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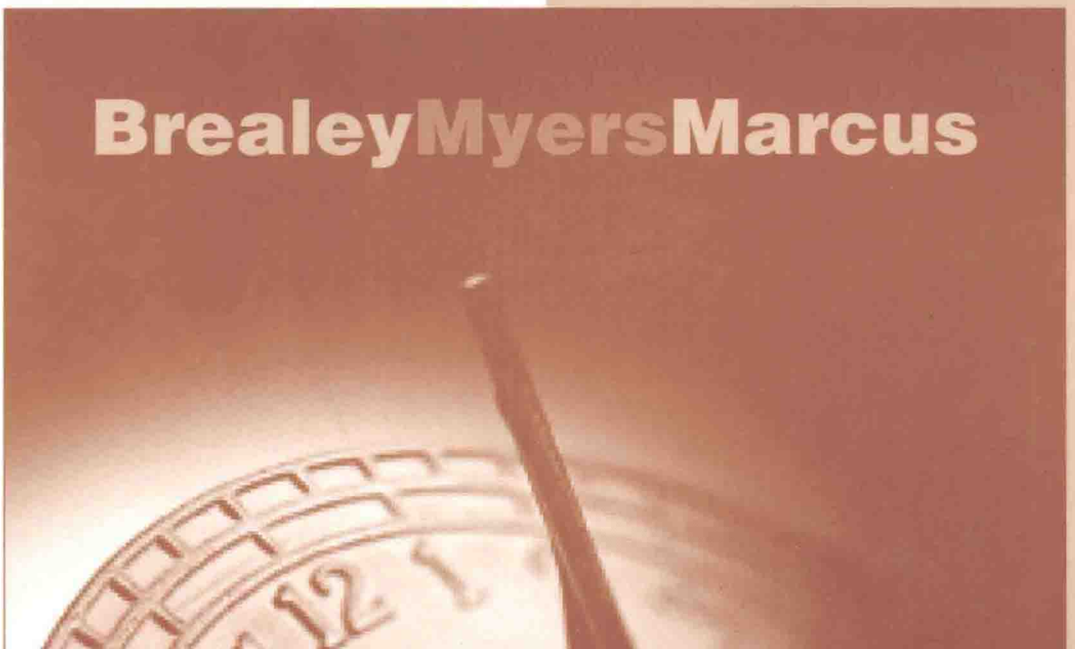

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Study Guide

for use with

Fundamentals of Corporate Finance

Second Edition

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CHAPTER 1

THE FIRM AND THE FINANCIAL MANAGER

INTRODUCTION

Like most first chapters of textbooks, the authors provide an introduction to the major areas of study and provide a brief overview of the topics and chapters which follow. Having a good overview of the scope of this course is important. One must have this overview or "big picture" because very soon each chapter will focus us on very detailed subjects. With a good understanding that this overview chapter provides, you will be able to see how the detailed chapter fits into the "big picture" of financial management. So focus early! Lock on, and let's go!

This first chapter provides an orientation to the study of financial management or financial decision making. Given a choice or several alternatives in a business decision, which should I choose? The criteria for choosing, or decision criterion used in this text, is the selection of the alternative which produces the highest value or maximizes value. What creates value in business assets or securities? That is a major topic in this course and several chapters focus on valuation theory, or what we and a lot of other people think affects value. We think that the future cash flow returns associated with a business asset or security affect the value as does the timing and variability or riskiness of those cash flows. So 1) cash flows, 2) timing or when the flow occurs, and 3) variability or riskiness of the cash flows receives considerable time and space in a finance class.

The financial manager or financial decision makers in any business have two major decisions: 1) what assets should we invest in, or the investment decision, and 2) how should we finance the assets, or the financing decision. Both decisions affect the value of the business, so several chapters are devoted to each. The capital budgeting chapters (6, 7 and 8) focus on tools for making value-creating investment decisions, while Part Four focuses on “financing” issues that are thought to impact value creation.

The choice of business organization has an impact upon the future cash flows, risk of the business, and the ability to raise capital. This choice has an impact upon the future value creating ability of the business, and thus it is important to discuss these concepts early.

LEARNING CHECKLIST

The major learning objectives of the chapter are listed below. Look at the list *before* reading the text and study guide chapter and *after*, just before you close the book or study session. Come back here and "check off" if you can discuss or write about the item in the learning objective, if you can tell someone else, in some detail, about the topic mentioned, or if you have done reasonably well in the text or study guide sample test questions related to the topic. In other words, if you can "check off" below, you know the material and are ready to test on it. Then it is time to move on to another topic.

