



An Introduction to Corporate Finance



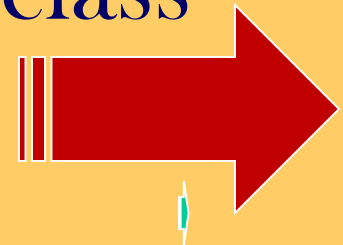
Ram Kumar Kakani
XLRI Jamshedpur

→ Please note that all slides are compilations from various books and presentations (largely available on the web).

→ Pdf files of the same would be made available

→ The views expressed herein are personal.

→ It is only for the purpose of class discussion.



Financial Statements for Ram Software Limited		
Statement of Cash Flows (for the year ended March 31)		
Cash Flows from Operating Activities		
cash received from customers	12000	
cash paid to supplies and employees	-7200	
Net cash provided by operating employees		4800
Cash Flows from Investing Activities		
purchase of office equipment	-58000	
Net cash used in investing activities		-58000
Cash Flows from Financing Activities		
Capital invested by owner	50000	
withdrawal by owner	-3500	
loan	20000	
Net cash provided by financing activities		66500
Net increase in cash		13300
Beginning balance		0
Ending balance		13300

Financial Statements for Ram Software Limited		
Profit and Loss Account (for the year ended March 31)		
Revenues		
Sales of Software		20000
Expenses		
Rent	1200	
Salaries	4000	
Total Expenses		5200
Net Profit		14800

Ram Software Limited
Statement of Retained Earnings
Year Ended March 31, 2003

Retained earnings, March 1, 2002	Rs. 0
Add: Net income for the year	<u>14,800</u>
	Rs. 14,800
Less: Dividends	<u>(3,500)</u>
Retained Earnings, March 31, 2003	<u><u>Rs. 11,300</u></u>

Ram Software Limited: Balance Sheet as on March 31

Assets		Liabilities & Owners Equity	
Cash	13300	Creditors	24000
Debtors	8000	Owner's Equity	
		Investment	50000
		add Profit	14800
		less Withdrawal	3500
Supplies	6000		
Office Equipment	58000		
	<u>85300</u>		<u>85300</u>

How Did Finance Get Here?

(<http://ssrn.com/abstract=905867>)

- Till 1800 AD: Industrial revolution and joint stock firms concept
- 1800-1900: ↑ size of business unit, ↑ capex level, & ↑ separation of ownership from management
- 1900-1950: ↑ Competition and Entry of Retail Investors
- 1950-2008: ↑ Research, ↑ Competition in Finance World, ↑ Technology/ Communication

How Did Finance Get Here?

(<http://ssrn.com/abstract=905867>)

- Till 1800 AD: Industrial revolution and joint stock firms concept led to
 - *Double Entry Accounting & Bookkeeping*
- 1800-1900: ↑ size of business unit, ↑ capex level, & ↑ separation of ownership from management meant introduction of
 - *Intermediaries, Stock and Commodity Exchanges*
 - *Financial Reporting Procedures, Management Accounting Systems*
 - *Debentures, Convertibles, & Preference Shares*

Historical Developments ...

<http://ssrn.com/abstract=905867>

- 1900-1950: ↑ Competition and Entry of Retail Investors led to
 - *Financial Analysis, Budgeting & Standard Costing*
 - *Common Stock Exchanges*
- 1950-2000: ↑ Research, ↑ Competition in Finance, ↑ Technology/Communication meant
 - *Theories – Random Walk, Portfolio, Market Efficiency, MM's Capital Structure and Dividend*
 - *Models – CAPM, Option Pricing*
 - *Derivatives, Swaps, ESOP, LBO, Securitization, EVA, ABC, SCM, MVA, Hedge Funds, ...*

Corporate Structure

Sole Proprietorships



Unlimited Liability
Personal tax on profits

Partnerships



Corporations



Limited Liability
Corporate tax on profits +
Personal tax on dividends

A Comparison

	Joint Stock Company	Partnership
Liquidity	Shares can be easily exchanged	Subject to substantial restrictions
Voting Rights	Usually each share gets one vote	General Partner is in charge; limited partners may have some voting rights
Taxation	Double	Partners pay taxes on distributions
Reinvestment and dividend payout	Broad latitude	All net cash flow is distributed to partners
Liability	Limited liability	General partners may have unlimited liability; limited partners enjoy limited liability
Continuity	Perpetual life	Limited life

What is Financial Management?

