Chapter 1:
Principles of finance

Liuren Wu
1. What is finance?

2. Three types of business organizations

3. The goal of the financial manager

4. The four basic principles of finance
Learning objectives

1. Identify the 3 primary business decisions that financial managers make.

2. Identify the key differences between 3 major legal forms of business.

3. Understand the role of the financial manager within the firm and the goal for making financial choices.

4. Memorize the 4 principles of finance that form the basis of financial management for both business and individuals.
What is finance?

- Finance is the study of how people and businesses evaluate investments and raise capital to fund them. *(how to get and use money)*

- Two questions addressed by the study of finance:
  1. What long-term investments should the firm undertake? *(capital budgeting decisions – how to spend the money?)*
  2. How should the firm fund these investments? *(capital structure decisions – how to get the money?)*
Three types of business organizations

1. Sole proprietorships
2. Partnerships
3. Corporations

Hybrids
Sole Proprietorship

- It is a business owned by a single individual that is entitled to all the firm’s profits and is responsible for all the firm’s debt.
- There is no separation between the business and the owner when it comes to debts or being sued.
- Sole proprietorships are generally financed by personal loans from family and friends and business loans from banks.
- Advantages:
  - Easy to start
  - No need to consult others while making decisions
  - Taxed at the personal tax rate
- Disadvantages:
  - Personally liable for the business debts
  - Ceases on the death of the proprietor
A **general partnership** is an association of two or more persons who come together as co-owners for the purpose of operating a business for profit.

There is no separation between the partnership and the owners with respect to debts or being sued.

**Advantages:**
- Relatively easy to start
- Taxed at the personal tax rate
- Access to funds from multiple sources or partners

**Disadvantages:**
- Partners jointly share unlimited liability
In limited partnerships, there are two classes of partners: general and limited.

The general partners runs the business and face liability for the firm’s debts, while the limited partners are only liable on the amount invested.

One of the drawback of this form is that it is difficult to transfer the ownership of the general partner.
Corporation

- Corporation is “an artificial being, invisible, intangible, and existing only in the contemplation of the law.”

- Corporation can individually sue and be sued, purchase, sell or own property, and its personnel are subject to criminal punishment for crimes committed in the name of the corporation.

- Corporation is legally owned by its current stockholders.

- The Board of Directors are elected by the firm’s shareholders. One responsibility of the Board of Directors is to appoint the senior management of the firm.
Advantages
- Liability of owners limited to invested funds
- Life of corporation is not tied to the owners
- Easier to transfer ownership
- Easier to raise Capital

Disadvantages
- Greater regulation
- Double taxation of dividends
These organizational forms provide a cross between a partnership and a corporation.

- **Limited liability company** (LLC) combines the tax benefits of a partnership (no double taxation of earnings) and limited liability benefit of corporation (the owner’s liability is limited to what they invest).

- **S-type corporation** provides limited liability while allowing the business owners to be taxed as if they were a partnership – that is, distributions back to the owners are not taxed twice as is the case with dividends in the standard corporate form.
How the Finance Area Fits into a Corporation

A firm's Vice President of Finance is many times called its Chief Financial Officer, or CFO. This person oversees all the firm's financial activities through the offices of the firm's Treasurer and Controller.
The goal of the financial manager must be consistent with the mission of the corporation to maximize firm shareholder’s wealth (as measured by share prices).

While managers have to cater to all the stakeholders (such as consumers, employees, suppliers, etc.), they need to pay particular attention to the owners of the corporation, i.e., shareholders.

If managers fail to pursue shareholder wealth maximization, they will lose the support of investors and lenders. The business may cease to exist and ultimately, the managers will lose their jobs!
“To achieve sustainable growth, we have established a vision with clear goals: maximizing return to shareholders while being mindful of our overall responsibilities.” – part of Coca-Cola’s mission statement

“Our final responsibility is to our stockholders...when we operate according to these principles, the stockholders should realize a fair return.” – part of Johnson & Johnson’s credo

“Optimize for the long-term rather than trying to produce smooth earnings for each quarter.” - Google
1. Money has a time value.  
   - A dollar received today is more valuable than a dollar received in the future (due to interests, investment returns, etc.)

2. There is a risk-return trade-off.  
   - One shall take extra risk only if one expects to be compensated for extra return.

3. Cash flows are the source of value.  
   - Profit is an accounting concept designed to measure a business’s performance over an interval of time.  
   - Cash flow is the amount of cash that can actually be taken out of the business over this same interval.

   - Investors respond to new information by buying and selling their investments.