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ECO 2200: Module 1

Dorina Tila
CUNY Kingsborough Community College

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An Overview of Financial Management

Outline is retrieved from Chapter 1

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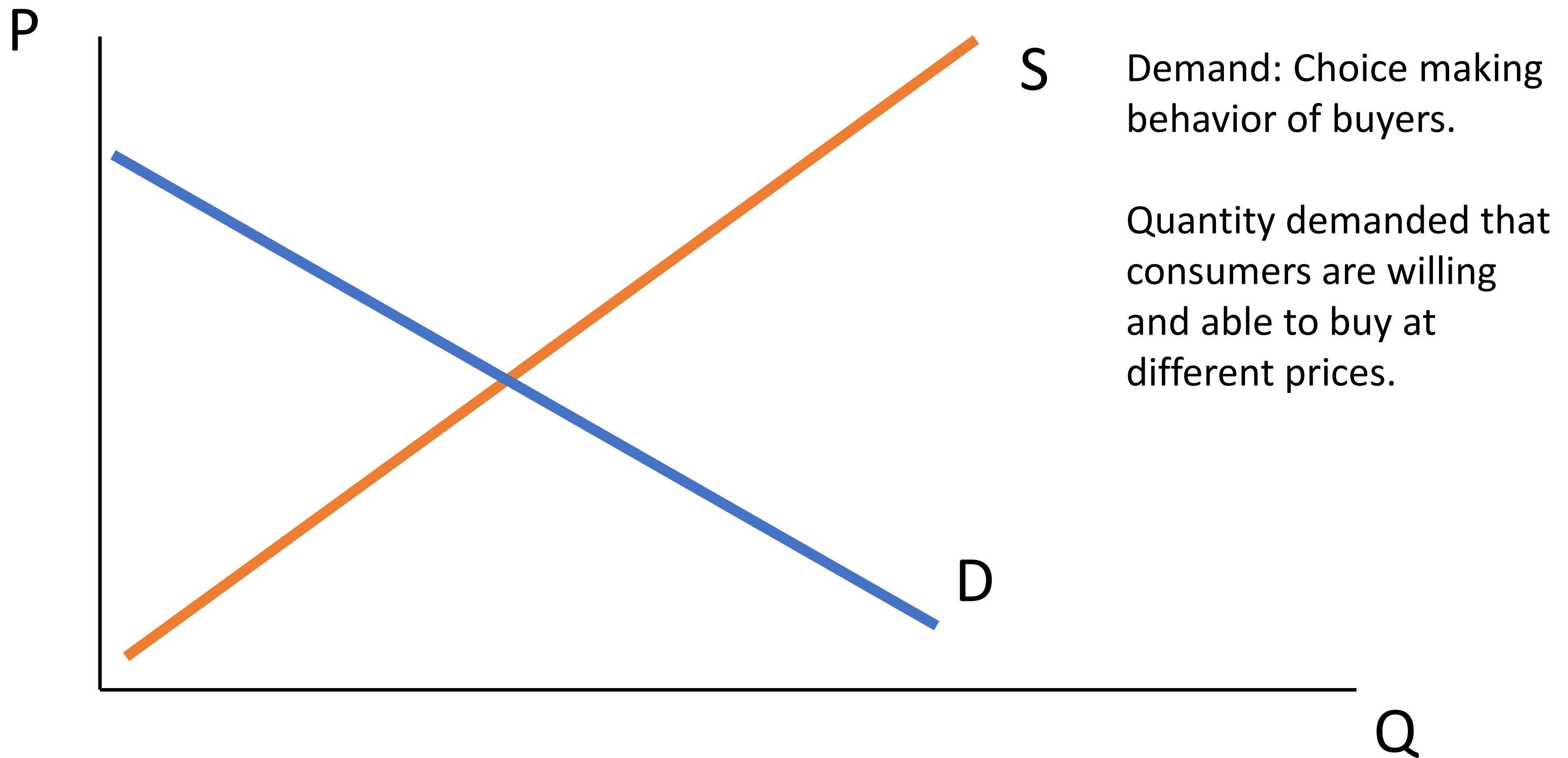
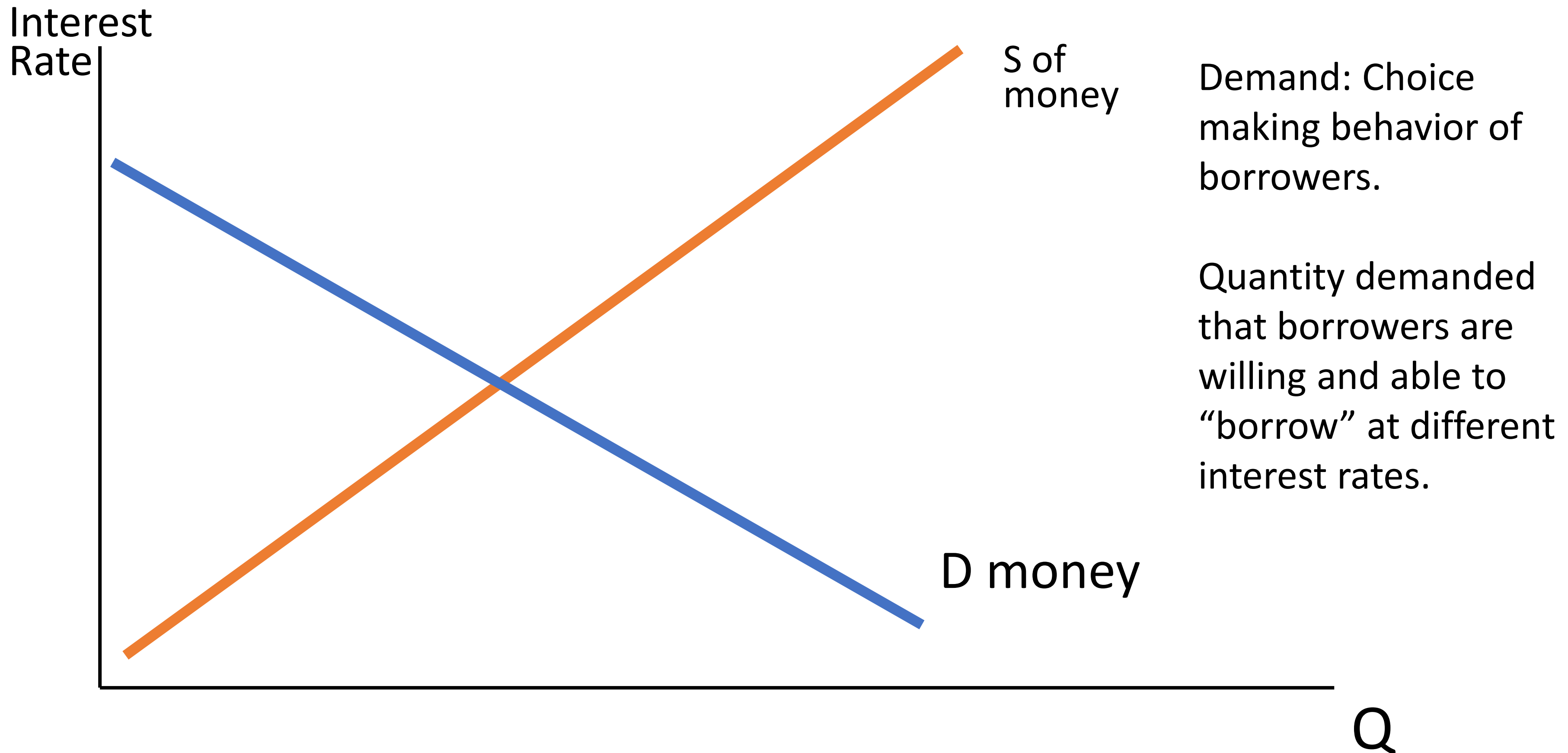
Module 1: Outline