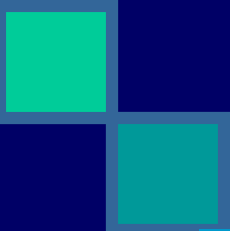

Concerns the acquisition, financing, and management of assets with some overall goals in mind

- Acquisition (includes Capex)
- Financing (includes Leverage)
- Management (includes WCM)



Investment Decisions

Most important of the
three decisions.

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- What is the optimal firm size?
 - What specific assets should be acquired?
 - What assets (if any) should be reduced or eliminated?
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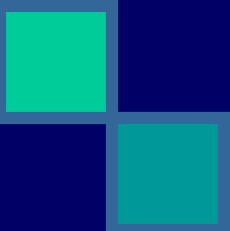

Financing Decisions

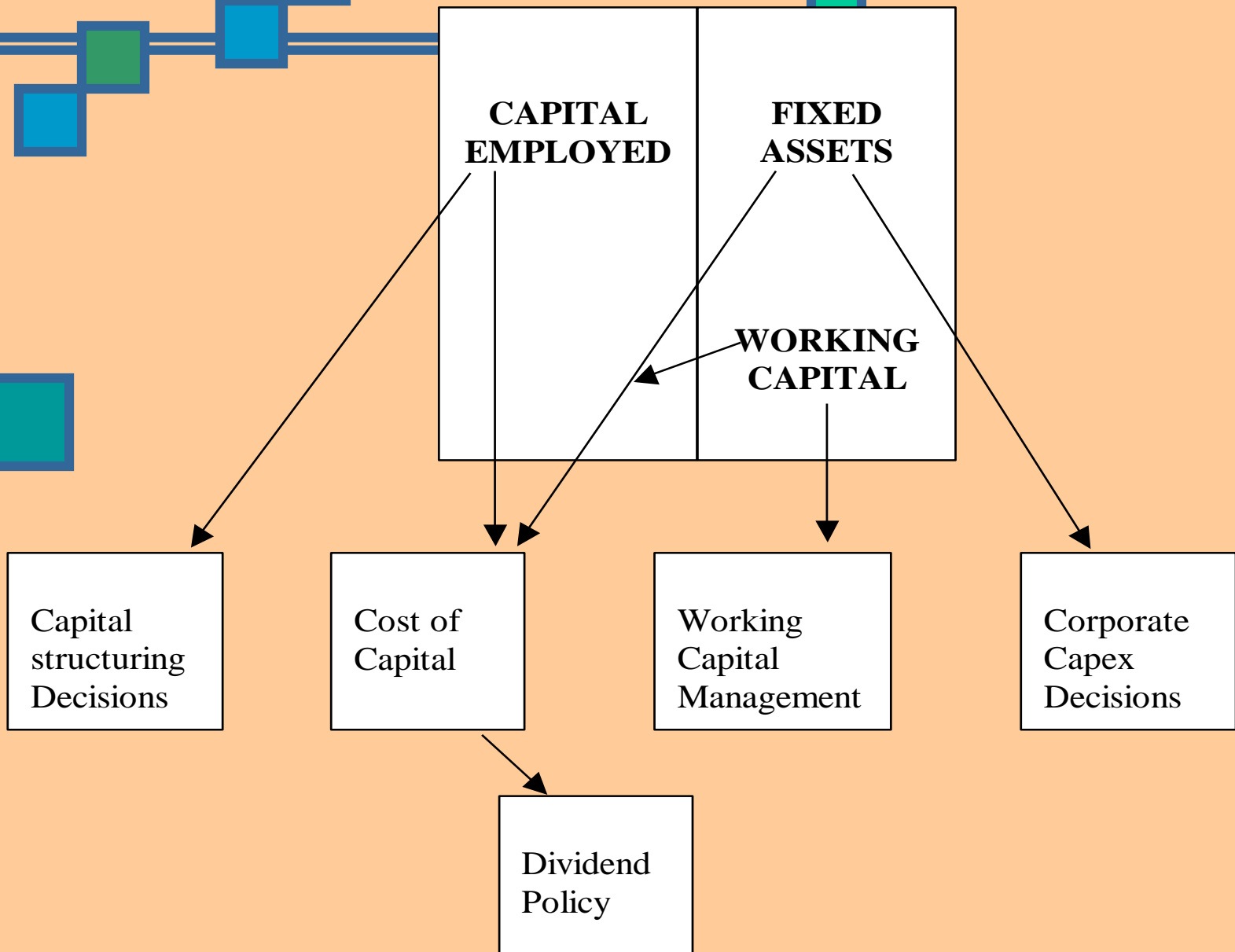
Determine how the assets (LHS of balance sheet) will be financed (RHS of balance sheet).

