

Chapter 1 overview of financial management and environment



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CHAPTER 1 Overview of Financial Management & Environment 1-1 Overview of Financial Management Role of financial management Forms of business organization Goals of the corporation Agency relationships 1-2 All Successful Firms Accomplish 2 Goals They identify, create, & deliver products or services that are highly valued This happens only if the firm provides more value than its competitors (in the form of either lower prices or better products)

They sell at prices high enough to cover costs and to compensate owners and creditors for their exposure to risk The profit must be high enough to adequately 1-3 compensate investors 3 Key Attributes for Success 1. 2. Skilled People at all levels Leaders, managers and work force Strong Relationships with groups outside the company Successful companies develop win-win relationships with suppliers, who then deliver high-quality materials on time and at a reasonable cost 3. Enough Capital to execute their plans & support operations 1-4 Key Attributes for Success 3. Enough Capital to execute their plans & support operations Most companies need cash to purchase land, buildings, equipment, and materials Companies can reinvest a portion of their earnings, but most must also raise additional funds externally, by some combination of selling stock and/or borrowing in the financial markets 1-5 3 questions Financial Management must answer What causes a company to have a particular stock value? How can managers make choices that add value to their companies?

How can managers ensure that their companies don't run out of cash while executing their plans? 1-6 5 Primary Activities of Financial Management Cash Management Minimize Cost of Capital Strategic Investment (Capital

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Budgeting) Allocation of Income (Dividends vs. Retained Earnings) Risk Management 1-7 Alternative Forms of Business Organization Sole proprietorship Partnership Corporation 1-8 Factors to consider Ease of formation Taxation Liability of owners Life of enterprise Ease/difficulty of raising capital Transfer of ownership 1-9 Sole Proprietorship

Unincorporated business owned by one individual (1 owner) Advantages: Easily and inexpensively formed Subject to few regulations Its income is not subject to corporate taxation but it is taxed only as a part of the proprietor's income 1-10 Sole Proprietorship Disadvantages: Difficult to raise capital It is difficult for a single owner to obtain the capital needed for growth Unlimited liability The proprietor has unlimited personal liability for the business's debts Limited life The life of a proprietorship is limited to the life of its founder Used primarily for small businesses -11 Partnership More than 1 owner Exists whenever two or more persons associate to conduct a business for profit Partnership agreements Formal or informal Define the ways any profits and losses are shared between partners 1-12 Partnership Major advantage Its low cost and ease of formation Partnership's income is not subject to corporate taxation but is taxed only as a part of the partner's personal income 1-13 Partnership Disadvantages Unlimited liability Limited life of the organization Difficulty transferring ownership Difficulty raising large amounts of capital

Regarding liability The partners can potentially lose all of their personal assets, even assets not invested in the business Under partnership law, each partner is liable for 1-14 the business's debts Partnership It is possible to limit the liabilities of some of the partners by establishing a limited
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partnership Certain partners are designated general partners and others limited partners Limited partners are liable only for the amount of their investment in the partnership Limited partners typically have no control General partners have unlimited liability 1-15 Partnership

In both regular and limited partnership, at least one partner is liable for the debts of the partnership In a limited liability partnership (LLP), or limited liability company (LLC) All partners enjoy limited liability with regard to the business's liabilities Their potential losses are limited to their investment This increase the risk faced by an LLP's lender, customers, and suppliers 1-16 Corporation Many owners Legal entity created by a state, and it is separate and distinct from its owners and managers 1-17 Corporation Advantages: Unlimited life A corporation can continue after its original owners and managers are deceased

Easy transfer of ownership Ownership interests can be divided into shares of stock, which can be transferred easily Limited liability Losses are limited to the actual funds invested Ease of raising capital 1-18 Corporation Disadvantages: Corporate earnings may be subject to double taxation The earnings of the corporation are taxed at the corporate level, and then earnings paid out as dividends are taxed again as income to the stock holders Cost of set-up and report filing Setting up a corporation involves preparing a charter, writing a set of bylaws and filling the many required reports 1-19 Corporation

Charter: Establishing Separate Legal Entity Name Activities Amount of Capital Stock Number of Directors Names & Addresses of Directors Bylaws:

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Rules for conduct of Activities How Directors will be elected Preemptive Right to new stock issues Procedures for changing Bylaws, if required 1-20 Goals of the Corporation The primary goal is shareholder wealth maximization, which translates to maximizing stock price 1-21 Factors that affect stock price Projected cash flows to shareholders Timing of the cash flow stream Riskiness of the cash flows 1-22 Three Determinants of Cash Flows 1. Sales revenues depend on the

