

## INTRODUCTION TO CORPORATE FINANCE (540-1)

*[Finance is the discipline that determines value, evaluates a company's financial status, and makes decisions about money, banking, investments, and other financial matters.*

*Corporate finance oversees a corporation's investment and financial decisions.*

***Risk managers** use finance and corporate finance concepts to determine appropriate methods of controlling and financing their companies' loss exposures.*

***Agents and brokers** use finance and corporate finance concepts to choose applicants that meet their insurers' financial underwriting guidelines.*

***Underwriters** use finance and corporate finance concepts to review applicants' financial information, as submitted by agents and brokers.*

***Actuaries** use finance and corporate finance concepts to develop premium rates.*

***Claims representatives** use finance and corporate finance concepts to investigate causes of loss.]*

### EO 1. THE THREE GENERAL FORMS OF BUSINESS ORGANIZATION:

1. **A SOLE PROPRIETORSHIP** is a business owned by one person.  
There are more sole proprietorships than there are all other businesses, combined.  
**Advantages:** The owner makes *all* the decisions *and* keeps *all* the profits.
  - Sole proprietorships are easy to establish.
  - State and federal controls are minimal.
  - Startup costs are low.**Disadvantages:** The owner has **unlimited liability** for business debts, so the owner could lose his business *and* his personal assets.
  - All business income is taxed as personal income.
  - The amount of equity that can be raised is limited to the owner's personal wealth.
  - The business exists only until the owner dies.
  - And, the transfer of ownership can be difficult.
2. **A PARTNERSHIP** is an unincorporated business owned by two or more people or entities.  
**A general partnership** has *all* partners share profits *and* losses, as described in their **partnership agreement**.  
**A limited partnership has**
  - a. one or more general partners who run the business *and* bear **unlimited** liability for business debts (like a sole proprietor) *and*
  - b. one or more limited partners who do *not* participate in running the business *and* bear **limited** liability for business debts (like a shareholder).**The advantages and disadvantages of a partnership** are the same as for a sole proprietorship, with the added advantages of greater access to capital and sharing of management responsibilities and the added disadvantage of potential conflicts among partners.
3. **A CORPORATION** is a business that is a legal entity distinct from the people or entities of which it is composed. **A corporation can** borrow money, own property, sue and be sued, *and* enter into contracts. **A corporation must have**
  - a. **articles of incorporation**, which supply basic information about the proposed corporation to the state that will incorporate it, *and*
  - b. **by-laws**, which are the corporation's own rules for conducting its business.In a large corporation, the stockholders elect the **board of directors** (sometimes known as the **board of governors**), which then hires executives and managers to run the corporation.  
**A limited liability company (LLC)** combines the tax advantage of a partnership (no corporate income taxation) with the limited liability of a corporation.  
**A professional corporation** is owned and managed by one or more professionals to provide professional services.

**Advantages:** Ownership is easy to transfer.

The life of the corporation is *not* limited.

Stockholders' liability for business debts is limited to the amount they have invested in the corporation.

And, the corporation can raise capital by selling new shares of stock.

**Disadvantages: Corporations are complex to establish and are subject to double taxation:**

Profits are taxed as corporate income when earned and again as personal income when they're paid out as dividends.

EO 2. **THE THREE GOALS OF CORPORATE FINANCE:**

1. **Maximization of shareholder wealth**--Maximize the value of the corporation's stock to compensate shareholders for the use of their capital.  
Maximizing shareholder wealth is *not* the same as maximizing profits.  
**Focusing on maximum profits can** hinder long-term profitability and growth, increase risk, *and* cause company accountants to reduce financial transparency.
2. **Financial transparency**--Provide shareholders with timely, understandable, informative, and accurate financial records that fully disclose key events and accounting methods, in order to maintain a market for the company's stock.  
Financial transparency is valued by a corporation's **stakeholders** (those with financial interests in the corporation) as well as its stockholders.  
**The Sarbanes-Oxley (SOX) Act of 2002 protects investors in publicly traded corporations by requiring each corporation's CEO or CFO to certify that each financial report**
  - a. has been reviewed by the signing officers,
  - b. contains accurate material facts,
  - c. omits no material facts,
  - d. fairly presents the corporation's financial condition and operational results, *and*
  - e. contains a recent evaluation of the effectiveness of internal controls.
3. **Ethical conduct--Develop and follow a code of ethics** to guide employee conduct, meet regulatory requirements, maintain company integrity, *and* retain customers.  
**The answers to three key questions determine if a business action or decision is ethical:**
  - a. Does the decision violate the corporation's code of ethics?
  - b. Would I like to have my decision reported on the front page of tomorrow's newspaper?
  - c. Would my spouse, family, and friends approve of or applaud my decision?