- What is the best type of financing?
- What is the best financing mix?
- What is the best dividend policy?
- How will the funds be physically acquired?



Asset Management Decisions

- How do we manage existing assets *efficiently*?
 - Financial Manager has varying degrees of operating responsibility over assets.
 - Greater emphasis on current asset management than fixed asset management.
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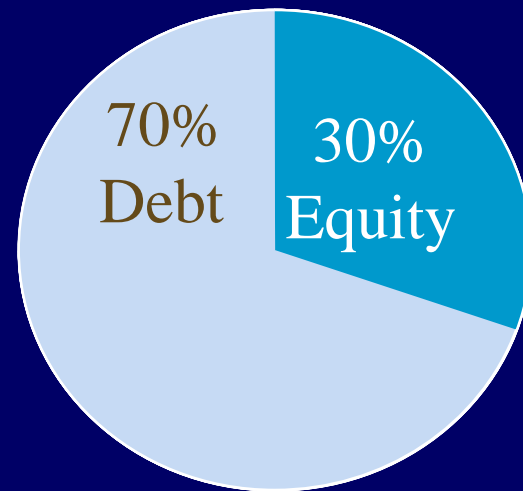
Capital Structure

The value of the firm can be thought of as a pie.

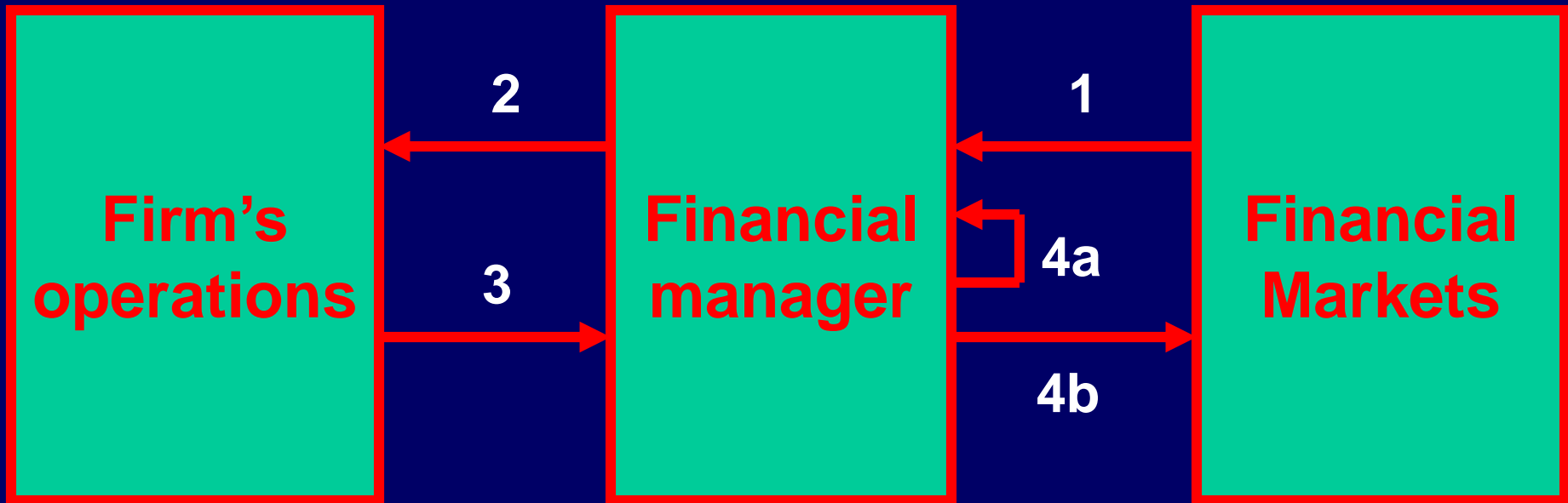
The goal of the manager is to increase the size of the pie.

