**INTRODUCTION:**

**COURSE MATERIALS AND LECTURE NOTES**

The Tenth Canadian Edition of ***Fundamentals of Corporate Finance*** can be readily adapted to meet the individual preferences of course instructors and the differing backgrounds and needs of introductory finance students. One of many possible sequences is listed below.

**Course Outline**

**Chapter Topic**

Chapter 1 Introduction to Corporate Finance

Chapter 2 Financial Statements, Cash Flow, and Taxes

Chapter 3 Working with Financial Statements

Chapter 4\*\* Long-Term Financial Planning and Corporate Growth

Chapter 5 Introduction to Valuation: The Time Value of Money

Chapter 6 Discounted Cash Flow Valuation

Chapter 7 Interest Rates and Bond Valuation

Chapter 8 Stock Valuation

Chapter 9 Net Present Value and Other Investment Criteria

Chapter 10 Making Capital Investment Decisions

Chapter 11\* Project Analysis and Evaluation

Chapter 12 Lessons from Capital Market History

Chapter 13 Return, Risk, and the Security Market Line

Chapter 14 Cost of Capital

Chapter 15\* Raising Capital

Chapter 16 Financial Leverage and Capital Structure Policy

Chapter 17 Dividends and Dividend Policy

Chapter 18 Short-Term Finance and Planning

Chapter 19 Cash and Liquidity Management

Chapter 20 Credit and Inventory Management

Chapter 21\*\* International Corporate Finance

Chapter 22 Leasing

Chapter 23 Mergers and Acquisitions

Chapter 24\*\* Enterprise Risk Management

Chapter 25 Options and Corporate Securities

Chapter 26\*\* Behavioural Finance: Implications for Financial Management

\* May be assigned as outside reading if time is short.

\*\* May be covered in part or omitted without loss of continuity if time is short.

*PowerPoint Note 1: If there is a slide that you do not wish to include in your presentation, choose to hide the slide under the “Slide Show” menu, instead of deleting it. If you decide that you would like to use that slide at a later date, you can just unhide it.*

*PowerPoint Note 2: Be sure to check out the notes that accompany the slides on the “Notes Pages” within PowerPoint.*

CHAPTER 1

**INTRODUCTION TO CORPORATE FINANCE**

**LEARNING OBJECTIVES**

After studying this chapter, students should understand:

**LO1** The basic types of financial management decisions and the role of the financial manager.

**LO2** The financial implications of the different forms of business organization.

**LO3** The goal of financial management.

**LO4** The conflicts of interests that can arise between managers and owners.

**LO5** The roles of financial institutions and markets.

**L06** Types of Financial Institutions

**L07** Trends in Financial Markets

**SLIDES**

**S1.1 : Key Concepts and Skills**

**S1.2: Chapter Outline**

**S1.3: Corporate Finance**

**S1.4: Financial Manager**

**S1.5: Financial Management Decisions**

**S1.6: Forms of Business Organization**

**S1.7: Sole Proprietorship**

**S1.8: Partnership**

**S1.9: Corporation**

**S1.10: Income Trust**

**S1.11 Co-operative**

**S113: Goal of Financial Management**

**S1.13: Primary Goal of Financial Management**

**S1.13: The Agency Problem**

**S1.14: Managing Managers**

**S1.15: Social Responsibility and Ethical Investing**

**S1.16: Work the Web Example (2 pages)**

**S1.18: What is the Role of Financial Markets in Corporate Finance?**

**S1.19: Cash Flows to and from the Firm**

**S1.20: Financial Institutions**

**S1.21: Trends in Financial Markets and Management**

**S1.22: Outline of Text**

**S1.23: Quick Quiz**

**S1.24: Summary**

**CHAPTER WEB SITES**

|  |  |
| --- | --- |
| *Section* | *Web Address* |
| 1.1 | [www.cfo.com](http://www.cfo.com) |
| 1.2 | [www.canadianlawsite.ca](http://www.canadianlawsite.ca) |
|  | [www.canadabusiness.ca](http://www.canadabusiness.ca)  [www.coop.gc.ca/](http://www.coop.gc.ca/) |
| 1.3 | [www.ethicscentre.ca](http://www.ethicscentre.ca) |
| 1.4 | [www.aircanada.ca](http://www.aircanada.ca) |
|  | [www.jantziresearch.com](http://www.jantziresearch.com) |
|  | [www.international.gc.ca/international/](http://www.international.gc.ca/international/) |
|  | [www.unepfi.org/fineadmin/documents/freshfields\_legal\_resp\_20051123.pdf](http://www.unepfi.org/fineadmin/documents/freshfields_legal_resp_20051123.pdf) |
| 1.5 | [www.rbcem.com](http://www.rbcem.com) |
|  | [www.osc.gov.on.ca](http://www.osc.gov.on.ca) |
|  | [www.tmx.com](http://www.tmx.com) |
|  | [www.nyse.com](http://www.nyse.com) |
|  | [www.microsoft.com](http://www.microsoft.com) |
|  | [www.intel.com](http://www.intel.com) |
|  | [www.world-exchanges.org](http://www.world-exchanges.org) |
| 1.6 | [www.globeinvestor.com](http://www.globeinvestor.com) |
|  | [www.ific.ca](http://www.ific.ca) |
|  | [www.terrapinn.com/2008/hfwcanada/](http://www.terrapinn.com/2008/hfwcanada/) |
|  | [www.hedgefund.net](http://www.hedgefund.net) |
| 1.7 | [www.royalbank.ca](http://www.royalbank.ca) |
| Internet Application | [www.tmx.com](http://www.tmx.com)  [www.cmhc.ca](http://www.cmhc.ca)  [www.sb.gov.bc.ca/bizstart-prop.php](http://www.sb.gov.bc.ca/bizstart-prop.php)  [www.goldmansachs.com](http://www.goldmansachs.com)  [www.nyse.com](http://www.nyse.com)  [www.socialinvestment.ca](http://www.socialinvestment.ca)  [www.janitziresarch.com](http://www.janitziresarch.com) |
|  |  |

##### CHAPTER ORGANIZATION

**1.1 CORPORATE FINANCE AND THE FINANCIAL MANAGER**

What Is Corporate Finance?

The Financial Manager

Financial Management Decisions

**1.2 FORMS OF BUSINESS ORGANIZATION**

Sole Proprietorship

Partnership

Corporation

Income Trust

Co-operative (Co-op)

**1.3 THE GOAL OF FINANCIAL MANAGEMENT**

Possible Goals

The Goal of Financial Management

A More General Goal

**1.4 THE AGENCY PROBLEM AND CONTROL OF THE CORPORATION**

Agency Relationships

Management Goals

Do Managers Act in the Shareholders' Interests?

Corporate Social Responsibility and Ethical Investing

**1.5 FINANCIAL MARKETS, AND THE CORPORATION**

Cash Flows to and from the Firm

Money versus Capital Markets

Primary versus Secondary Markets

**1.6 FINANCIAL INSTITUTIONS**

**1.7 TRENDS IN FINANCIAL MARKETS AND FINANCIAL MANAGEMENT**

**1.8 OUTLINE OF THE TEXT**

**1.9 SUMMARY AND CONCLUSIONS**

**ANNOTATED CHAPTER OUTLINE**

##### S1.1: Key Concepts and Skills

* Know the basic types of financial management decisions and the role of the financial manager
* Know the financial implications of the different forms of business organization
* Know the goal of financial management
* Understand the conflicts of interest that can arise between owners and managers
* Understand the various types of financial markets and financial institutions
* Know the types of financial institutions
* Understand and know the trends in the financial markets

##### S1.2: Chapter Outline

* Corporate Finance and the Financial Manager
* Forms of Business Organization
* The Goal of Financial Management
* The Agency Problem and Control of the Corporation
* Financial Markets and the Corporation
* Financial Institutions
* Trends in Financial Markets and Financial Management
* Outline of the Text

1.1 CORPORATE FINANCE AND THE FINANCIAL MANAGER

##### S1.3: Corporate Finance

**A. What Is Corporate Finance?**

*Corporate finance* is the study of the answers to the following questions:

*1. What long-term investments should we make? That is, what lines of business will you be in and what sorts of buildings, machinery, equipment, and research and development facilities will you need?*

*2. Where will we get the funds to pay for our investment? Will you bring in other owners or will you borrow the money?*

*3. How will you manage your everyday financial activities, such as collecting from customers and paying suppliers?*

In other words, the capital budgeting question, the capital structure question, and the net working capital question.

##### S1.4: Financial Manager

**B. The Financial Manager**

The *Chief Financial Officer, CFO*.

*Treasurer* - oversees cash management, financial planning, and capital expenditures.

*Controller* – oversees taxes, cost accounting, financial accounting, and data processing.

Financial managers try to answer some or all of these questions.

