

Course: Corporate Finance

Week One: Lecture 1- Introduction to Corporate Finance

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Introduction & Welcoming Note

- My name is Dr. Charity Njoka
- Am delighted to take you through Corporate Finance Course
- This lesson is purely theoretical, future lessons will have some calculations
- Welcome we learn together

Class Requirements

- A scientific Calculator
- Lecture notes to be provided
- Access to the Internet

Course Text Books:

1. Corporate Finance: Hillier, D, S Ross, R Westerfield, J Jaffe, & B Jordan, McGraw- Hill Education, 2022
2. Principles of Corporate Finance, Brealey, Myers & Allen, The McGraw-Hill Companies, Inc., 2007.
3. Any other book on Introduction to/Principles of Corporate Finance

Intended Learning Outcomes

By the end of this lesson 1, you should be able to,

1. State the meaning and identify the scope of Corporate Finance
2. Discuss objective of a firm: Profit Maximisation Vis- a- Vis Wealth Maximisation
3. Discuss Shareholders Value Maximization Concept
4. Identify agency relationships within a firm
5. Discuss Agency problem and its mitigation

What is Corporate Finance and Corporations by Extension?

- ✓ Corporate Finance: A field of finance that deals with sources of funding/ capital structure, allocation of funds /capital budgeting and other activities to maximise the value of the business
- ✓ Corporations: These are businesses operating in different industries. They can be big or small in terms of membership, products/ Services they offer, number of employees they offer etc.

Characteristics of a Corporation.

1. Are legal entities – Legally they are distinct from the owners (shareholders) and pay their own taxes
2. Have limited liability – Shareholders can only lose their initial investments in case of bankruptcy; their personal property cannot be sold to pay obligations of the business
3. Separated ownership and Control – Owners engage managers to control/ manage the firms on their behalf

Types of Corporations

There are **two** types: Public and Private Companies

Features of a Public Company

- ✓ A minimum Membership (shareholders) but there is no maximum
- ✓ Shares are traded in a stock/ security Exchange – Such companies are hence known as quoted or listed companies

NB-Check the minimum members/Shareholders for quoted firms in your country

Types of Corporations- CtD

Features of a private Company

- ✓ A minimum Membership (shareholders) but there is a maximum
- ✓ The company cannot offer its shares for sale to the general public, the shares are not freely transferable

NB-Check the minimum and Maximum members for private Companies in your country

Scope of Corporate Finance

Corporate Finance covers wide range of issues:

1. Which investments should the company undertake? Acquisitions of businesses, physical assets, and if so which?
2. How, where, when and how much finance should the firm raise? Borrowing or raising funds from within, how many USD etc
3. How should the firm's profit be used or distributed? The percentage to be withheld for reinvestment purposes, to be paid out as dividend and the form of dividend etc

Main Firms/Corporate Decisions

The main issues facing a firms Financial manager are commonly referred to as;

1. The investment Decisions
2. The financing Decisions
3. The Dividend Decisions

Objectives/Goals of a Firm

1. Profit Maximisation.

where, Profit = Revenue – Costs

Limitations of this goal:

- The term profit is vague/ ambiguous; is it Gross profit, Net profit, Profit before tax or Profit after tax?
- Risky projects may be undertaken to achieve this objective

Limitations of Profit maximization CtD

- The objective does not take into account the time value of Money- it assumes money has equal purchasing power over time
- The objective is too narrow- fails to take into consideration the interests of employees, consumers etc- This goal is inward looking/ self centred from managers perspective

Objectives/Goals of a Firm- Profit Maximisation CtD

Disadvantages of Profit Maximisation

- Emphasizes short term gains- How much profits has the firm made in the first 4, 6 or 12 months, of from a project etc
- Ignores risk or uncertainty- Riskier projects can be undertaken if they seem profitable
- Requires immediate Resources- to achieve the profits foreseen

Goals of a Firm, CtD

2. Shareholder's Wealth/ Value Maximisation

- Refers to maximization of the net present value (NPV) of every decision made in the firm.

- Wealth= present value of benefits – present value of costs.

For a quoted company, it refers to maximising market value of the firm's share price NB: NPV to be handled later (I have uploaded Present Value and Future Value Tables – feel free to print)

Goals of a Firm- Wealth Maximisation CtD

Limitations & Disadvantages of this Objective

1. No clear relationship between financial decisions and share price
2. Can lead to management anxiety and frustration-

Advantages

Emphasizes Long term gain

- Recognise timing of returns
- Considers shareholders Returns
- Recognises risk or uncertainty

Other goals of a Firm, CtD

3. Attaining a larger market share
4. Promoting employee welfare
5. Increasing customer satisfaction
6. Gain leadership on markets in terms of technology and Products
7. Achieving higher growth rate- eg sales
8. Business Survival

NB. All these other objectives are primal to shareholders wealth maximisation if no personal interests are in place

Conflicts in Profit VS Value Maximization Principle

1. Management decision making authority may tend to pursue profit maximization – especially where bonuses are based on profits
2. Evaluation of management is fulfilment of the respective stakeholder(s) objective ; thus survival of management may be threatened if stakeholders objectives are not fulfilled- Hence they will pursue objective of the stakeholder

Conflicts in Profit VS Value maximization Principle.. CtD

3. Wealth maximisation objective is generally aligned to interest of various groups hence it may be consistent with management objective of survival- Majority of stakeholder groups(Lenders, shareholders etc) are wealth oriented hence this will be the goal of management too

4. Taking into account the timing and social consideration, profit maximisation in the real world may be uncertain, hence wealth maximisation may be the a better objective.