The Capital Structure decision can be viewed as how best to slice the pie.

If how you slice the pie affects the size of the pie, then the capital structure decision matters.



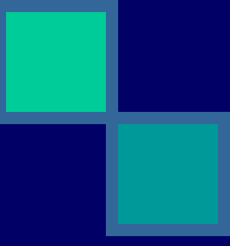
Role of the Financial Manager




1. Cash raised from investors
2. Cash invested in firm
3. Cash generated from operations
4. Cash reinvested
5. Cash returned to investors



What is the Goal of the Firm?



Maximization of Market Value (a.k.a. Shareholder Wealth)!



Value creation occurs when we maximize the share price for current shareholders.

Shortcomings of Alternative Perspectives

Profit Maximization

◆ Maximizing a firm's earnings after taxes.

Problems

- Could increase current profits while harming firm (e.g., defer maintenance, issue common shares to buy T-bills, manipulate figures, etc.).
- Ignores changes in the risk level of the firm.

Shortcomings of Alternative Perspectives

Earnings per Share Maximization

Maximizing earnings after taxes divided by shares outstanding.

Problems

- Does not specify timing or duration of expected returns.
- Ignores changes in the risk level of the firm.
- Calls for a zero payout dividend policy.

Strengths of Shareholder Wealth Maximization

- Takes account of: current and future profits and EPS; the timing, duration, and risk of profits and EPS; dividend policy; and all other relevant factors.
- Thus, share price serves as a barometer for business performance.

The Modern Corporation

Modern Corporation

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graph TD; A[Modern Corporation] --> B[Shareholders]; A --> C[Management];
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The diagram illustrates the structure of a modern corporation. At the top, a red box contains the text "Modern Corporation". Two black arrows point downwards from this box to two separate green boxes below. The left green box contains the text "Shareholders" and the right green box contains the text "Management". This visualizes the separation of ownership (shareholders) and management (management).

Shareholders

Management

There exists a SEPARATION between owners and managers.

Managerial Goals

- More than two-thirds of Indian economy is run by Business Groups.
- In such cases, managerial goals may be very different from shareholder goals
 - Expensive perquisites
 - Survival
 - Independence
- Increased growth and size are not necessarily equivalent to increased shareholder wealth


Role of Management

Management acts as an *agent* for the owners (shareholders) of the firm.

- An *agent* is an individual authorized by another person, called the principal, to act in the latter's behalf.




Agency Theory

- ◆ Jensen and Meckling developed a theory of the firm based on *agency aspects (a.k.a. contractual problems)*.
 - *Agency Theory* is a branch of economics relating to the behavior of principals and their agents.
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Agency Theory

- ◆ Principals must provide *incentives* so that management acts in the principals' best interests and then *monitor* results.
 - Incentives include **profit sharing**, **stock options**, **perquisites**, and **bonuses**.
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Ownership Vs Management

Differences in Information

- Stock prices and returns
- Issues of shares and other securities
- Dividends
- Financing