After preparing this chapter, you should be able to:

____1. List the advantages and disadvantages of the following forms of business organization: sole proprietorship, partnership, and corporation.
____2. List and briefly discuss the business functions and major decisions associated with the financial manager.
____3. Explain why, even with many stakeholder interests in a business, shareholder wealth maximization is a reasonable basis for major business decisions.
____4. Explain what is meant by "agency problems," and how shareholders and boards of directors can provide incentives for managers to work toward shareholder value maximization.

SOURCES OF BUSINESS INFORMATION

Your professor has selected an excellent textbook package for you to learn financial management concepts. Finance is a really exciting subject and the concepts and principles discussed in the text are practiced every day by businesses, investors, governments, and financial markets and institutions. To keep up with this every day excitement, we encourage you to follow the current events of business and finance. While the library is a great, and prepaid source of recent business happenings, a subscription to publications such as The Wall Street Journal (WSJ), Business Week, Fortune, and other business publications is the best way to stay focused on recent business and finance events, and on the conditions in the job market. All of the items above are available through your professor at close to half price, if the professor places the order. If the WSJ form is passed around, consider it an opportunity to see the ideas of this class and your other business courses come alive every day. From major business announcements to personal money management, reading these business publications on a regular basis is one good sign that you are developing a professional attitude and are serious about your future.

In chapters to come, this section is devoted to highlighting a few important business and finance publications, many located in your library and the internet, with which you should be familiar. In the earlier chapters, the important areas of the WSJ are featured along with a number of finance and business web sites that have become popular. Later, important references and periodicals are discussed. Many of you will have assignments beyond this textbook, usually focused on work in the library or the internet. We hope the materials in this section may be of assistance with those assignments, and for some, help you prepare for a lifelong interest in finance.

CHAPTER OUTLINE, KEY CONCEPTS AND TERMS

I. ORGANIZING A BUSINESS

A. The choice of business organization affects the risk and the potential return in the form of after-tax cash flows and thus, the value of the business.

B. Compare and contrast the following business organizational forms by:
1. The exposure or risks of personal assets from a business venture--limited or unlimited liability.
2. The ease and cost of organization and maintenance of the business organization.
3. The expected life of the business under each form or business organization.
4. The relative tax exposure of the earnings of the business.
5. The relative ease of raising capital in financial markets.

	Sole Proprietorship	Partnership	Corporation
Who owns the business?	The Manager	Partners	Stockholders
Are managers and owners separate?	No	No	Usually
What is the owner's liability?	Unlimited	Unlimited (exceptions)	Limited
Are owners & the business taxed separately?	No	No	Yes

C. **Sole Proprietorship**

1. The sole proprietor business blends the personal and business assets of the individual toward a business venture.
2. The sole proprietor incurs unlimited liability (exposure of personal assets to business obligations), limited life, business and personal income/assets are viewed by taxing authorities as one, and because of these risks, has considerable difficulty raising funds in financial markets.

D. **Partnerships**

1. A partnership is an agreement of sole proprietors to pool their assets and talents in a business.
2. Like the sole proprietorship, partners are exposed to unlimited liability, limited life of the business, business income is combined with personal income for tax purposes; unlike a sole proprietorship, more than one person is involved, and thus, more capital may be raised in financial markets.

