



FN 201 BUSINESS FINANCE



Lecture 3

Topics: Business Type, Debt and Equity

Agenda



- Business Type
- Organizational Structure of firm
- Financial Manager
- Debt vs Equity

Business Type

□ Issue of Ownership VS Management

□ Proprietorship or sole proprietorship

- Same ownership and management

- 3 important advantages:
 - (1) Easily and inexpensively formed
 - (2) Subject to few government regulations
 - (3) Income is not subject to corporate taxation but is taxed as a part of personal income

- 3 important limitations:
 - (1) Difficult to obtain capital needed for growth and expansion
 - (2) Unlimited personal liability for the business's debts -> losses can exceed money invest in the company
 - (3) Company life is limited

Business Type (2)

□ Issue of Ownership VS Management

□ Partnership

- Joint ownerships and managements
- Similar advantages and disadvantages to proprietorship
- Also there is difficulty in transferring ownership
- Regarding the liability issues, you could establish “limited partnership”, but certain partners will have to be “general partners” (with unlimited liability).

Business Type (3)

□ Issue of Ownership VS Management

▣ Corporation

- Separated ownership and management
 - Shareholders vote to elect board of directors (BOD) to represent them
 - BOD appoints top managements and is supposed to ensure that management body act in the shareholder's best interests

- Corporation is a separate legal entity from shareholders
 - is a “legal person”, it can borrow or lend money, and it can sue or be sued etc.

Business Type (4)

□ Issue of Ownership VS Management

□ Corporation

■ Key Advantages

- Unlimited life
- Easy transferability of ownership
- Limited liability
- Specialization of management
- Efficient risk sharing

