

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>Rs. 11,300</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>61300</u>
			85300

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, ...*

What is Financial Management?

Corporate Finance addresses the following questions with some overall goals in mind :

- What long-term investments should the firm choose?

Acquisition of Assets (includes Capex)

- How should the firm raise funds for the selected investments?

Financing of Assets (includes Leverage, Dividend)

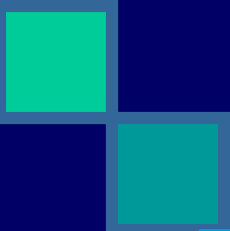

- How should short-term assets be managed and financed?

Day-to-day Management of Assets (includes WCM)



Investment Decisions

Most important of the
three decisions.

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

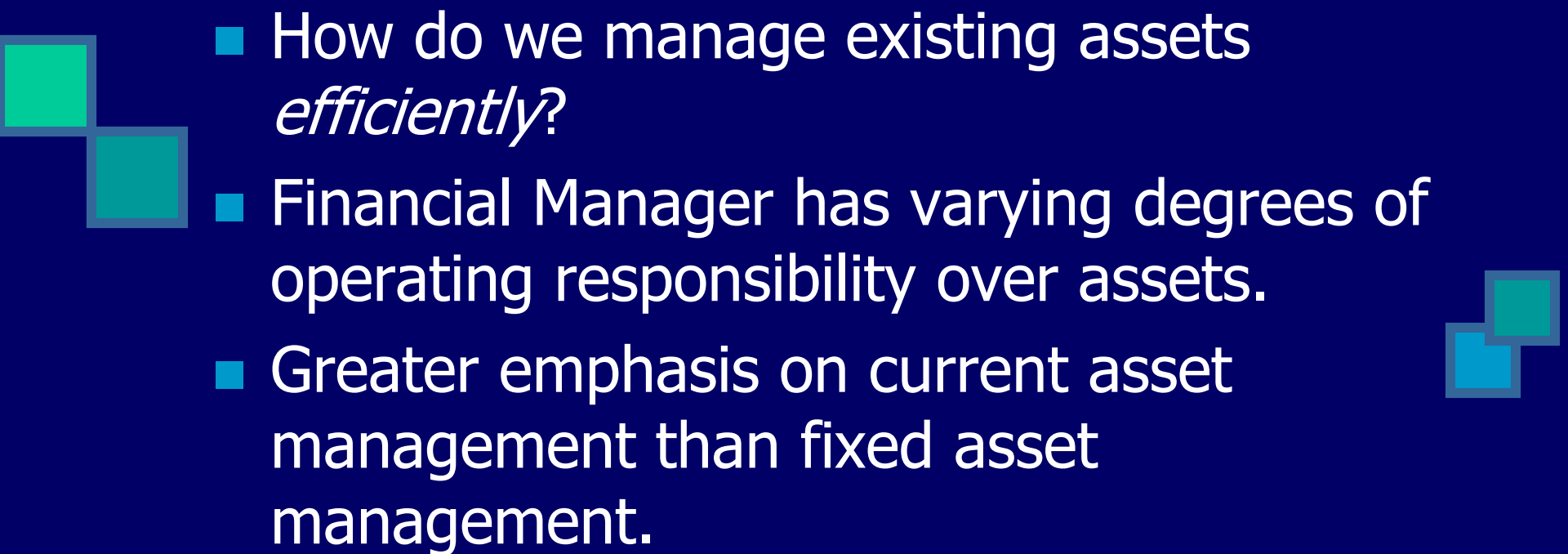
Financing Decisions

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?