Current level of unit sales Price per unit Short-term growth rate in sales Long-term sustainable growth rate in sales 2. 3. Operating costs and taxes Required investments in operations 1-23 Operating costs and taxes The second determinant of cash flows The combined impact of operating costs and taxes which Determines the amount of after-tax profit that is available to investors after the company pays its employees and suppliers 1-24 Required investments in operations The third factor affecting cash flows Amount of money a company must invest in its operations including assets such as factories, equipment, computer systems, inventory -25 Factors that Affect the Level & Risk of Cash Flows Decisions made by financial managers: Investment decisions product lines, production processes, geographic market, use of technology, marketing strategy Financing decisions choice of debt policy and dividend policy The firm's capital structure and the risk of its operations determine the total risk of the cash flows This risk is combined with the level of interest rates in the economy and investors' overall attitude toward risk, resulting in the rate of return that investors require 1-26

Agency Relationships An agency relationship exists whenever a principal hires an agent to act on his or her behalf Within a corporation, agency <https://assignbuster.com/chapter-1-overview-of-financial-management-environment/>

relationships exist between: Shareholders and managers Shareholders and creditors 1-27 Shareholders versus Managers Managers are naturally inclined to act in their own best interests But the following factors affect managerial behavior: Managerial compensation plans Direct intervention by shareholders The threat of firing The threat of takeover 1-28 Shareholders versus Creditors

Shareholders (through managers) could take actions to maximize stock price that are detrimental to creditors In the long run, such actions will raise the cost of debt and ultimately lower stock price 1-29 The Financial Environment: Markets, Institutions, and Interest Rates Financial markets Types of financial institutions Determinants of interest rates Yield curves 1-30 What is a market? A market is a venue where goods and services are exchanged A financial market is a place where individuals and organizations wanting to borrow funds are brought together with those having a surplus of funds 1-31

Types of financial markets Physical assets vs. Financial assets Money vs. Capital Primary vs. Secondary Spot vs. Futures Public vs. Private 1-32 Physical assets vs. Financial assets Physical asset markets Called "tangible" or "real" asset markets, Those for such products as wheat, computers and real estate Financial asset markets Deal with stocks, bonds, notes, mortgages, and other claims on real assets Futures and options (derivatives) 1-33 Money vs. Capital Money markets The markets for short-term (less than one year), highly liquid debt securities The New York and London money markets world's largest

Capital markets The markets for intermediate (one to five years) or long-term (more than five years) debt and corporate stocks New York Stock Exchange 1-34 Primary vs. Secondary Primary markets The markets in which corporations raise new capital Example - if Microsoft were to sell a new issue of common stock to raise capital, this would be a primary market transaction Secondary markets Markets in which existing, already outstanding, securities are traded among investors Exist for stocks, bonds, mortgages and other financial assets 1-35 Spot vs. Futures

Spot markets and futures markets are terms that refer to whether the assets are being bought or sold for "on-the-spot" delivery (within a few days) or for delivery at some future date (six months or a year into the future) 1-36

Public vs. Private Public markets Where standardized contracts are traded on organized exchanges Public market securities are more liquid Private markets Where transactions are worked out directly between two parties Examples of private market transactions Bank loans and private placements of debt with insurance companies 1-37

How is capital transferred between savers and borrowers? Direct transfers Indirect transfers through Investment Bankers (Investment banking house) Indirect transfers through Financial Intermediation 1-38 Types of financial intermediaries Commercial banks Savings and loan associations Mutual savings banks Credit unions Pension funds Life insurance companies Mutual funds 1-39 Secondary market can be A physical location exchange (NYSE, AMEX, CBOT) Computer/telephone network (Nasdaq) 1-40 The way orders from sellers and buyers are matched

Auction system Where traders actually meet in a pit and sellers and buyers communicate with one another through shouts and hand signals (CBOT)

Dealer market Electronic communications network 1-41 Dealer market There are "market makers" who keep an inventory of the stock Dealers list bid and ask quotes (the prices at which they are willing to buy or sell) Computerized quotation system keep track of all bid and ask prices Traders must contact a specific dealer to complete transaction 1-42 Electronic communications network (ECN)

