Scope of Corporate Finance Cheat Sheet

by Natalie Moore (NatalieMoore) via cheatography.com/19119/cs/11139/

What Should a Financial Manager Try to Maximize?

Maximize Profit?

Many believe managers job

Take only actions to increase revenues

Maximise amount earned on each share

Earnings per share (EPS) = earnings of common stockholders divided by number of shares of common stock outstanding

Flaws in approach:

- Figures for earnings historical, reflect past performance

- Do not focus on what is happening now / in future

- Timing may be ignored. Large profits that pay off many years in future may be less valuable than smaller profits received next year

Maximize Shareholder Wealth?

Current theory

Measured by market price of firm's stock.

Stock price reflects timing, magnitude, and risk of cash flows that investors expect a firm to generate over time.

Take only actions that increase value of firms future cash flows.

Shareholders are residual claimants. Can claim only on cash flows that remain after employees, suppliers, creditors, governments, and other stakeholders are paid in full

There is a risk shareholders receive nothing

Shareholders bear most of risk of running firm

This is why firms operate to maximize shareholder wealth. The benefit to all is that it gives investors incentive to accept the risks necessary to buy stock and provide funds necessary for a business to thrive.

What Should a Financial Manager Try to Maximize? (cont)

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Focus on other Stakeholders?

Many firms also focus on employees, customers, tax authorities, and communities

These firms consciously avoid actions that harm stakeholders by transferring their wealth to shareholders.

Not to maximize others interests but to preserve those interests.

Benefits

- Keeping stakeholders happy has long-term benefit to share-holders
- Helps minimise employee turnover, conflicts, and litigation.
- Usually actually leads to maximizing shareholder wealth

Conflicts

- Between these two objectives inevitably arises.
- Firms is ultimately run to benefit stockholders.
- Corporations are generally expected to be socially responsible
- But rarely required by law to be in US and AUS

Finance skills

All finance jobs require:

Good written and verbal communication skills

Ability to work in teams

Proficiency with computers and the Internet

Many finance jobs require:

In-depth knowledge of international business

Finance career opportunities:

Finance skills (cont)

Corporate finance

Commercial banking

Investment banking

Money management

Consulting

Consulting

Analyse firms business processes and strategies

Recommend how practices should change to make firms more competitive

Implement recommendations

Spend up to 200+ days yearly on the road

Money Management

Industry

Investment advisory firms

Mutual fund companies

Pension fund managers

Trust departments of commercial banks

Investment arms of insurance companies

Any person or institution that acts as a fiduciary—someone who invests and manages money on someone else's behalf

Trends

Baby Boomers investing large sums in preparation for retirement - demand for pofessional money managers surged

Australian superanuation legislation passed in 1992 requring all employees to be members of a superfund - that industry grew massively

Institutionalisation of investment, means today institutional investors dominate the markets

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Corporate Finance

The duties of the financial manager in a business / Not for profit / Corporation

Tasks include:

- Budgeting
- Financial forecasting
- Cash management
- Credit administration
- Investment analysis
- Funds procurement

Modern business changes:

Increases in regulatory environments have increased the importance and complexity of the financial manager's duties

Globalisation has increased need to assess and manage the risks associated with volatile exchange rates and rapidly changing political environments.

Finance Function: Financial Management

Managing firms operating cash flows as efficiently and profitably as possible.

Capital structure decision finding right mix of debt and equity securities to maximise firms overall market value.

Managing working capital

- Ensure enough working capital on hand for day-to-day operations
- Obtaining seasonal financing
- Building up enough inventories to meet customer needs
- Paying suppliers
- Collecting from customers
- Investing surplus cash
- Maintaining adequate cash balances

Skills:

- Technical and analytical skills

Finance Function: Financial Management (cont)

- People skills - relationships with customers, suppliers, lenders, and others

Finance function: Risk Management

Identifies, measures, and manages many types of risk exposures including:

- Predictable business risks-losses such as adverse interest rate movement commodity price changes, and currency value fluctuations.
- Unpredictable 'acts of nature'

Risk management techniques

- Insurance products (fire, flood, theft, injury)
- Self-insurance to manage exposures
- Quantify the sources and magnitudes of risk exposure and decide whether to accept them or to manage them.
- Diversification (contract with several suppliers, even if it means purchasing the input at slightly more than the lowest possible price)

Modern risk management

Market-driven risks interest rates, commodity prices, and currency values.