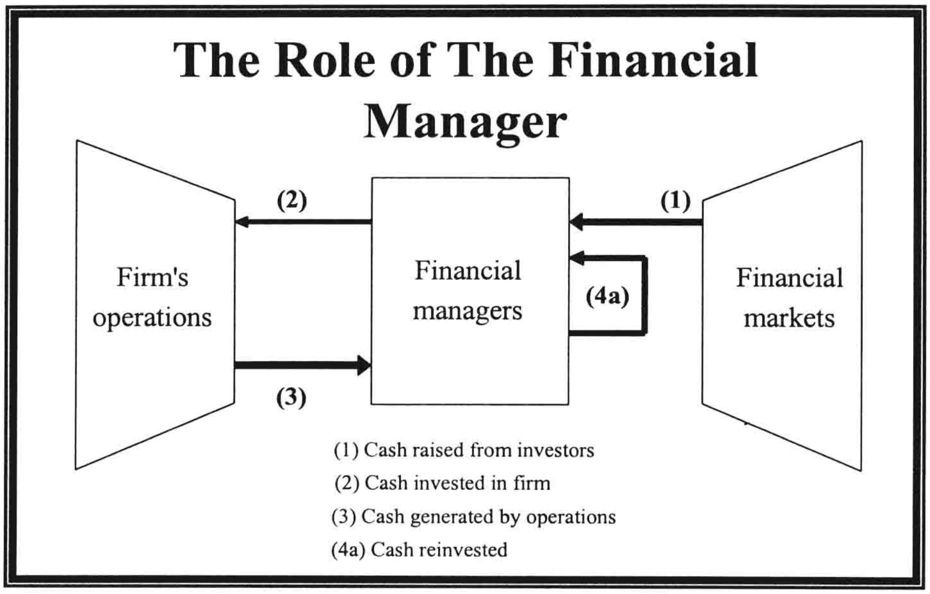
E. **Corporations**

1. A corporation is a legal entity separate from its owners called shareholders. The legal entity concept causes the corporation to differ considerably from the sole proprietorship and partnership: corporations are taxable entities, have perpetual lives, and are able to combine the capital of many shareholders, have greater organizational and legal costs, but are more likely to raise capital in financial markets.
2. Shareholder owners have limited liability, or their personal assets are free from the obligations of the corporations, and shareholders are more inclined to invest in riskier asset ventures to create value.
3. Shareholders vote for the board of directors, who in turn, appoint senior management, creating a separation of ownership and management of the business.
4. In a small, closely held business, the owner, board member and manager/worker may be the same person or family, while larger, corporations, with professional boards and management may have a broad base of shareholders or be known as public companies.

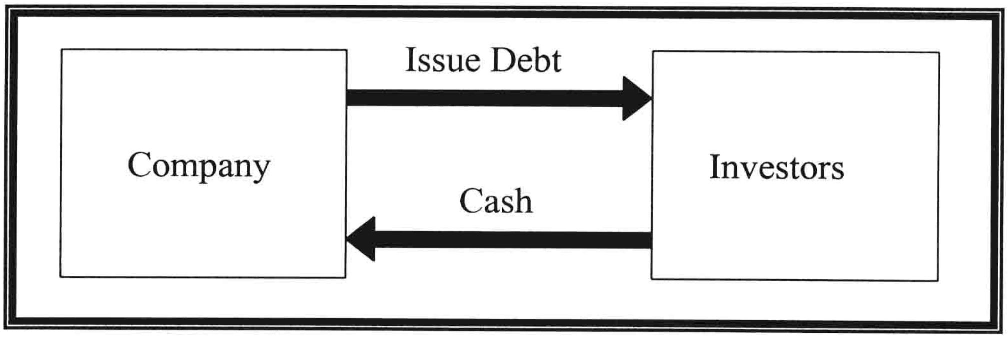
II. THE ROLE OF THE FINANCIAL MANAGER

A. The primary functions of the financial manager or financial decision-maker is to raise cash in financial markets (the financing decision), to invest cash (capital budgeting decision), to generate cash from efficient operations, and to allocate cash flows generated for reinvestment or to pay cash dividends.

B. Funds are raised in financial markets by selling financial assets or securities to investors (stocks and bonds) and investing cash in, in the case of manufacturing firms, in real assets, or physical assets used to produce goods and services.



C. The Capital Budgeting Decision
   1. The decision as to the amount and which real assets to acquire is a capital budgeting decision.
   2. Where cash if invested affects the amount of future cash flows generated, the timing of those cash flows, and the variability or riskiness of those future cash flows and thus, the value or worth of the capital budgeting decisions.



D. **The Financing Decision**
   1. The maturity and type of funds raised in financial markets is the financing decision.
   2. The selection and mix of long-term debt and equity securities in sold in capital markets determines the capital structure of the firm.