Participants in an ECN post their orders to buy and sell, and the ECN automatically matches orders The two largest ECNs for trading U. S. stocks are Instinet (owned by Reuters) and Island 1-43 Interest Rates The cost of money The price, or cost, of debt capital? The interest rate The price, or cost, of equity capital? The required return on equity The required return investors expect is composed of compensation in the form of dividends and capital gains 1-44 What four factors affect the cost of money? Production opportunities Time preferences for consumption Risk Expected inflation -45 Production opportunities The ability to turn capital into benefits Time preferences for consumption Providers can use their funds for consumption or savings By saving, they give up consumption now in the expectation of having more consumption in the future 1-46 Risk If an investment is risky, then providers require a higher expected return to induce them to take the extra risk Inflation Also leads to higher interest rates 1-47 "Nominal" vs. "Real" rates r = represents any nominal rate r^* = ("r-star") represents the "real" risk-free rate of interest.

It is the rate that would exist on a riskless security if there was no inflation.

Typically ranges from 1% to 4% per year (USA) r_{RF} = it is the quoted

(nominal) risk-free rate of interest on a security such as a U. S. Treasury bill

r_{RF} includes the premium for expected inflation $r_{RF} = r^* + IP$ 1-48

Determinants of interest rates $r = r^* + IP + DRP + LP + MRP$ $r = r^* = IP =$

$DRP = LP = MRP =$ required return on a debt security real risk-free rate of

interest inflation premium default risk premium liquidity premium maturity

risk premium 1-49 $r = r^* + IP + DRP + LP + MRP$ $DRP =$ default risk premium

this premium reflects the possibility that the issuer will not pay interest or

principal) $LP =$ liquidity premium (this is a premium charged by lenders to

reflect the fact that some securities cannot be converted to cash on short

notice at a "reasonable" price) $MRP =$ maturity risk premium (long-term

bonds are exposed to a significant risk of price declines, and a maturity risk

premium is charged by lenders to reflect this 1-50 risk) Premiums added to

r^* for different types of debt IP S-T Treasury L-T Treasury S-T Corporate L-T

Corporate 1-51 MRP DRP LP Yield curve and the term structure of interest

rates

Term structure - relationship between interest rates (or yields) and

maturities The yield curve is a graph of the term structure A Treasury yield

curve from October 2002 can be viewed at the right 1-52 What is the

relationship between the Treasury yield curve and the yield curves for

corporate issues? Corporate yield curves are higher than that of Treasury

securities. However, corporate yield curves are not necessarily parallel to the

Treasury curve The spread between corporate and Treasury yield curves

widens as the corporate bond rating decreases (risk increases) 1-53

Illustrating the relationship between corporate and Treasury yield curves

Interest Rate (%) 15 BB-Rated 10 AAA-Rated 5.9% Treasury 6.0% Yield

Curve Years to Maturity 0 1 5 10 15 20 1-54 5 5.2% 0 Pure Expectations

Hypothesis The PEH contends that the shape of the yield curve depends on investor's expectations about future interest rates. If interest rates are expected to increase, L-T rates will be higher than S-T rates, and vice-versa the yield curve can slope up, down, or even bow. 1-55 Assumptions of the PEH

Assumes that the maturity risk premium for Treasury securities is zero

(MRP = 0) Long-term rates are an average of current and future short-term

rates. If PEH is correct, you can use the yield curve to "back out" expected

future interest rates. 1-56 An example: Observed Treasury rates and the PEH

Maturity 1 year 2 years 3 years 4 years 5 years Yield 6.0% 6.2% 6.4% 6.

5% 6.5% If PEH holds, what does the market expect will be the interest rate

on one-year securities, one year from now? Three-year securities, two years

from now? 1-57 One-year forward rate $6.2\% = (6.0\% + x\%) / 2$ $12.4\% = 6.$

$0\% + x\%$ $6.4\% = x\%$ PEH says that one-year securities will yield 6.4%, one

year from now. 1-58 Three-year security, two years from now $6.5\% = [2(6.$

$2\%) + 3(x\%) / 5$ $32.5\% = 12.4\% + 3(x\%)$ $6.7\% = x\%$ PEH says that three-

year securities will yield 6.7%, two years from now. 1-59 Conclusions about

PEH Some would argue that the MRP $\neq 0$, and hence the PEH is incorrect

Most evidence supports the general view that lenders prefer S-T securities,

and view L-T securities as riskier. Thus, investors demand a MRP to get them

to hold L-T securities (i. e. , MRP > 0) 1-60