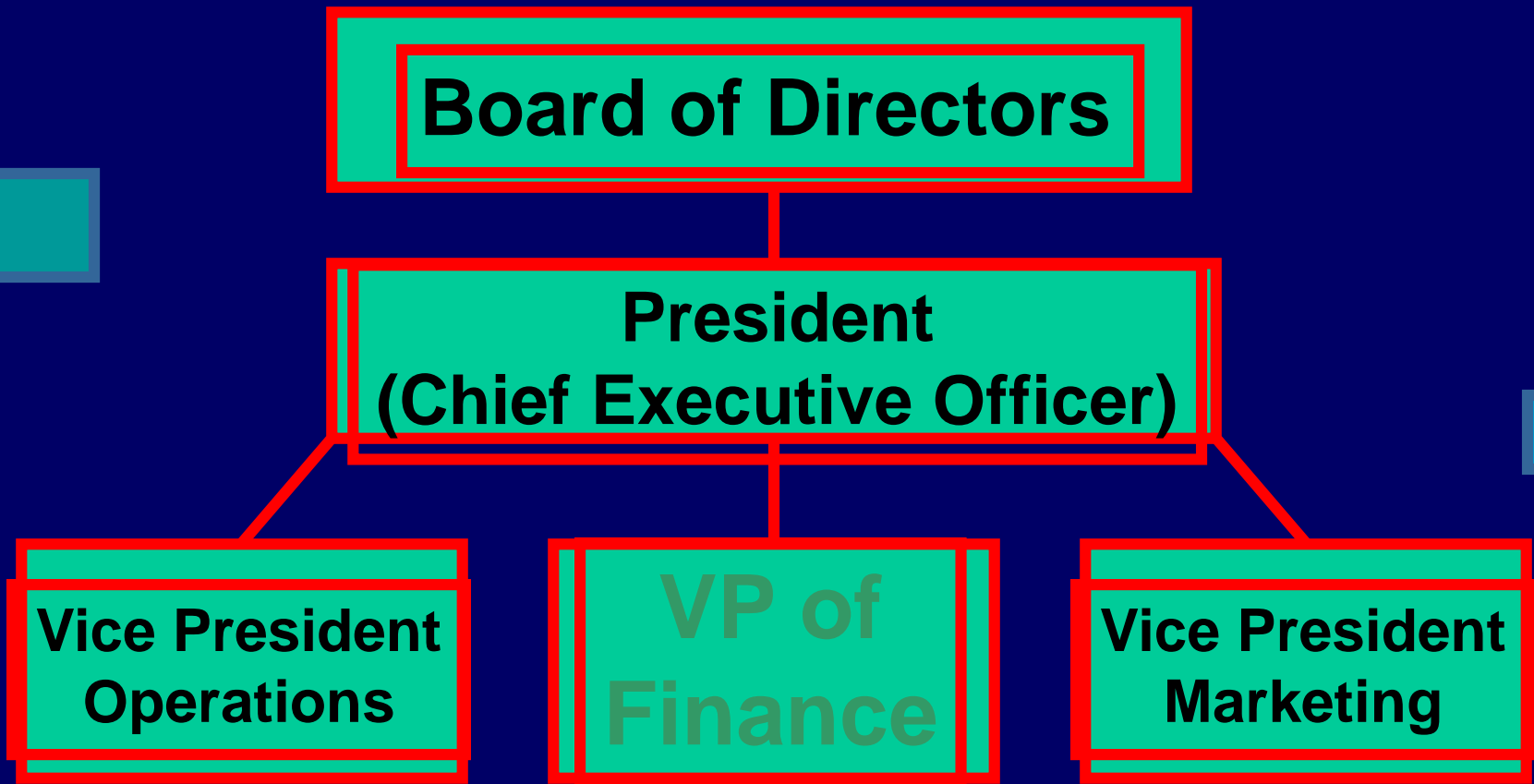
Different Objectives

- Management Vs stockholders
- Top management Vs operating management
- Stockholders Vs banks and lenders

Social Responsibility

- Wealth maximization does *not* preclude the firm from being socially responsible (??)
- Assume we view the firm as producing *both* private and social goods.
- Then shareholder wealth maximization remains the appropriate goal in governing the firm.
- There can be other opinions also ...