- What is Finance
- Firm vs. markets
  - Goal of the firm
  - Structure of the firm
  - Size of the firm
  - Forms of business organizations
- Creating value for investors
- Agency Problem: Principal – Agent Conflict
  - Stockholder – Manager Conflict
  - Stockholder – Debtholder Conflict
- Balancing Interests of Shareholders and Society

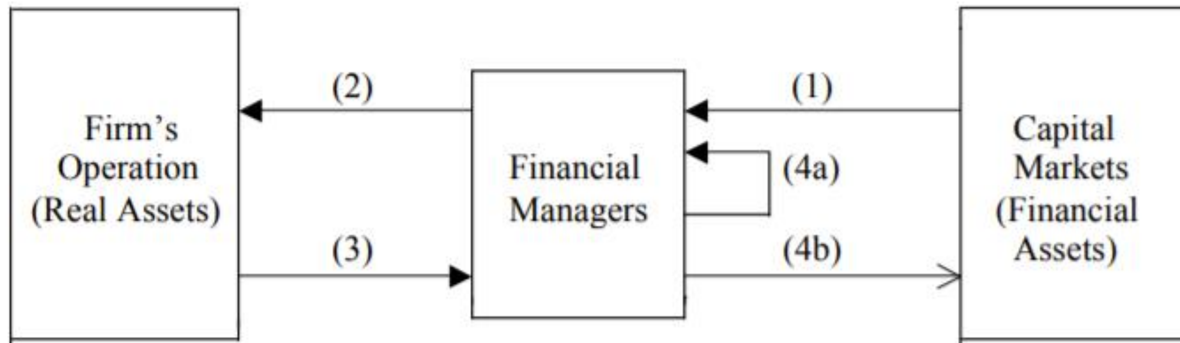
Supply & Demand for Goods and Services



Supply & Demand for Money



I. What is Finance



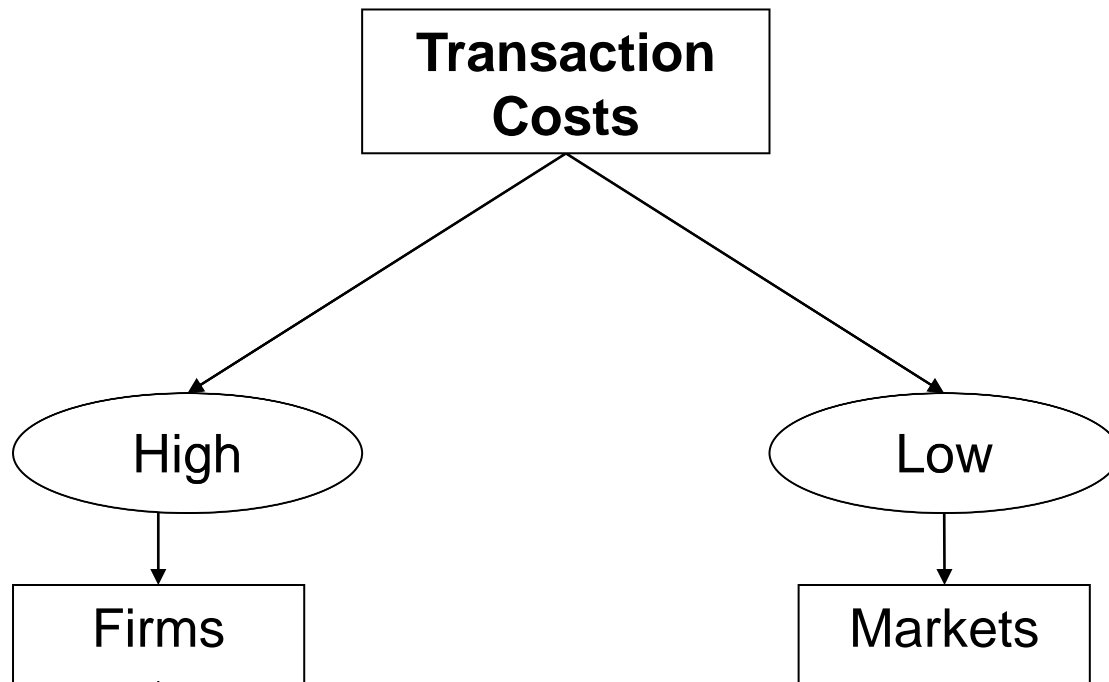
(1) Cash raised by selling financial assets in financial markets
(2) Cash invested in firm's operations and used to purchase real assets
(3) Cash generated from firm's operations
(4a) Cash reinvested in firms' operations
(4b) Cash returned to investors