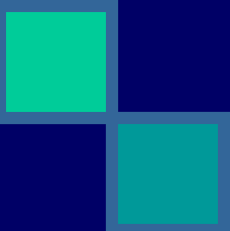


Asset Management Decisions


- 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.
- 



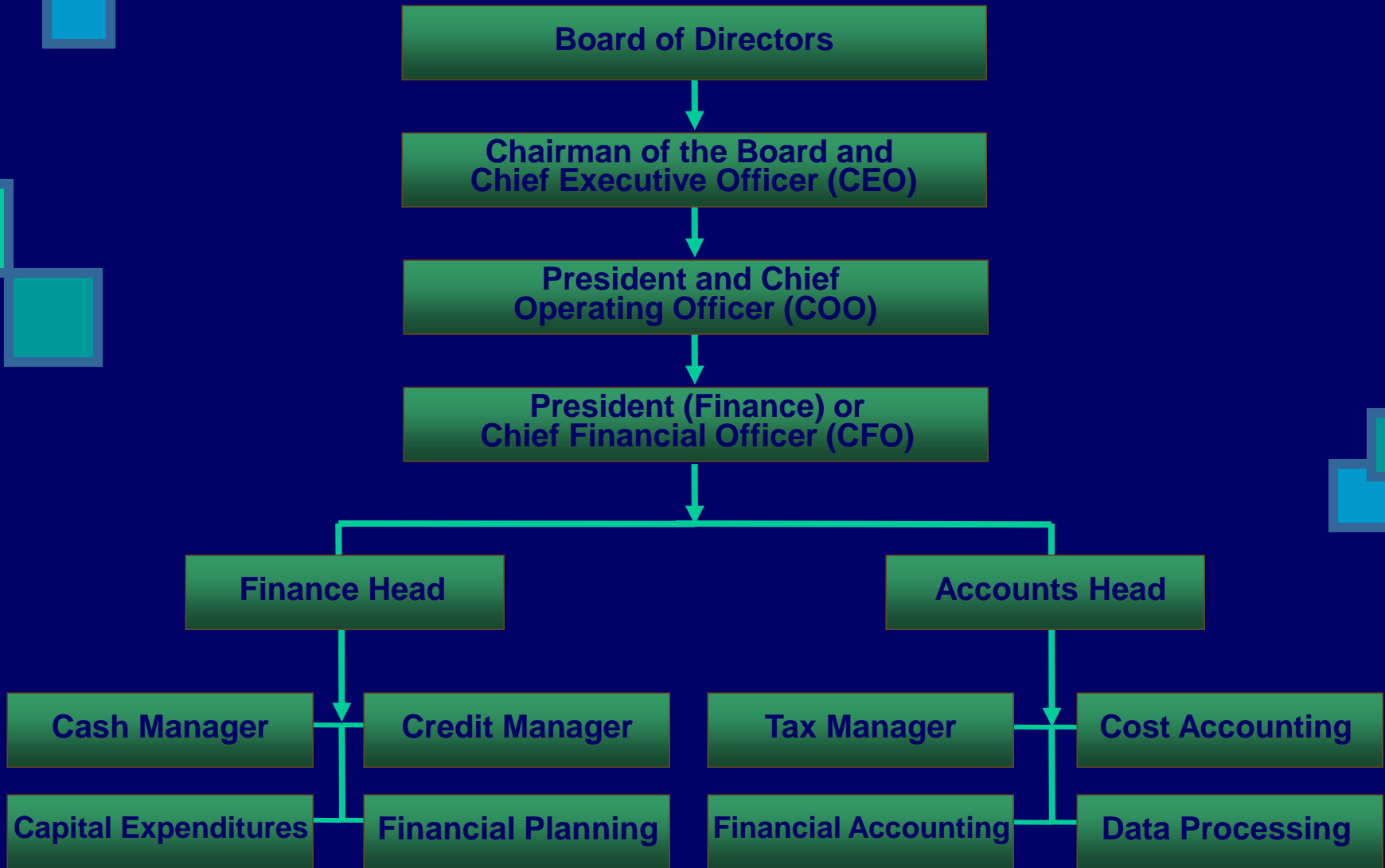
The Financial Manager



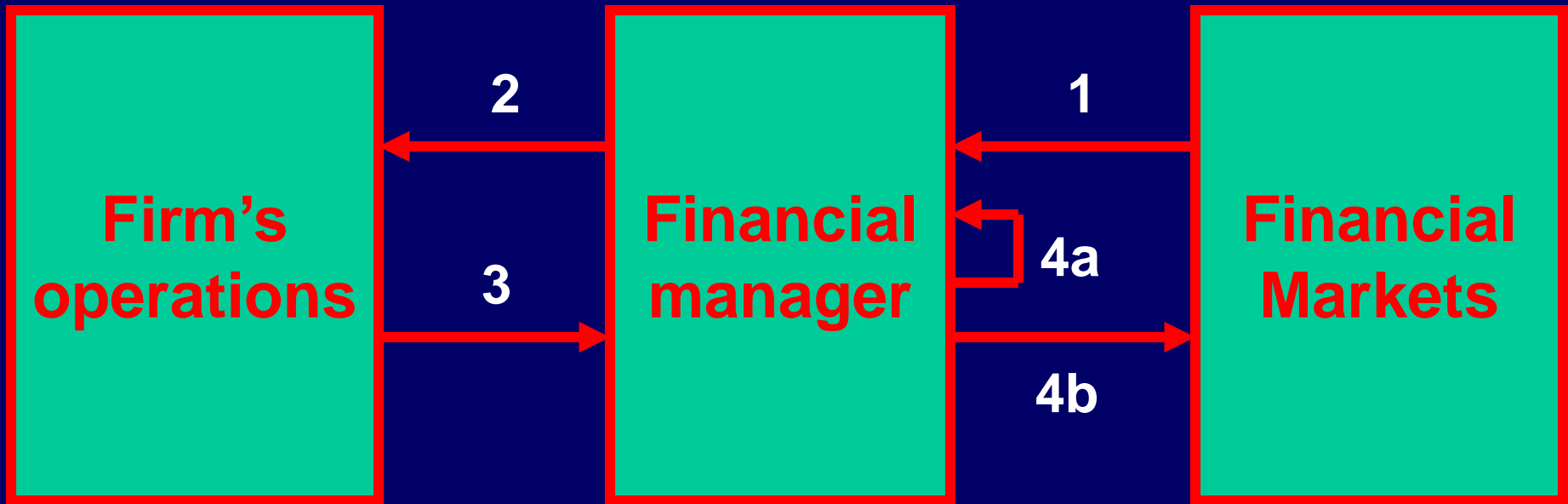
The Financial Manager's primary goal is to increase the value of the firm by:

1. Selecting value creating projects
 2. Making smart financing decisions
- 

Hypothetical Organization Chart



Role of the Financial Manager

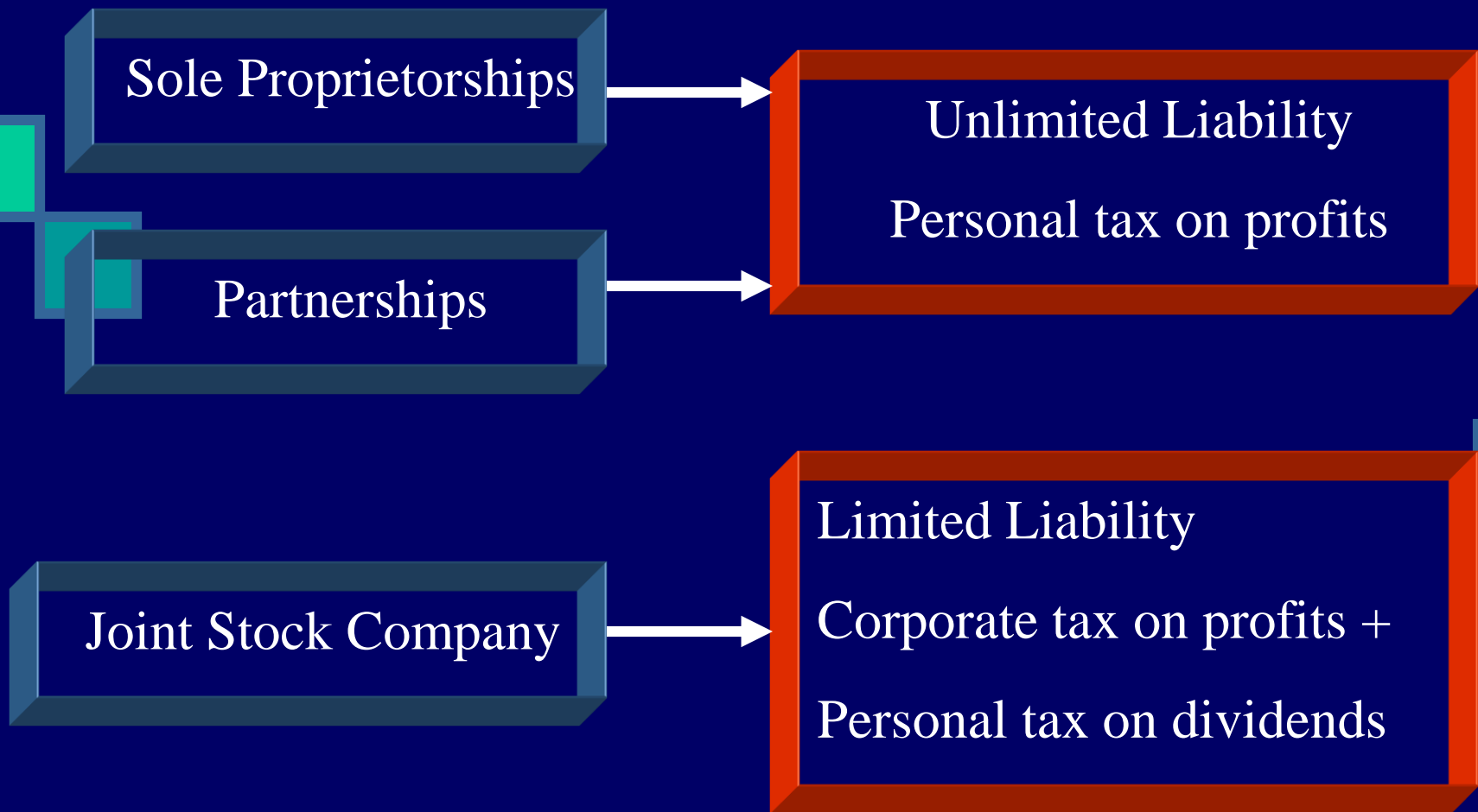


1. Cash raised from investors
2. Cash invested in firm
3. Cash generated from operations
4. Cash reinvested
5. Cash returned to investors

Forms of Business Organization

- The Sole Proprietorship
- The Partnership
 - General Partnership
 - LLP ... Limited Liability Partnership
(introduced in India from 2009)
- The Joint Stock Company

Corporate Structure




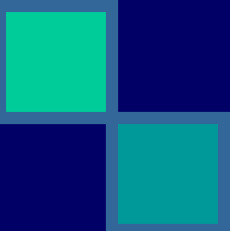
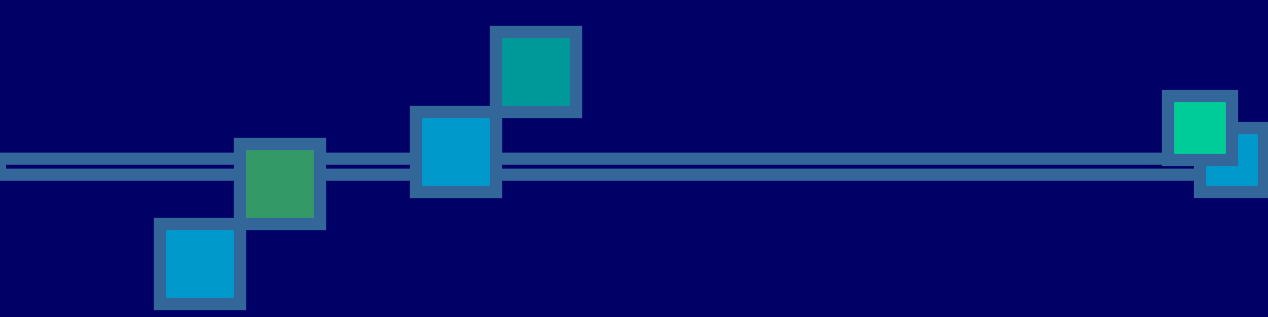
The Corporate Firm

- The corporate form of business is the standard method for solving the problems encountered in raising large amounts of cash.
- However, businesses do take other forms [... depending on the situation].

	Joint Stock	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

The Goal of Financial Management

- What is the correct goal?
 - Maximize profit?
 - Minimize costs?
 - Minimize risks?
 - Maximize size?
 - Maximize EPS?
 - Maximize market share?
 - Maximize profitability?
 - Maximize owners wealth?
 - Maximize shareholder value?



*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

```
graph TD; A[Modern Corporation] --> B[Shareholders]; A --> C[Management];
```

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) from day-to-day operations (management).

Shareholders

Management

There exists a SEPARATION between owners and managers.


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.
- 

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
 - Conflict of interest between principal and agent (example, interests of Business Groups Vs Other Shareholders)
- Costs of the Agency Relationship – monitoring costs, bonding costs, residual loss

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.
- In the 'so-called' professional organizations, typical problems are:
 - Expensive perquisites
 - Survival
 - Independence
- Increased growth and size are not necessarily equivalent to increased shareholder wealth

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
- Corporate control
 - The threat of a takeover may result in better management
- Other stakeholders



Agency Theory

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

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 ...

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

- Primary Market

- Issuance of a security for the first time

Secondary Markets

- Buying and selling of previously issued securities
- Securities may be traded in either a dealer or auction market
 - NSE and BSE
 - OTCEI

Financial Markets