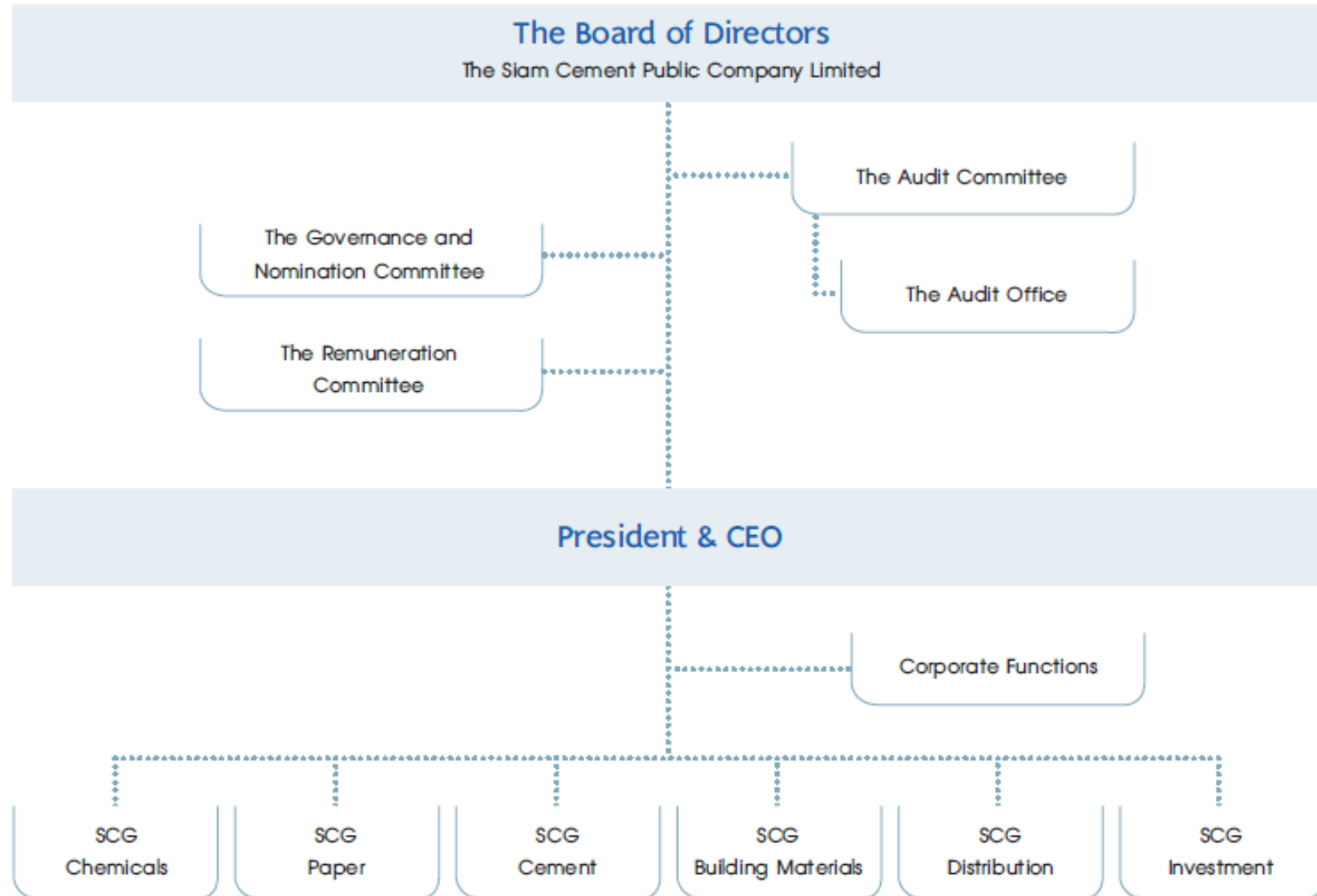
■ Key Disadvantages

- Double taxation
- High cost of setting up and running the corporation

Primary Objectives of Corporation

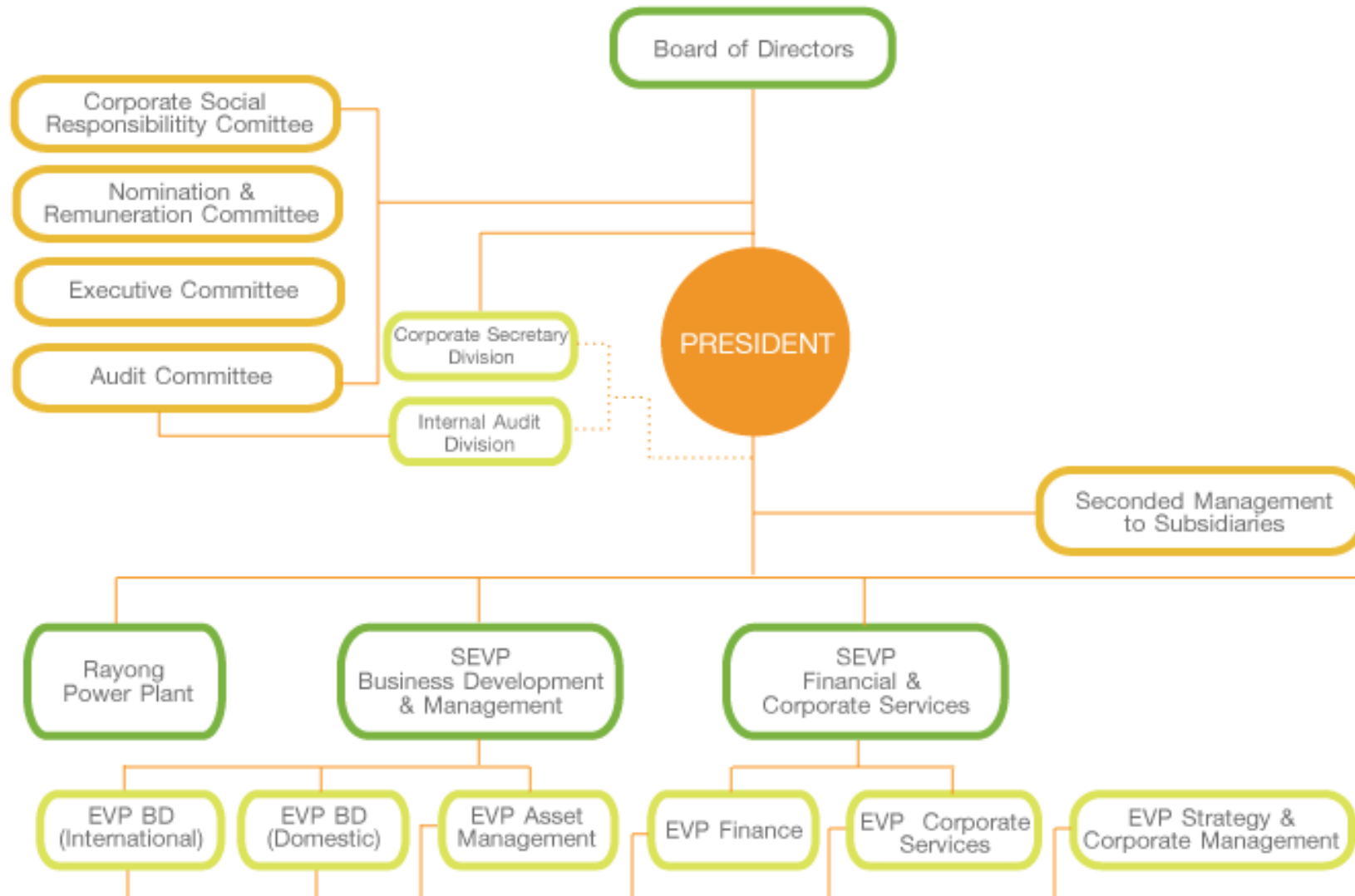
- Shareholders are the owners of a corporation
 - ▣ Shareholders elect directors
 - ▣ Directors hire managers to run business on day-to-day basis
 - ▣ Manager should act for best interest of shareholders
- There are potential conflicts between shareholders and management as well as among shareholder themselves