Financing decisions vs. investment decisions: raising money vs. allocating money
Activity (1) is a financing decision
Activity (2) is an investment decision
Activities (4a) and (4b) are financing decisions

What is finance: cash flows between capital markets and firm's operations.
https://www.csun.edu/~zz1802/Finance%20303/Web-New/Lecture-Notes-Mid1.pdf

Firms vs. Markets

Transaction Costs Shape Decentralized Markets or Centralized Structure



Transaction Costs are too high → Firms integrate

Ronald Coase (1937) explained that a firm and a market are alternative means of organizing economic activity.

Size of the Firm

Small → Cost of doing business with other firms (HIGH)
Large → Cost of monitoring its managers (HIGH)

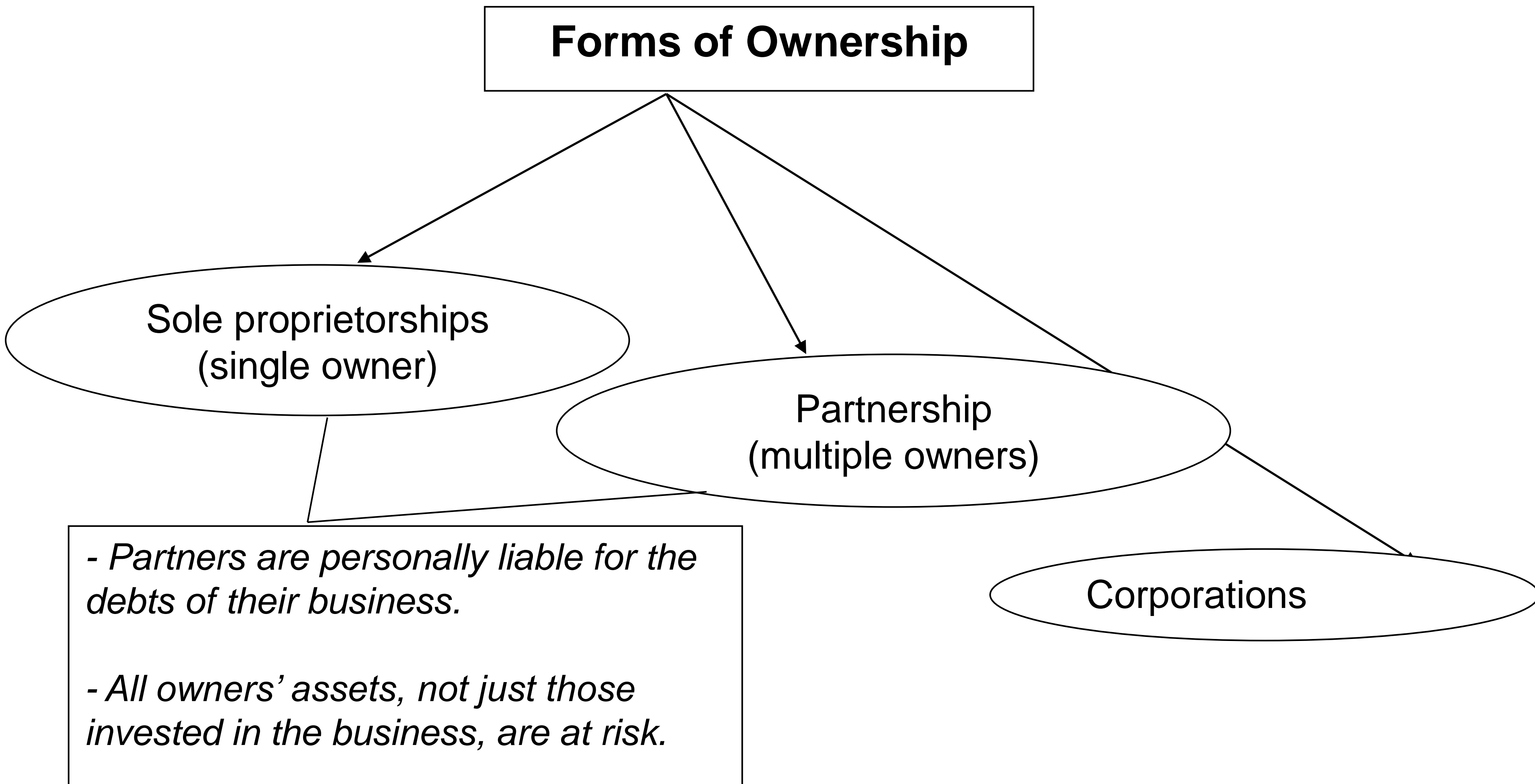
How to Expand a Firm?