III. WHO IS THE FINANCIAL MANAGER?

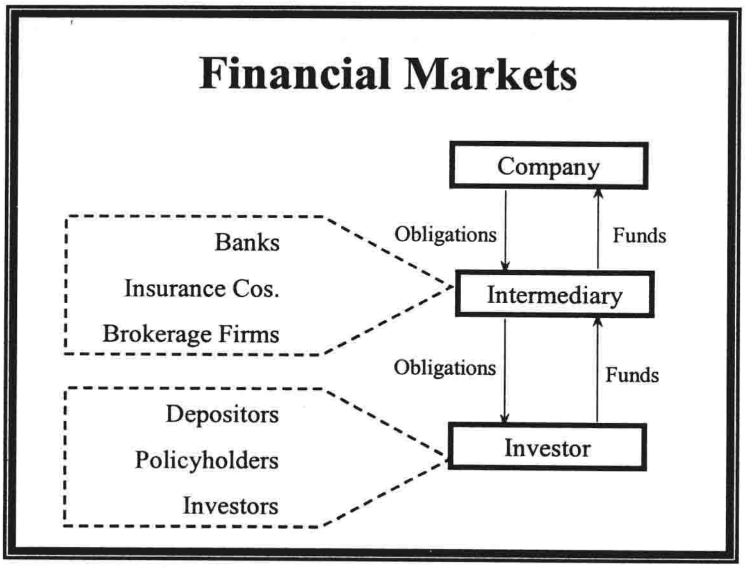
A. The financial manager refers to anyone responsible for a significant corporate investment or financing decision. The term is more oriented to the decisions rather than a specific title or job position. This book studies a number of financial manager decision areas, several of which, have a significant impact on shareholder value.

B. The classic financial manager titles are the treasurer and the controller, with the former more associated with financing, cash management, and financial market relationships and the latter associated with more traditional accounting functions of financial statements, budgeting, and auditing. The chief financial officer, in larger firms, oversees the treasurer and controller and is involved in formulating corporate strategy and financial policy.

C. **Understanding Financial Markets and Institutions**
   1. Knowing the players and procedures of financial markets is an important factor for a financial manager, influencing the cost of funds, terms, and other features of the fund raising activities.
   2. The choice and investment returns of capital budgeting decisions affects the value of the securities issued by the business. Thus, investment and financing decisions are closely related.

IV. FINANCIAL MARKETS AND INSTITUTIONS

A. Financial Markets
   1. Financial markets enable businesses to raise funds, enable investors to invest in financial assets, change or trade their portfolio of financial assets, and provide a continuous evaluation or valuation of the firm's securities.



   2. The initial sale of securities, where funds are acquired by the business, is called a primary issue or the securities are sold in the primary market.

3. Subsequent trading of the securities in the financial markets is said to trade on the secondary market, such as on stock exchanges or on the over-the-counter (OTC) market, where dealers trade inventories of securities held. Note: no new funds are raised by the firm in the secondary market; however, the firm's securities are evaluated or valued by the secondary market on a continuous basis.

B. Financial Institutions
1. A financial intermediary stands in between (is an intermediary) the saver/investor and borrower of funds, writing a **separate** contract for each.
2. Assets of financial institutions are financial assets such as loans and securities issued by borrowers; liabilities are contracts with investors or depositors.
3. Financial assets appear on two balance sheets as an asset (accounts receivable) and as a liability (accounts payable). Real assets, such as equipment, appear only on one balance sheet.
4. Besides functioning as an intermediary between lenders and borrowers, financial institutions:
   a. Serve as the center of the payments system of checks and electronic payments.
   b. Provide contract services permitting borrowers (loans) and savers (pension fund reserves) to transfer expenditures across time.
   c. Pool various risks in a portfolio, thus reducing the total variability or risk of the stock portfolio or auto insured customers.

V. GOALS OF THE CORPORATION

A. Shareholders want managers to make decisions based upon which alternative will maximize the value of the shareholders' investment.
1. Making decisions that maximize focuses the financial manager on expected cash flows from investments, the timing of the cash flows, and the variability or riskiness of those cash flows.
2. Other decision criterion, such as profit or market share maximization do not achieve value maximization. Making decisions based on profit maximization may focus on accounting income and not consider cash flow, is biased toward short run returns, perhaps ignoring the longer run implications of decisions, and ignores the relative riskiness of the alternatives.

B. Ethics and Management Objectives -- shareholders and the public are concerned that managers operate within the law and maintain the reputation and ethical good standing of the business. Fair and ethical relationships build and maintain long run value.