Organization of the Financial Management Function



Organization of the Financial Management Function

VP of Finance

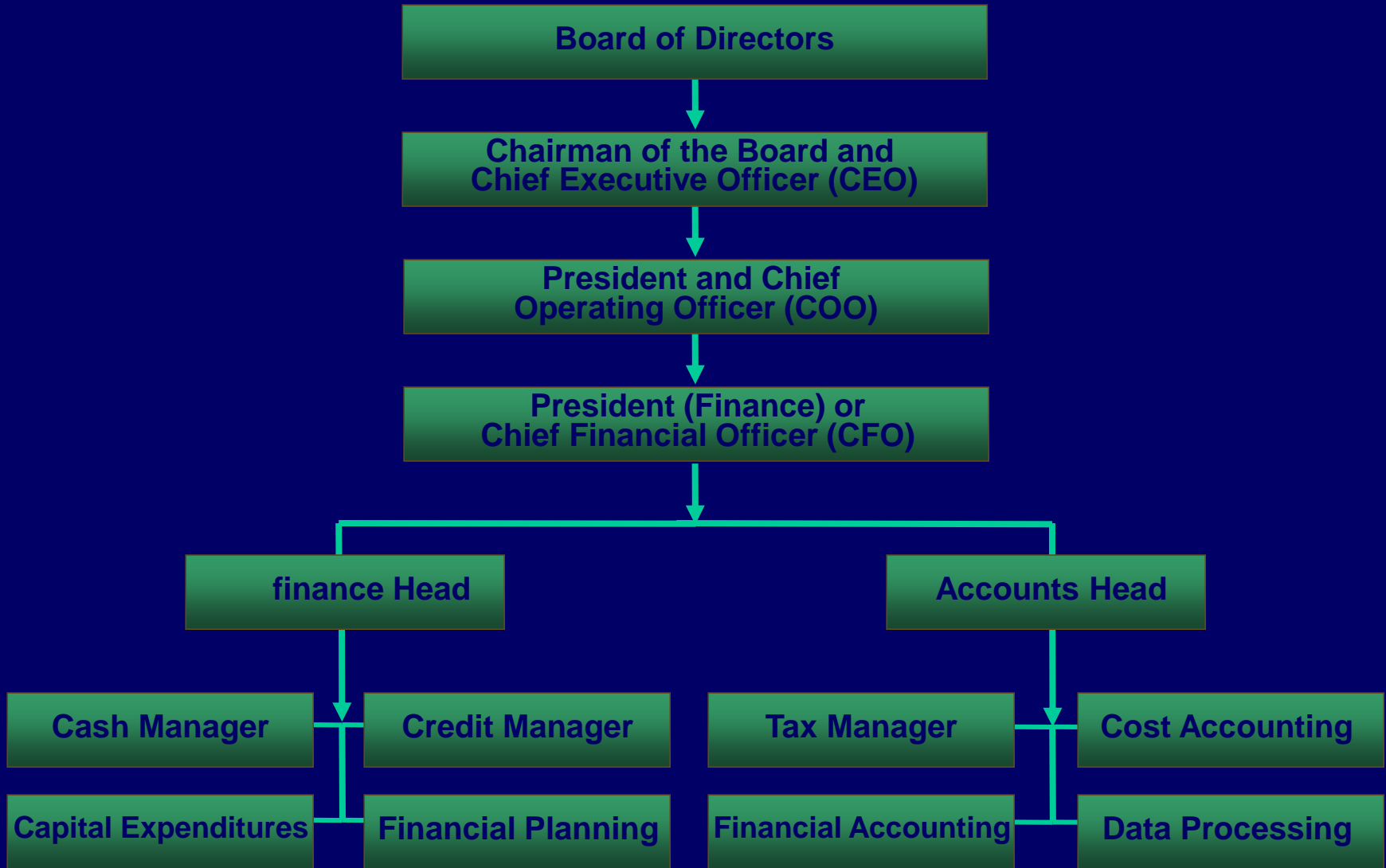
Treasurer

Capital Budgeting
Cash Management
Credit Management
Dividend Disbursement
Fin Analysis/Planning
Pension Management
Insurance/Risk Mgmt
Tax Analysis/Planning