##### S1.5: Financial Management Decisions

**C. Financial Management Decisions**

*Capital budgeting* - The process of planning and managing a firm’s investments in fixed assets. It is concerned with the *size*, *timing*, and *riskiness* of cash flows.

*Capital structure* - The mix of debt and equity used by a firm. What are the least expensive sources of funds? Is there a best mix? When and where to raise funds?

*Working capital management* - Managing short-term assets and liabilities. How much cash and inventory to keep around? What is our credit policy? Where will we obtain short-term loans?

1.2 FORMS OF BUSINESS ORGANIZATION

## S1.6: Forms of business organization

Three major forms: Sole Proprietorship

Partnership

Corporation

Income Trust

Co-operative (Co-op)

##### S1.7: Sole Proprietorship

**A. Sole Proprietorship**

*Sole Proprietorship* - A business owned by one person. Easy to start up, with low regulation, and profits are taxed as personal income. But involves *unlimited liability*, its life is limited to the owner’s, and the equity that can be raised is limited to the proprietor’s wealth.

##### S1.8: Partnership

**B. Partnership**

In a partnership there are multiple owners.

*General partnership* - All partners share in gains or losses, all have unlimited liability for all partnership debts.

*Limited partnership* - One or more *general partners* will run the business and have unlimited liability. The *limited partner's* liability is limited to their contribution to the partnership.

Partnerships allow more equity capital than is available to a sole proprietorship, are relatively easy to start up, and are taxed at the personal rate. But there is *unlimited liability*, and the partnership dissolves upon death or sale. Furthermore, it is difficult to sell and there can be disputes between partners.

##### S1.9: Corporation

**C. Corporation**

A corporation is a business created as a distinct legal entity composed of one or more individuals or entities.

Corporations are the most important form of business organization in Canada. There are several advantages to the corporate form:

*1. Limited liability for stockholders.*

*2. Unlimited life for the business.*

*3. Ownership can be easily transferred.*

*4. Professional management (separation of ownership and management)*

These characteristics make it easier for corporations to raise capital.

The disadvantage to corporations is *double taxation* and *management is different from ownership (principal-agent problem)*

##### S1.10: Income Trust

**D. Income Trust**

Business income trusts (also called income funds) hold the debt and equity of an underlying business and distribute the income generated to unit holders.

Because income trusts are not corporations, they are not subject to corporate income tax and their income is typically taxed only in the hands of unit holders. As a result, some investors viewed trusts as tax efficient and were generally willing to pay more for a company after it converted from a corporation to a trust.

##### S1.11: Co-operative (Co-op)

A co-operative is an enterprise that is equally owned by its members, who share the benefits of co-operation based on how much they use the co-operative’s services.

The co-ops are generally classified into four types:

1. Consumer Co-op
2. Producer Co-op
3. Worker Co-op
4. Multi-Stakeholder Co-op

##### S1.12: Work the Web Example

The Internet can help people to get information about how to start a new business.

One excellent site is www.canadabusiness.ca

1.3 THE GOAL OF FINANCIAL MANAGEMENT

## S1.13: Goal of Financial Management

**A. Possible Goals**

There are many possible goals - some involve profit, some not.

**B. The Goal of Financial Management**

Maximize the current value per share of existing stock.

**C. More General Goals**

To increase the market value of equity, even for private firms.

The goal does not imply illegal or unethical practices.

##### S1.14: Primary Goal of Financial Management

Three equivalent goals of financial management:

Maximize shareholder wealth

Maximize share price

Maximize firm value

1.4 THE AGENCY PROBLEM AND CONTROL OF THE CORPORATION

# S1.15: The Agency Problem

**A. Agency Relationships**

The relationship between stockholders and management is called an *agency relationship*. This occurs when one party (*principal*) pays another (*agent*) to represent them. The possibility of conflict of interest between the parties is termed the *agency problem*.

**B. Management Goals**

The goals of management may conflict with those of shareholders.

*Agency costs* - Two types: *direct* and *indirect*. Direct costs come about in compensation and perquisites for management. Indirect costs are the result of monitoring managers.

**C. Do Managers Act in Shareholders’ Interest**

Whether managers do, in fact, act in the best interest of shareholders depends on two factors. First, how closely are management goals aligned with shareholder goals? Second, can managers be replaced if they do not pursue shareholder goals?

##### S1.16: Managing Managers

**C. Do Managers Act in the Stockholders’ Interests?**

The alignment between management and shareholders is influenced by compensation, possible change of control, and stakeholder claims.

