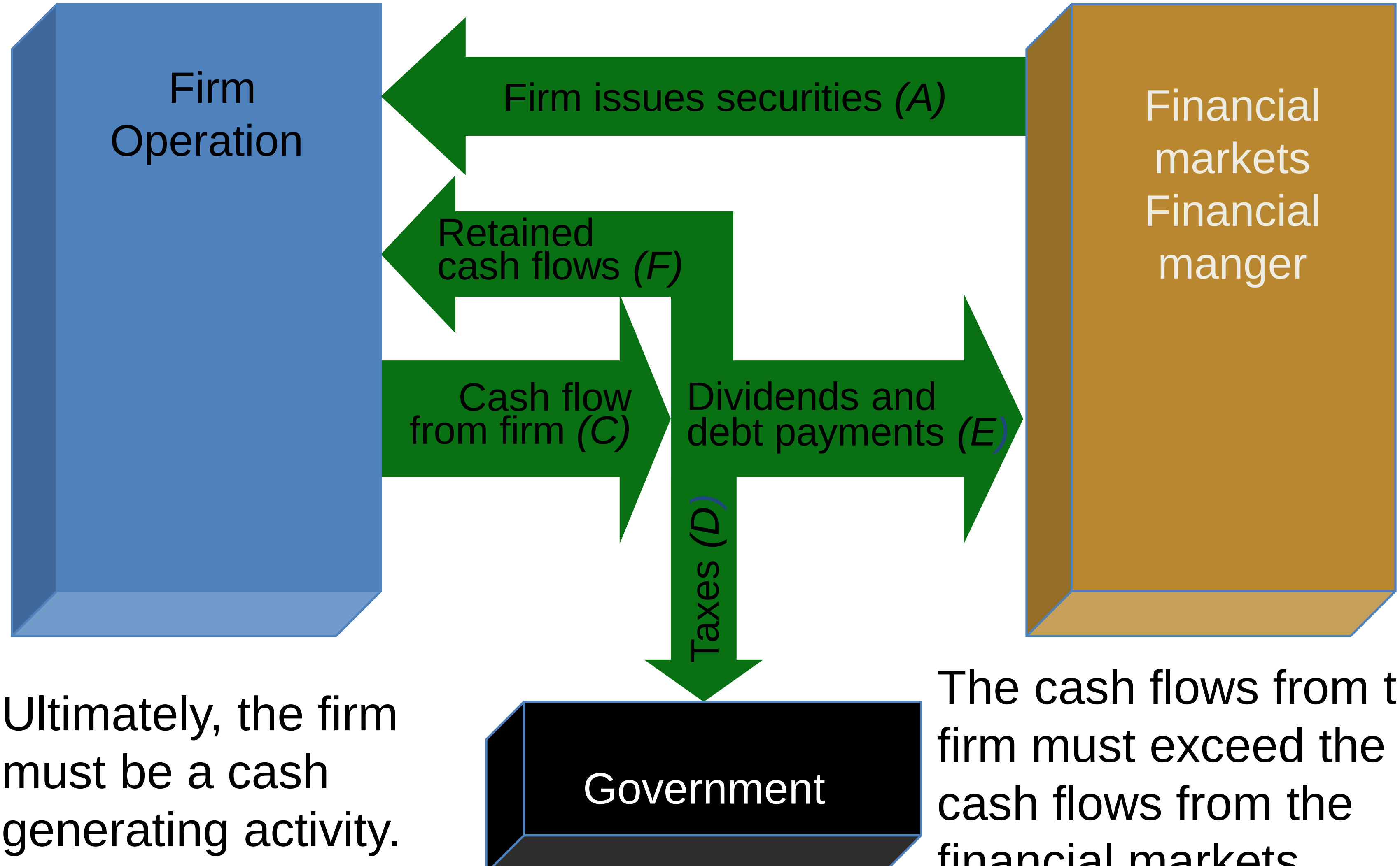
The financial manager must decide whether to raise more money from new and existing owners by *selling more shares* of stock (equity) or to *borrow* the money instead (debt).

Hypothetical Organization Chart



Cited by the text book (p. 37)

The Firm and the Financial Markets



Ultimately, the firm must be a cash generating activity.

The cash flows from the firm must exceed the cash flows from the financial markets.

Cited by the text book (p. 42)

1.2 The Corporate Firm

- The corporate form of business is the standard method for solving the problems encountered in raising large amounts of cash.
- However, businesses can take other forms.

Forms of Business Organization

- The Sole Proprietorship(자영업)
  - Sole proprietorships are straightforward to set up. Consequently, many new businesses use this organizational form.
  - Owned by one person: individual business
  - Unlimited liability : The principal limitation is that there is no separation between the firm and the owner

Forms of Business Organization

- The Partnership: Any two or more people can get together
- A limited partnership is a partnership with two kinds of owners, general partners and limited partners
  - General Partnership (합명회사)
  - Have the same rights and privileges as partners in any general partnership
  - Are personally liable for the firm’s debt obligations
  - Limited Partnership (합자회사)
  - Have limited liability and their ownership interest is transferable
  - They have no management authority

Forms of Business Organization

- The Corporation (주식회사)
  - A distinct legal entity composed of one or more owners separate of ownership and management
  - Limits the owners' liability to their investment in shares
  - The owners cannot be held personally liable for the firm's debts
  - Companies may be private limited companies or public limited companies
  - A corporation (or company) is a legally defined, artificial being, separate from its owners.
  - It has many of the legal powers that people have.
  - The corporation is not liable for any personal obligations of its owners

1.3 The Goal of Financial Management

- What is the correct goal?
  – Maximize profit?
  – Minimize costs?
  – Maximize market share?
  – **Maximize shareholder wealth?**

The goal of financial management is to maximize the current value per share of the existing stock (p. 45)

1.4 The Agency Problem

- Agency relationship
  - Principal hires an agent to represent his/her interest
  - Stockholders (principals) hire managers (agents) to run the company
- Agency problem (대리인 문제)
  - Managers, acting as agents for stockholders, may act in their own interests rather than maximizing value..
  - Conflict of interest between principal and agent
  - This topic is related with an ethics discussion.

Managerial Goals

- Agency Problem and Corporate Governance Solutions
  - Legal and Regulatory Requirements
  - Compensation plans: stock option
  - Board of Directors
  - Monitoring
  - Takeovers: Proxy fight

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 intended goal;
  - Stock option: The idea is that if management has an ownership interest in the firm, they will be more likely to try to maximize owner wealth.
- Corporate control
  - The threat of a takeover may result in better management
- Other stakeholders
  - Creditors, employees, customers, and the government.

1.5 Financial Markets

- Primary Market
  - When a corporation issues new shares of stock and sells them to investors.
  - Issuance of a security for the first time, Initial Public Offering(IPO)
- Secondary Markets
  - Organized Markets on which the shares of many corporations are traded
  - Buying and selling of previously issued securities
  - Securities may be traded in either a dealer or auction market
    - NYSE
    - NASDAQ
    - KOSPI

References

- Ross, Westerfield, Jaffe and Jordan, Core Principles and Application of Corporate Finance, 3ed, McGraw Hill.
- Jordan, Miller, and Dolvin, Fundamentals of Investments, 6ed, MacGraw Hill.
- Berk, DeMarzo and Harford, Fundamentals of Corporate Fiance, 2nd ed, Pearson.