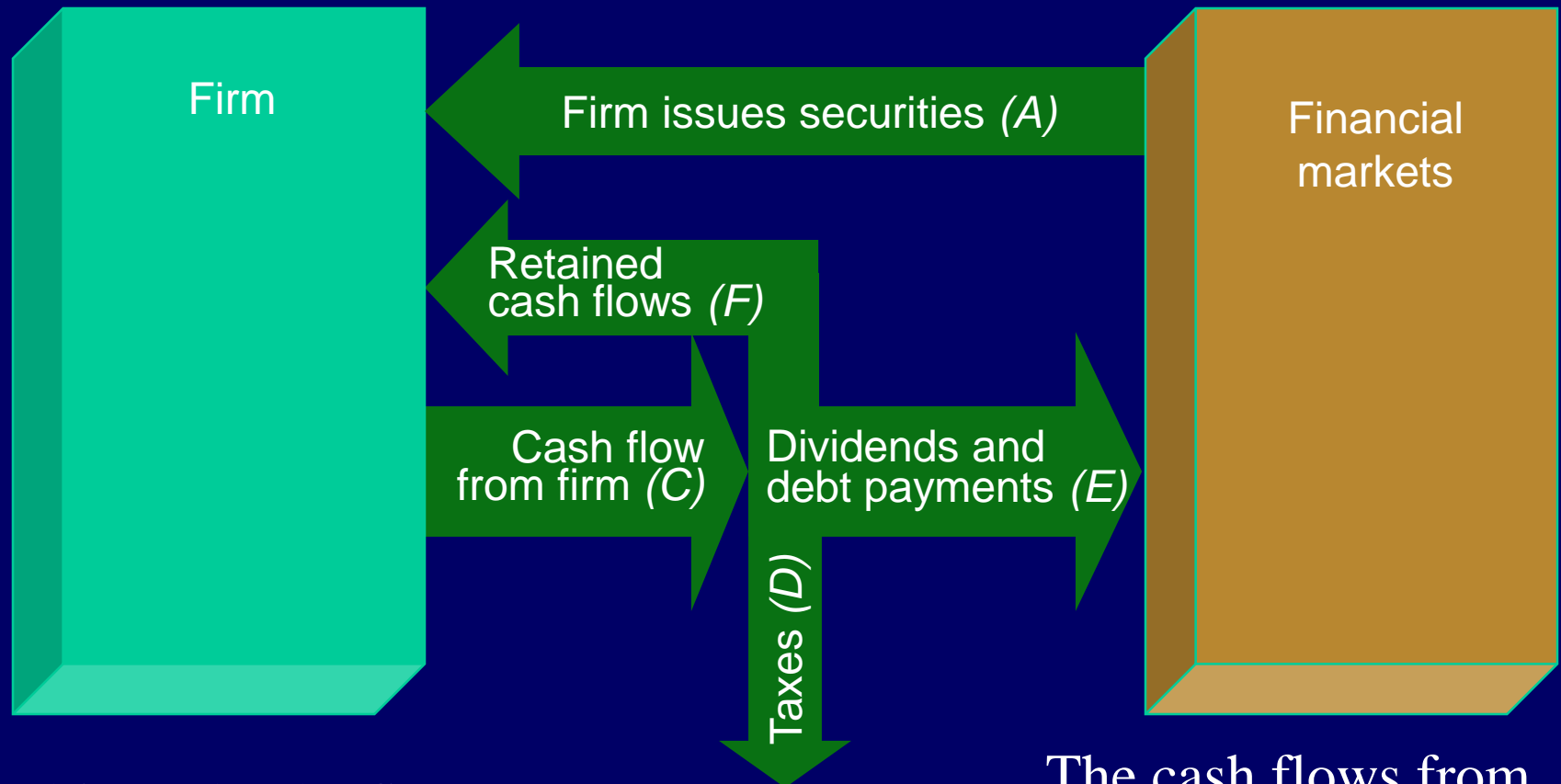
Controller

Cost Accounting
Cost Management
Data Processing
General Ledger
Government Reporting
Internal Control
Preparing Fin Stmts
Preparing Budgets
Preparing Forecasts