*Managerial compensation* - Firm performance and management compensation and prospects are linked.

*Control of the Firm* - Management can be replaced by several methods which involve stockholders, such as proxy fights or takeovers.

*Stakeholders* - Anyone who potentially has a claim on a firm, including creditors and employees.

##### S1.17: Social Responsibility and Ethical Investing (2 pages)

**D. Corporate Social Responsibility and Ethical Investing**

Many large corporations maintain specific policies on important social issues and there is a growing trend among many investors to make an effort to invest in socially responsible firms while at the same time deemphasizing businesses engaged in various controversial business activities.

Issues include treatment of the community, customers, the environment, and human rights

* Work the web example:
  + The Internet provides a wealth of information about individual companies
  + One excellent site is ca.finance.yahoo.com
  + Click on the web surfer to go to the site, choose a company and see what information you can find!

1.5 FINANCIAL MARKETS AND THE CORPORATION

##### S1.18: Financial Markets and the Corporation?

# A. Cash Flows to and from the Firm

*Financial markets*: As is typical of other markets, financial markets are a mechanism that brings buyers and sellers together. Here debt and equity securities are bought and sold.

**B. Money versus Capital Markets**

*Money market* - The market in which short-term (1 year or less) securities are bought and sold. It is a *dealer market*, i.e., dealers buy and sell from their inventories.

*Capital market* - The market for long-term debt and equity shares. It is primarily a *brokered market*, i.e., brokers match up buyers and sellers.

**C. Primary versus Secondary Markets**

*Primary market* - Refers to the original sale of securities. *Public offer*, *SEC registration*, *underwriters* are part of this market.

*Secondary market* - Refers to the resale of securities. *Stock exchanges (TSE)* and the *over-the-counter*, *OTC*, are parts of this market.

*Listing* - Stocks that trade on an exchange are said to be *listed*.

##### S1.19: Cash flows to and from the Firm

1. The firm issues securities to raise cash
2. Firm invests in assets
3. Firm’s operations generate cash
4. Cash is paid to government as taxes, and to other stakeholders
5. Reinvested cash flows are plowed back into the firm
6. Cash is paid to investors in the form of dividends and interest

1.6 FINANCIAL INSTITUTIONS

**S1.20: Financial institutions**

**A. Financial Institutions**

*Intermediaries* - Financial institutions make funds available to firms from the funds placed in their trust by investors. Examples of financial institutions or intermediaries include: *chartered banks*, *trust companies*, *investment dealers*, *insurance companies* and *mutual funds*.

*Indirect finance* - funds are supplied to demanders through a financial intermediary. One example is a bank loan.

*Direct finance* - funds are supplied to demanders directly from suppliers - with no financial intermediary. One example is a bond issue directly to the end bondholder.

1.7 TRENDS IN FINANCIAL MARKETS AND FINANCIAL MANAGEMENT

##### S1.21: Trends in Financial Markets and Management

* + *Financial engineering* - the creation of new securities or financial processes which help to reduce risk, lower financing costs and/or minimize taxes. A controversial example of this is the *credit default swap* in the United States.
  + *Derivatives* – financial assets that depend on the value of other assets
  + *Technology* such as E-business
  + *Corporate Governance* reform
  + *Excessive leverage – the lead up to the financial crisis was the result of high amounts of leverage*

1.8 OUTLINE OF THE TEXT

**S1.22: Outline of the Text**

Part One: Overview of Corporate Finance

Part Two: Financial Statements and Long-Term Financial Planning

Part Three: Valuation of Future Cash Flows

Part Four: Capital Budgeting

Part Five: Risk and Return

Part Six: Cost of Capital and Long-Term Financial Policy

Part Seven: Short-Term Financial Planning and Management

Part Eight: Topics in Corporate Finance

Part Nine: Derivative Securities and Corporate Finance

**S1.23: Quick quiz**

* What are the three types of financial management decisions and what questions are they designed to answer?
* What are the three major forms of business organization?
* What is the goal of financial management?
* What are agency problems and why do they exist within a corporation?
* What is the difference between a primary market and a secondary market?

1.9 SUMMARY AND CONCLUSIONS

**S1.24: Summary**

* You should know:
  + The advantages and disadvantages between a sole proprietorship, partnership and corporation
  + The primary goal of the firm
  + What an agency relationship and agency cost are
  + What ethical investing is
  + The role of financial markets
  + The role of financial institutions