SCG Organizational Structure



EGCO Organizational Structure

Organization Chart



Potential Conflicts

- Conflicts b/w shareholders and management arise due to:
 - Different time horizon for individual shareholder's interest
 - Information asymmetries between shareholders and managements
 - As a result, corporation has high (agency) cost

- Conflicts among shareholders also arises due to:
 - Different time horizon for individual's interest
 - Risk Appetite

Management's Objective

- Management's primary objective should be shareholder wealth maximization
 - Or maximize firm's value
 - What about social corporate responsibilities (CSR)?

- What determines a firm's value?
 - Ability to generate cash flows now and in the future

- How to maximize firm's value?
 - Capture investment opportunity with net (present) value greater than zero

Who does finance in the Firm?

➤ Financial Managers refer to anyone responsible for a significant investment or financing decision..

➤ Top manager, CFO, Treasurer, Controller and even the Board of Directors

Chief Financial Officer (CFO)

- Financial policy
- Corporate planning
- Supervising capital budgeting process

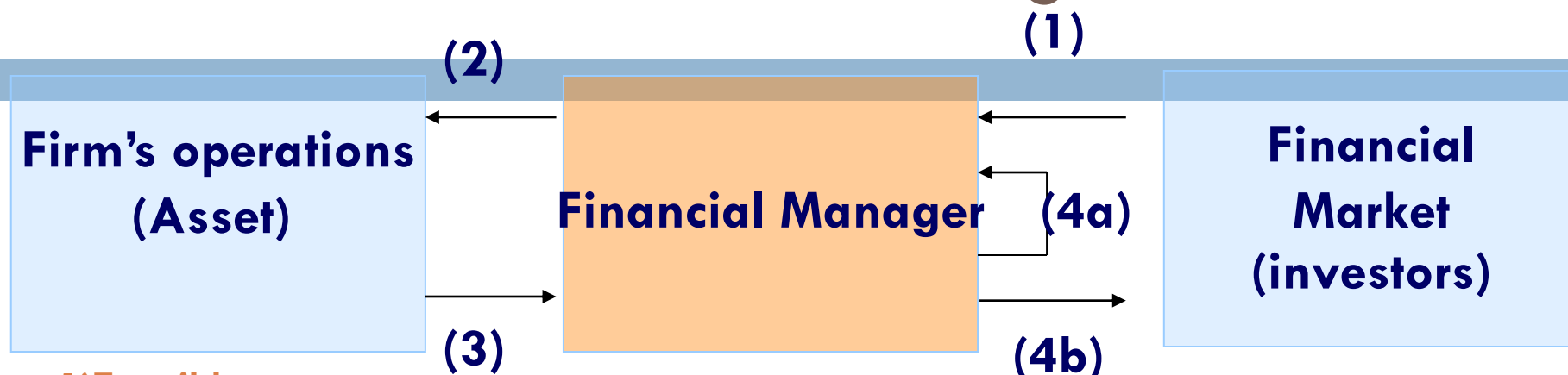
Treasurer responsible for:

- Cash management
- Raising capital
- Banking relationship

Controller responsible for:

- Preparation of financial statements
- Accounting
- Taxes

Financial Manager



- **1) Tangible**
 - Machinery
 - Factories
 - Offices
- **2) Intangible**
 - Expertise
 - Trademark
 - Patents

- **Financial Manager stands between firm and financial markets (Investors)**
- **Financial markets mean : 1) Capital (equity) and 2) Money Markets (debts)**
- **2 Basic questions**
 - What real assets should firm invest? (Investment decision) -> whether project is worth more than capital required to undertake it
 - How should the cash for investment be raised? (Financing decision) -> how it should be financed

- **Claims on real assets or cash generating from those assets**
 - Bank loans
 - Shares of stock
 - Bonds



Debt and Equity



	Debt	Equity
Title of holders	Creditor	Shareholders
Ownership in firms	No	Yes
Limited return	Max return is interest earned	Unlimited gain
Seniority of payment	Higher	Lower
Ability to transfer (liquidity)	Depend	Depend
Time limit	Specified maturity	Whenever
Loss	Limited loss	Unlimited loss



Q & A