Financial instruments called derivatives (derive their value from other, underlying assets) have been developed for use in hedging (offsetting) for more threatening market risks.

Australian legal forms of business

- Sole proprietorships
- General Partnerships
- Limited Partnerships
- Proprietry Limited Company
- Company

General Partnerships

- Proprietorship between 2+ owners
- No distinction between owners and business
- Joint and several liability
- Unless specified all debts and equity, profits, are split evenly
- Decision making ability is split evenly
- Income taxed at personal level
- Limited life - cease when one owner dies or retires
- Limited access to capital - Reinvesting profits, personal loans
- Unlimited personal liability - Personally liable owner for all debts, including lawsuits

Proprietry Limited Company

- Business seperate entity to owner
- Creates roles of employee, director, shareholder
- Regulated under the corporations act 2001
- Establishment and ongoing costs to manage can be high
- Suited to Medium and Large businesses

Role of finance manager

- constantly apply financial tools to solve real business problems
- Ensure business managers take only actions where benefits exceed costs
- Interact with experts in a wide range of disciplines
- Study economics of a market
- Develop pricing strategy
- Negotiate licensing agreements
- Work with authorities to ensure compliance
- Advise business managers and professionals

Role of finance manager (cont)

Work with accounting and systems staff to develop systems

Managing cash flows

Assessment and funding of research

Aid business in accumulating the capital needed to fund projects

The skills and knowledge needed to achieve corporate business objectives are the same as those needed to be a successful entrepreneur, to manage family businesses, or to run a nonprofit organization. Successful financial managers must be able to creatively manage both people and money.

Financial intermediary

Companies can obtain debt capital by selling securities either directly to investors or through financial intermediaries.

Financial intermediary

Institution that raises capital by issuing liabilities against itself

Uses the capital raised to make loans to corporations and individuals

Borrowers have no direct contact with those who funded the loan

Financial intermediaries include:

- Insurance companies
- Savings and loan institutions
- Credit unions
- Commercial banks

Modern financial intermediary services

Loans to corporations and individuals

Allow companies and individuals to place their money in demand deposits

Backbone of the payments system:

Financial intermediary (cont)

- Collect payment on transfers sent to corporate customers
- Make payment on the transfers by their customers to other parties
- Provide information-processing services to SME businesses
- Handle large-volume transactions such as payroll

These organisations issue liabilities such as demand deposits (checking accounts) to companies and individuals and then loan these assets to corporations, governments, and households

Investment Banking

Interesting nature of work

Three main types of activities:

Helping corporate customers obtain funding by selling securities such as stocks and bonds to investors

Providing advice to corporate clients on strategic transactions such as mergers and acquisitions

Trading debt and equity securities for customers or for the firm's own account

Profitability

High income potential

Extraordinarily high since the early 1990s

Highly volatile industry

Entry-level salary range $50,000 to more than $80,000, plus bonuses

Incomes often rise rapidly

Industry

Dominant AU firms: Macquarie Group, and CommSec

Dominant foreign firms: BNP, Deutsche Bank, Credit Suisse, HSBC, J. P. Morgan Chase, Merrill Lynch, Morgan Stanley, Goldman Sachs, Citigroup

Investment Banking (cont)

Extremely competitive

Long working hours

Lucrative rewards for those who master the game

Key skills

Good analytical and communication skills

Social and networking skills also pay handsome dividends.