C. **Do Managers Really Maximize Firm Value?**

1. Shareholders are concerned that managers work for maximizing shareholders' wealth and not managers' wealth and lifestyle. Agency problems exist when managers, as agents of shareholders, have a conflict of interest with shareholders.
2. There are many diverse interests with a "stake" in well being of a business: managers, workers, suppliers, customers, government, shareholders, etc. These stakeholders' interest may conflict at times; managers must work to resolve these diverse interests.
3. Compensation plans motivate managers to work for their own best personal interest and the best interest of the shareholders, thus resolving some agency problems.
4. The board of directors, elected by shareholders, oversees and at times, interferes, if managers do not act in the best interest of shareholders.
5. Managers whose company does not perform for the best interest of shareholders are candidates for a takeover by a new investor group.

6. Every public company and its managers are scrutinized and monitored by stock analysts. This specialist monitoring tends to focus managers on value creation.

VI. TOPICS COVERED IN THIS BOOK -- Following the definition of the financial manager, this book first studies investment decision making, then financing decisions, then a variety of special issues. Please review the table of contents of your text.

COMPLETION QUESTIONS

1. Knowing which assets to buy involves a (*financing/investment*) decision.

2. Investment decisions are also called (*capital/cash*) budgeting decisions.

3. Knowing how to pay for assets is a (*finance/investment*) decision.

4. A business that is organized without partners or stockholders is called a ______________.

5. A business that is owned by stockholders is called a ______________.

6. Shareholders (*are/are not*) personally liable for obligations of the firm.

7. ______________ assets are used to produce goods and services.

8. Financial assets are called (*tangible assets/securities*).

9. A firm may raise cash in the _____________ markets.

10. The firm's mix of long-term financing determines its _____________ structure.

11. Long-term financing is available in the _____________ markets.

12. A new issue of securities is sold in the (*primary/secondary*) market.

13. The trading of existing securities among investors occurs in the (*capital/secondary*) market.

14. Shareholders want the firm to maximize its (*profits/market*) price.

15. In most large companies where managers are not major owners, a conflict of interest may occur. This is known as an (*agency/broker*) problem.

16. Anyone with a financial interest in the firm is known as a (*shareholder/stakeholder*).

17. The person in a company who is responsible for financing, cash management, and relationships with financial markets and institutions is called the (*controller/treasurer*).

18. The company officer who is responsible for budgeting, accounting and auditing is called the (*controller/treasurer*).

19. The chief (*executive/financial*) officer oversees the treasurer and controller and sets overall financial strategy.

PROBLEMS

As previously stated in the introduction of the Study Guide, this section presents problems similar to those in the corresponding chapter of the textbook. Those problems serve to illustrate applications of concepts and formulas. In the case of the first chapter, there were no quantitative problems and the relatively few conceptual matters covered have been treated in the Completion section above.

ANSWERS TO COMPLETION QUESTIONS

1. investment
2. capital budgeting
3. financing
4. partnership
5. corporation
6. are not
7. Real
8. securities
9. financial
10. capital
11. capital
12. primary
13. secondary
14. market price
15. agency
16. stakeholder
17. treasurer
18. controller
19. financial

CHAPTER 2

ACCOUNTING AND FINANCE

INTRODUCTION

In this second chapter the authors reinforce a number of basic accounting concepts that you established in your accounting courses. Accounting stresses generally accepted accounting principles (GAAP) as the basis for presenting financial statements. Historical cost, book value was one of the underlying basics of GAAP, but the financial manager and financial markets are focused on estimating market value. Accounting income differs from the financial manager's focus on cash flows, so the authors provide you with a finance perspective of accounting statements and the necessary adjustments needed for a value focus. Value is related to the future cash flows, the timing of the cash flows and the variability or riskiness of future cash flows. Note the futuristic orientation of finance versus the historical perspective of accounting statements.

The last part of the chapter keys on the federal income tax implications for proprietors (personal) and corporations. Taxes paid affects cash flows and cash flows impact value. Therefore, taxes affect value. Learn these few basics, such as marginal tax rate, average tax rate, after-tax concept, etc., for they will be used in future chapters.

LEARNING CHECKLIST

After preparing this chapter, you should be able to:

____1. Interpret the accounting information associated with basic financial statement such as the balance sheet, income statement, and the statement of cash flows.