Stakeholders in a Firm

1. Management
2. Owners/ Shareholders
3. Employees
4. Customers
5. Suppliers of goods and services and utility providers
6. Lenders
7. Government
8. Financial Analysts
9. Competitors
- 8 General Community

Agency Relationship

Agency relationship arises where one person (Agent) undertakes to act on behalf of another or carry out activities of another person (Principal)

Types of Agency Relationships in a Firm

1. Shareholders Vs Management
2. Lenders Vs Firm/ Business
3. Shareholders Vs Auditors
4. Business Vs Employees
5. Government Vs Business

Agency Problem and Agency Costs

- ✓ Agency problem arises where the agent places personal goals ahead of those of the principal.
- ✓ Agency Costs – costs incurred to align the goals of an agent with those of the principal; these costs are mostly borne by the Principal

Why Agency Relationship ?

In case of corporations , **managers will act on behalf of shareholders** because;

1. There are very many shareholders who cannot effectively manage the firm all at the same time.
2. Shareholders may lack the skills required to manage the firm.
3. Shareholders may lack the required time.
4. Shareholders may be widely dispersed- ie Geographically/Physically dispersed

Conflicts Between Management & Shareholders

1. Managers may not work hard to maximize shareholders wealth if they perceive that they will not share in the benefit of their labour.
2. Managers may award themselves huge salaries and other benefits more than what a shareholder would consider reasonable
3. Managers may maximize leisure time at the expense of working hard.

Conflicts Between Management & Shareholders...CtD

4. Manager may undertake projects with different risks than what shareholders would consider reasonable.
5. Manager may undertake projects that improve their image at the expense of profitability- Empire building
6. Management buy out is threatened. 'Management buy out' occurs where management of companies buy the shares not owned by them and therefore make the company a private one.

Solutions to Conflict between Management & Shareholders

1. Incur Agency Costs in the form of:

- ✓ Monitoring expenses such as audit fee;
- ✓ Tighter internal controls

2. Offer the management profit-based remuneration, can be

- ✓ Bonuses based on profits
- ✓ Share options: (Option to buy shares at a fixed price at a future date).

3. Threat of firing- During AGM

4. Threat of acquisition

Agency Problem: Lenders & Shareholders/ Management

Creditors lend funds to the firm at rates that are based on:

- i. Riskiness of the firm's existing assets
- ii. Expectations concerning the riskiness of future assets additions
- iii. The firm's existing capital structure
- iv. Expectations concerning future capital structure changes.

NB: Shareholders (acting through management) may make decisions which will cause the firm's risk to change. This will affect the value of debt eg Borrowing more debt

Agency Problem: Lenders & Shareholders/ Management

Shareholders (acting through management) may make decisions which will cause the firm's risk to change. This will affect the value of debt

These may include

1. Borrowing more debt
2. Selling the Collaterals
3. Undertaking risky projects
4. Undertaking different projects than those for which the funds were borrowed for

Solutions to conflicts Between Lenders & Shareholders

1. Insisting on restrictive covenants to be incorporated in the debt contract. These covenants may restrict:

- ✓ The company's asset base
- ✓ The company's ability to acquire additional debts
- ✓ The company's ability to pay future dividend and management remuneration.
- ✓ The management ability to make future decision (control related covenants eg management buy out)

Solutions to conflicts Between Lenders & Shareholders..CtD

2. Refuse to deal further with the firm
3. Require a much higher than normal rate of interest to compensate for the risks of such possible exploitations.
4. Representation in board of Directors

Conflicts Between Auditors and Shareholders

1. Colluding along with the management in performance of their tasks whereby their independence is compromised
2. Demanding a very high audit fee that reduces the profits of the firm even if there is unimportant audit work because of the strong internal control system existing in the firm.
3. Failure to exercise professional care and due diligence in the performance of their duties and hence failing to detect errors and frauds which they could have otherwise detected

Solutions to conflicts Between Auditors and Shareholders

1. Legal action – shareholders can institute legal proceedings against auditors who issue misleading reports in order to be compensated for damages
2. Disciplinary action by professional bodies for example the institute of certified public accountants of the country in which the audit firm is registered and practicing

Conflicts Between Firms/Shareholders and Government

1. Tax evasion – Failing to give accurate picture of earnings of a company to minimise taxes
2. Avoiding investing in certain areas or in businesses which are considered risky
3. Not taking part in social responsibilities

Solutions to conflicts between Firms and Government

NB. Firms are owned by shareholders;-

1. By insisting on a more independent Board of directors
2. Mandatory disclosure of the firms financial performance, especially for quoted firms
3. Government Representation in the board of directors especially where it is a shareholder

Conflicts between Employees and Managers/Firms

1. Failure to attend to their duties/ laziness/ absenteeism
2. Theft, pilfering etc
3. Lack of morale/ enthusiasm in ones work leading to customer loss

Solutions to conflicts between Employees and Firms

1. Bonuses based on ones productivity
2. Offer employee benefits- eg Medical cover, annual leave etc
3. Salary increment to cater for inflation etc

THE END

- We have come to the end of Lecture one for week one
- It was nice having you in this class
- See you in the next class
- I have uploaded present value and Future Value Tables – to be used in next lesson and in future