Growth expectations

Ongoing development of new financial products and services

Continued internationalization of corporate finance

Finance Function: Capital Budgeting

Financial managers single most important activity

Managers evaluate very large investments in the capital budgeting process

Companies prosper in a competitive economy only by seeking out the most promising new products, processes, and services to deliver to customers.

Big companies make huge capital outlays

ROI drive the value of their firms and wealth of shareholders.

Consequences of flawed capital budgeting processes are serious

The capital budgeting process:

1. Identifying potential investments

2. Analysing the set of investment opportunities and identifying those that create shareholder value

3. Implementing and monitoring the investments selected in Step 2

Managers have the greatest opportunity to create value for shareholders by acquiring assets that yield benefits greater than their costs

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Finance function: Corporate Governance

Important to avoid scandal and damage to reputation

Systems of incentive / structures that influence good ethical behaviours and decision making

Intentions

Determine who benefits most from company activities

Develop procedures to maximise firm value and to ensure that employees act ethically and responsibly

Encourage the hiring and promotion of qualified and honest people

Motivate employees to achieve company goals through salary and other incentives

Challenges in practice

Conflicts inevitably arise among stockholders, managers, and other stakeholders.

Stockholders want managers to work hard and to protect shareholders interests.

It costs time and money to ensure that managers act appropriately.

Though managers may wish to maximize shareholder wealth, they do not want to work harder than necessary, especially if others are going to reap most of the benefits.

Managers and shareholders may decide together to run a company to benefit themselves at the expense of creditors or other stakeholders

Creditors and other stakeholders generally don't have a voice in corporate governance.

Strong boards of directors play a vital role in any well-functioning governance system, because boards must hire, fire, pay, and promote senior managers.

Finance function: Corporate Governance (cont)

Boards must also develop fixed and contingent compensation packages that align managers incentives with those of shareholders.

In Australia

ASIC - Australian Securities and Investments Commission oversees corporate activities

Est in 1998

Corporate, markets and financial services regulator

ASIC enforce and regulate company and financial services laws to protect Australian consumers investors and creditors

ASIC oversees the Australian Securities Exchange (ASX) (2006 merger of Aus stock exchange and Sydney Futures Exchange)

Most work done under the Corporations Act 2001

Governments governance

Countries also struggle

Governments establish legal frameworks for corporate finance that encourage competitive businesses to develop and efficient financial markets to run properly

Commercial laws should

- Provide protection for creditors and minority shareholders
- Limit opportunities for managers or majority shareholders to transfer corporate wealth from investors to themselves.

Sole proprietorships

One legal owner

No distinction between owner and business

Owners personal property

Limited life - cease when owner dies or retires

Limited access to capital - Reinvesting profits, personal loans

Unlimited personal liability - Personally liable owner for all debts, including lawsuits

High risk, often not insurable

Income taxed at personal level

Limited Partnerships

Sprung from legislation in 2000

Unlimited personal liability

Ideal for start ups with losses in early years - limited partners can use to offset other income tax

1+ partners with unlimited personal liability who receives a greater share of income

Other partners

- Limited liability partners
- Must be completely passive
- Name cannot be associated with business
- Can not take a role in the business
- Can not be employed by the business
- No personal liability for debts
- Can not be sued
- Income taxed as personal income

Modern businesses

Face a modern, knowledge based economy

Finance role is vital in creating wealth

Involve people with many different skills and backgrounds working together toward common goals.

Debt and Equity: The Two Flavors of Capital

Two broad types of capital exist: debt and equity

Debt capital

Long term borrowing from creditors

Borrower pays interest, at a specified annual rate, on the loans principle (full amount borrowed)

Borrower repays the principal amount at the debts maturity

Payments made on a fixed schedule

Creditors have a legally enforceable claim against the firm.

Defaults on debt payments mean creditors can take legal action to force repayment.

Creditors can sometimes force the borrowing firm into bankruptcy, out of business and selling (liquidating) assets to repay creditor claims.