____2. Distinguish between market and book value.

____3. Explain why accounting income may differ from cash flow in the period.

____4. Understand the basics of federal taxation of personal and corporate income.

SOURCES OF BUSINESS INFORMATION

The Wall Street Journal: The Wall Street Journal is a global business daily newspaper. We talk about finance in this class. The WSJ reports about people and organizations that *do* it and, make money doing it! The WSJ, besides the classic first page, has three sections: Section A is a newspaper with news and macro issues; Section B, entitled Marketplace, features companies and micro issues; and Section C, Money & Investing, focuses on financial market activity and issues.

In addition to the feature articles highlighted on the front page, there are many diverse and interesting columns in Section A. On the second page, the "Economy" section examines current economic events and issues. "Industry Focus" features business and industry analysis, while "International" provides news, discussion and analysis of our shrinking, more interdependent world. The "Leisure & Arts" section provides reviews and commentaries on a variety of areas including films, theater, books, television, sports, opera, and music. Finally, the "Review and Outlook" section provides the opinion of others on a variety of topics. Be sure and find the cartoon, "Pepper and Salt." "Politics and Policy" is assigned to the back page of Section A.

Business Internet Search Engines and Directories: All of the major search engines available from your browser, such as Netscape or Microsoft Explorer, have a business-related search area. Here you able to type in companies, products, industries, etc. and begin your assignments. From Yahoo, Infoseek, Excite, etc., located via the Netsearch button in Netscape, there are many other "search" sites that may help you. Directories are listings of speicific sites, classified by topic. A few interesting ones described below and easily accessed via my website at http://www.uakron .edu/cba/faculty/durst/durst.html.

WWWBusiness Yellow Pages--A directory of businesses on the Web, arranged by product or service.

Larry's InfoPower Pages--A directory of business sites on the Internet, annotated and rated for usefulness by a reference librarian.

BizInfo Search--An extensive directory of online business information and resources, categorized by industry, geography. Also a search engine, performing topic or keyword searches.

The Business Woman's Internet Directory: An extensive listing of woman's business resources, including a tutorial on using search engines.

Money Search: A search engine devoted to financial websites. Gives a short review of sites.

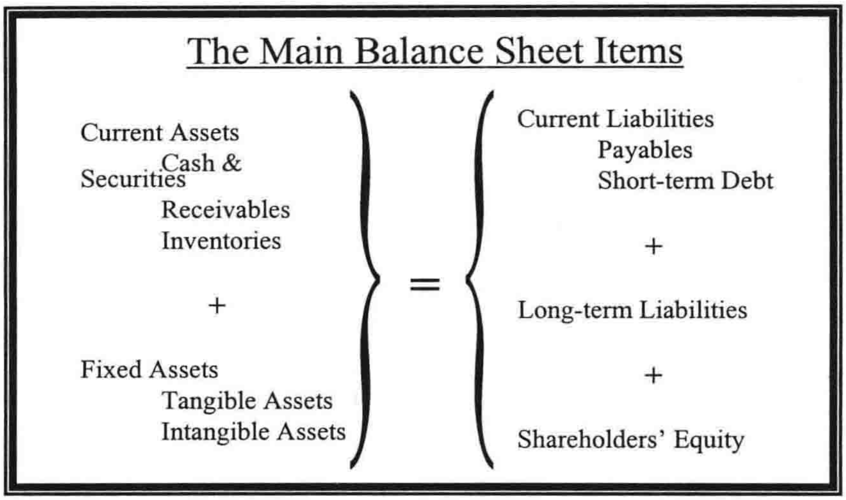
COMFIND: A database of corporate websites. The fastest way to find a company on the internet.

Starting Point: A great place to start your research on any topic. A combined search engine and directory of sites.

CHAPTER OUTLINE, KEY CONCEPTS AND TERMS

I. THE BALANCE SHEET

A. The **balance sheet** presents the accounting value of assets and the source of money used to purchase those assets at a particular time.



B. Assets are usually listed in descending order of liquidity, or the ability to convert to cash.

1. Cash and marketable securities, accounts receivables, and inventories are current assets, each of which expect to cycle through cash over the next year.
2. Longer term fixed assets, both tangible assets like plant and equipment and intangible assets such as patents and trademarks, will not be converted to cash but are expected to generate cash over future accounting cycles.

C. While the assets depict what is owned, liabilities and equity represent what is owed or who provided the funding for the assets.

1. Current liabilities, such as accounts payable, represent obligations requiring cash payment within the next year.
2. Current assets minus current liabilities is net working capital, or the extent to which current assets are financed with long-term sources of financing.
3. Long-term liabilities are debt obligations due beyond one year.