EO 3. **ORGANIZATION OF CORPORATE FINANCE DEPARTMENTS:**

In large corporations, the financial manager is a senior executive called the chief financial officer (**CFO**).

**The CFO coordinates the activities of the** treasurer, controller, *and* chief information officer (**CIO**).

**The treasurer controls** working capital management, capital structure management, *and* capital budgeting.

**The controller controls** financial accounting, financial reporting, *and* taxation.

**The CIO manages** the corporation's information technology.

**THE FOUR KEY ACTIVITIES OF CORPORATE FINANCE DEPARTMENTS:**

1. **CAPITAL BUDGETING** plans and manages the firm's long-term investments.  
**Financial managers predict the** size, timing, and risk of future cash flows from investments.
2. **CAPITAL STRUCTURING** is the mix of debt and equity the firm uses to finance its operations.  
**Financial managers decide** how and where to raise money, and they compare lenders and loan types to get the most money from the safest and least expensive sources.  
**Financial managers also answer these two questions:**
  - a. How much capital will be financed by borrowing, and how much through stock sales?
  - b. What specific financial vehicles will the corporation use to raise capital?

3. **WORKING CAPITAL MANAGEMENT** plans and manages the firm's short-term assets and short-term liabilities.  
**Working capital equals current assets** (cash, accounts receivable, marketable securities, *and* inventory) *minus* **current liabilities** (amounts owed to suppliers and employees, *plus* the current portion of loans payable, ie, loan payments due within the accounting year).  
**Financial managers decide**
  - a. how much cash and inventory to keep on hand,
  - b. whether to sell goods and services on credit, *and*
  - c. how to get short-term financing.
4. **ACCOUNTING** accumulates and reports financial data for internal and external use.  
**Accounting activities encompass** financial accounting, financial reporting, *and* taxation.

EO 4. **THE ROLE OF FINANCIAL MARKETS IN CORPORATE FINANCE:**

A **financial market** is a mechanism for trading securities.

**Financial markets** are made up of **money markets** (which trade **short-term securities**, which mature in one year or less) *and* **capital markets** (which trade **long-term securities**, which mature in over one year, *if* at all).

A **security** is paper or electronic evidence of an equity or debt instrument.

**The components of a financial market include** the item traded, the buyer, the seller, *and* the individuals or institutions that organize the market.

**Sellers of debt and equity** are willing to pay for use of others' capital to finance their operations.

**Buyers of debt and equity** want to use their own money to generate income.

**Demand for capital takes the forms of** mortgages, corporate and foreign bonds, common and preferred stock, short-term loans, consumer credit, bank loans, bank advances, *and* government debt.

**Supply of, or sources of, capital include** individual investors, insurers, pension funds, thrift institutions, investment companies, commercial banks, *and* business corporations.

EO 5. **HOW PRIMARY MARKETS OPERATE:** In a **primary market**, a corporation sells securities *for the first time*. A **public offering** sells securities to the general public.

A **private placement** sells securities to a specific buyer (or to specific buyers).

Corporations must register their *public* offerings with the Securities and Exchange Commission (**SEC**).

**The four types of primary market structure:**

1. **Direct search**--Participants find interested trading partners by themselves.
2. **Broker**--Participants hire brokers to find trading partners for them.
3. **Dealer**--Participants trade with dealers who buy and sell securities themselves.
4. **Auction**--Participants communicate with each other through a single, centralized intermediary.

**In a dealer market,**

1. **the bid price** is the price the dealer is willing to pay for the security,
2. **the asked price** is the price at which the dealer is willing to sell the security, *and*
3. **the bid-asked spread** is the difference between the security's bid price and its asked price.

**HOW SECONDARY MARKETS OPERATE:** In a **secondary market**, a securities owner sells his securities to another buyer.

An **over-the-counter (OTC) market** (aka, a **dealer market**) has the securities owner sell his securities directly to the buyer.

An **organized exchange** (aka an **auction market**) sells securities through brokers and agents, who match sellers with buyers.

**Secondary market efficiency depends on market depth** (a market's ability to handle a large number of transactions *without* a significant effect on price) *and* **market breadth** (the percentage of the overall market participating in the market's up or down move).