Equity capital

Business owners contribution

Expected to remain permanently invested in the company

Sources of equity capital

Common stock

- Bear most of the firms business and financial risk
- Receive returns on their investments only after creditors and preferred stockholders are paid in full

Preferred stock

- Similar to creditors

"Preferred Stockholders"

Promised a fixed annual payment on their invested capital

Claims are not legally enforceable

Debt and Equity: The Two Flavors of Capital (cont)

Cannot force a company into bankruptcy if a preferred stock dividend is missed

Upon liquidation, preferred stockholders claims are paid before any money is paid to common stockholders.

Commercial Banking

In Australia is dominated by the 'big four' (75% market share):

ANZ

Commonwealth Bank

NAB

Westpac

Hiring

Banks continue to hire large numbers of new business and finance graduates each year

Banks train many managers who later migrate to other fields

Key skills

Cash flow valuation

Financial and credit analysis

Consumer banking vs Commercial banking

Excellent finance skills

Intimate knowledge of telecommunications and computer technology

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Five Basic Corporate Finance Functions

Generally = managing cash flows

Five basic functions

Raising capital via external financing

Capital budgeting function - choosing the best projects in which to invest resources

Financial management (cash flows)

Corporate governance

Five Basic Corporate Finance Functions (cont)

Risk management

Finance function: Financing

Raise money to support investment and other activities

Via

Internally by retaining and reinvesting operating profits

Externally from shareholders or creditors

Internally

Companies raise about two-thirds of their required funding internally each year

Externally

Sole proprietorships and partnerships have limited external funding opportunities

Corporations have varied opportunities

- selling equity (common or preferred stock)
- borrowing money from creditors
- Young and small corps usually raise equity capital privately, from friends and family, or from professional investors such as venture capitalists.
- **Venture capitalists** make high-risk/high--return investments in rapidly growing entrepreneurial businesses
- Larger corps can **go public** by conducting an initial public offering (IPO) of stock—selling shares to outside investors and listing the shares for trade on a stock exchange.
- After IPO, selling additional stock in the future

Growing Importance of Financial Markets

Traditional intermediaries (banks) useage as providers of debt capital to corporations has declined

Nonfinancial corporations often go to capital markets for external financing

New types of intermediaries: pension funds and mutual funds

Because

- Modern information processing enables investors to evaluate thousands of potential corporate borrowers and issuers of common and preferred stock equity
- These intermediaries are major purchasers of the securities non-financial corporations issue

Primary market transactions

Corporations sell securities to investors in exchange for cash

Raise capital

Firm actually receives the proceeds from issuing securities

Large fraction of all bond market transactions

True capital-raising events

Secondary-market transactions

After firms initial offering (IPO) investors can sell securities to other investors

Trades between investors

Generate no new cash flow for the firm

Most stock market transactions

Not true capital-raising events

Company

An entity created by charter, prescription or legislation

A 'person' seperate from shareholders

Many same economic rights / responsibilities as individuals

Owned by shareholders

- Shares of stock carry voting rights

- Shareholders vote at annual meetings to elect boards of directors (BOD)

- BOD hire / fire managers, and set corporate policys

Constitution

- Legal document

- Created at company's inception

- Parameters of corporate governance

- Can only be changed by vote of shareholders

Can sue and be sued

Can own property and execute contracts in their own names

Can be tried and convicted for crimes committed by their employees

Unlimited life - Perpetual life until explicitly terminated

Limited liability - Shareholders cannot be held personally liable

CEOs and chief financial officers (CFOs) can be held personally liable under the Sarbanes-Oxley Act if the debts result from improper accounting practices or fraudulent acts.

Separable contracting. Can contract individually with managers, suppliers, customers, and ordinary employees, and each contract can be renegotiated, modified, or terminated without affecting other stakeholders.

Company (cont)

Improved access to capital

- Can borrow money from creditors
- Can issue preferred and common stock to equity investors
- Ownership stock claims can be freely traded among investors without obtaining permission from other investors
- A public company can list shares on a public security market

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