1. Through investment such as building new factories
2. Mergers

A transaction in which the assets of one or more firms are combined in a new firm.

1. Vertical merger:
Firm combines with its supplier
2. Horizontal merger:
Firms that compete within the same market combine.
3. Conglomerate merger:
Firms in unrelated lines of businesses combine.

Forms of Business Organizations



Proprietorships & Partnerships

- Advantages
  - It is easy to form
  - It is subject to few regulations
  - Pass-through entities for tax purposes: no subject to corporate income taxes
- Disadvantages
  - Difficult to raise capital
  - Unlimited liability
  - Limited life
- Often set up through LLCs/LLPs.

Corporations

- Advantages
  - Unlimited life
  - Easy transfer of ownership
  - Limited liability
  - Ease of raising capital
- Disadvantages
  - Double taxation
  - Cost of setup and report filing

Summary of Business Organizations

Items	Proprietorship	Partnership	Corporation
Formation	Easier	Easier	More difficult
Liability	Unlimited	Unlimited	Limited*
Ownership	One	Two or more	One or more*
Ownership transfer	More difficult	More difficult	Easier*
Raise capital	More difficult	More difficult	Easier*
Life	Limited	Limited	Unlimited*
Corporate Income Tax	No	No	Yes

Corporations Raise Money

- Issuing NEW stocks
  - a. A buys stock → Shareholder of the company
  - b. A receives: Dividend + P.stock when sold
- Issuing Debt
  - a. B gives a loan X → B: creditor
  - b. B receives: Interest + X (repayment of loan)
- *** Corporations do not raise money by transactions of old stocks (these are sold and bought by third parties).

Corporations: Agency Problem

(+) Limited Liability

Shareholders' losses are limited to the price of stock paid.

(-) Separation of Ownership and Control

- Managers and Shareholders: different interests
- Board of Directors monitors Managers

Firm’s Organization

Board of Directors

Governing body: an elected group of individuals that represent shareholders

CEO

Chief Executive Officer (CEO) leads the firm

CIO

Chief Investment Officer (CIO) is responsible for investment decisions

CFO

Chief Finacial Officer(CFO) is responsible for tax and financial topics (e.g., Accounting, Treasury, Credit,x` Legal, Capital Budgeting, and Investor Relations)

COO

Chief Operating Officer (COO) is responsible for daily operations (e.g., Marketing, Production, Human Resources, and Other Operating Departments)

Other Topics

- Insider Trading
- Efficient Market

Corporations
Stockholder – Manager Conflict

- Managers are naturally inclined to act in their own best interests (which are not always the same as the interest of stockholders).
- But the following factors affect managerial behavior:
  - Managerial compensation packages
  - Direct intervention by shareholders
  - The threat of firing
  - The threat of takeover

Corporations
Stockholder – Debtholder Conflict

- Stockholders are more likely to prefer riskier projects, because they receive more of the upside if the project succeeds. By contrast, bondholders receive fixed payments and are more interested in limiting risk.
- Bondholders are particularly concerned about the use of additional debt.
- Bondholders attempt to protect themselves by including covenants in bond agreements that limit the use of additional debt and constrain managers' actions.

Corporations
Balancing Shareholder Interest & Society Interest

- The primary financial goal of management is shareholder wealth maximization, which translates to maximizing stock price.
  - Value of any asset is present value of cash flow stream to owners.
  - Most significant decisions are evaluated in terms of their financial consequences.
  - Stock prices change over time as conditions change and as investors obtain new information about a company's prospects.
- Managers recognize that being socially responsible is not inconsistent with maximizing shareholder value.