Hypothetical Organization Chart



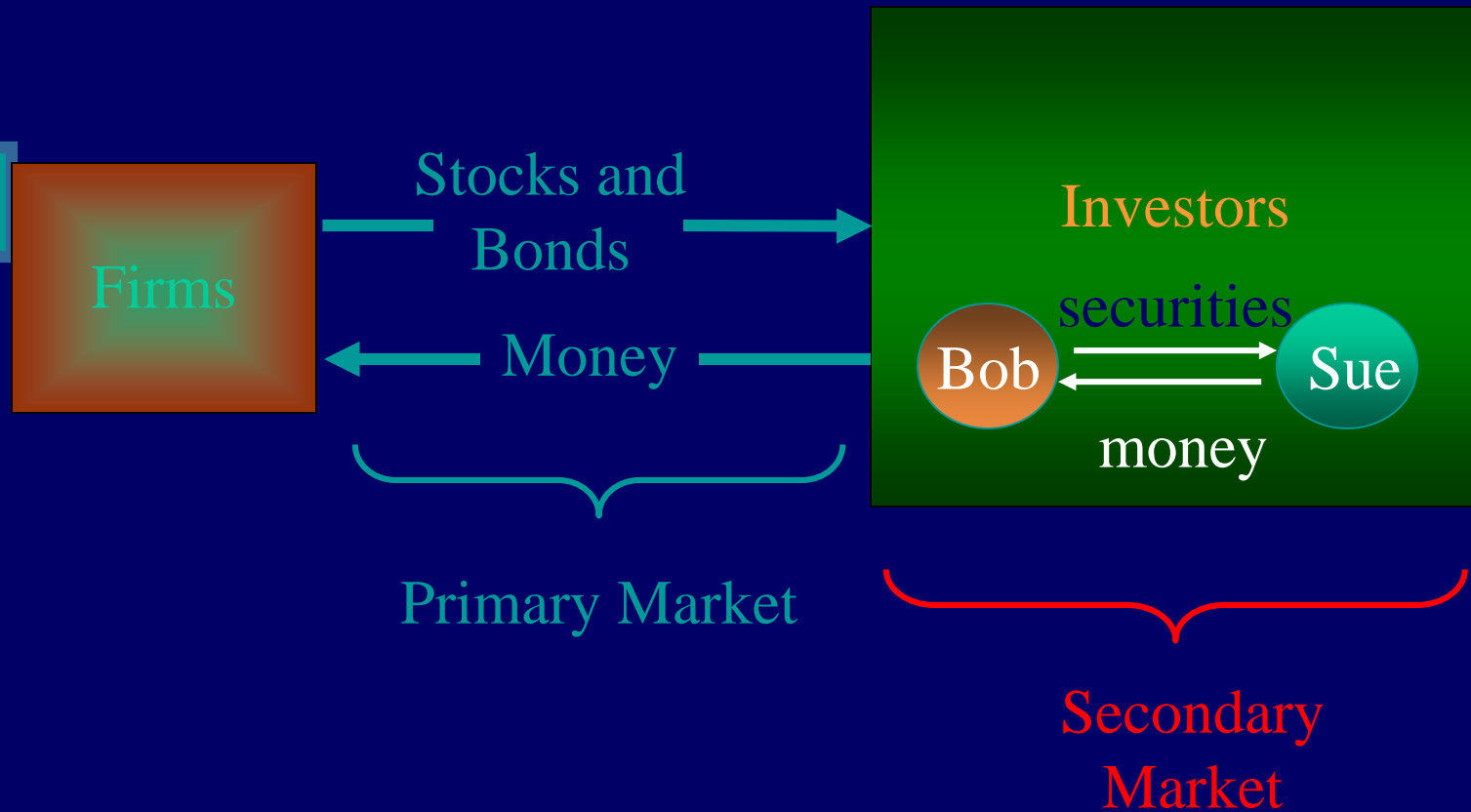
The Firm and the Financial Markets



Ultimately, the firm must be a *cash generating activity*.

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

Financial Markets



Market Differences ...

- Primary Vs Secondary
- Money-market Vs Capital-market
- U.S. Vs Japanese/German markets
- Indian markets: Pre-liberalization Vs Post-liberalization

Financial Markets

- Cash flows to the firm
- Primary vs. secondary markets
 - Dealer vs. auction markets
 - Listed vs. over-the-counter securities
 - BSE, NSE, NYSE
 - NASDQ, OTCEI

Course Outline

■ Readings: Course Notes; Class Material;

■ Lower Level: Gitman; VanHorne & Wachowicz

■ Middle Level: Ross, Westerfield & Jaffe

■ Evaluation Components:

■ Class Participation; Take Home Assignment; End-term Exam;

■ Take Home Assignment has already been detailed

■ Ask doubts ... otherwise we will proceed fast

Quick Quiz

- What are the three basic questions Financial Managers must answer?
- What are the three major forms of business organization?
- What is the goal of financial management?
- What are agency problems, and why do they exist within a corporation?
- What is the difference between a primary market and a secondary market?



Web Resources



www.careers-in-finance.com/

www.careers.wsj.com

www.wageweb.com

www.corpgov.net

www.thecorporatelibrary.com

www.finance.yahoo.com

www.kakani.net

