

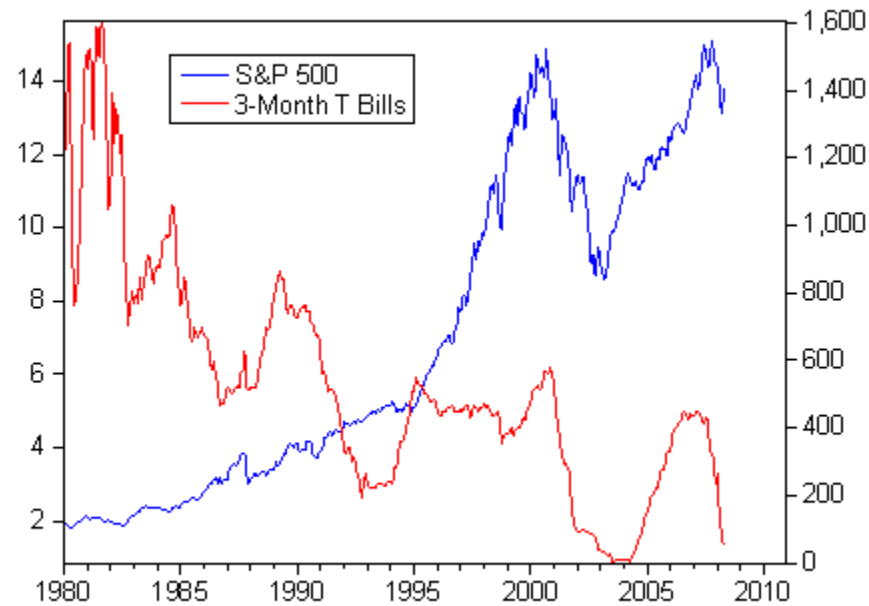
# Lecture 1

## Financial Institutions

## Financial Managers Role

FINA 614  
Summer 2014

# Interest rates and Equity



# Without FIs

**Equity & Debt**

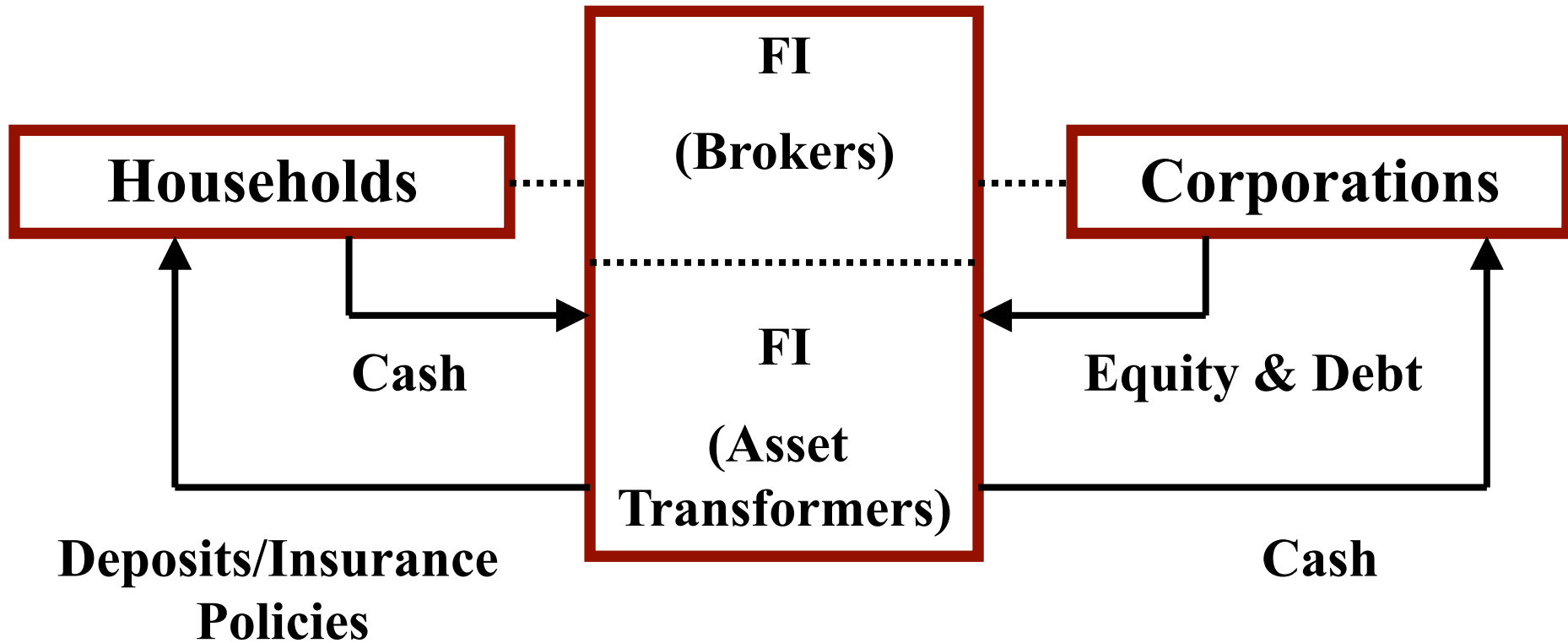


**Households**  
**(net savers)**

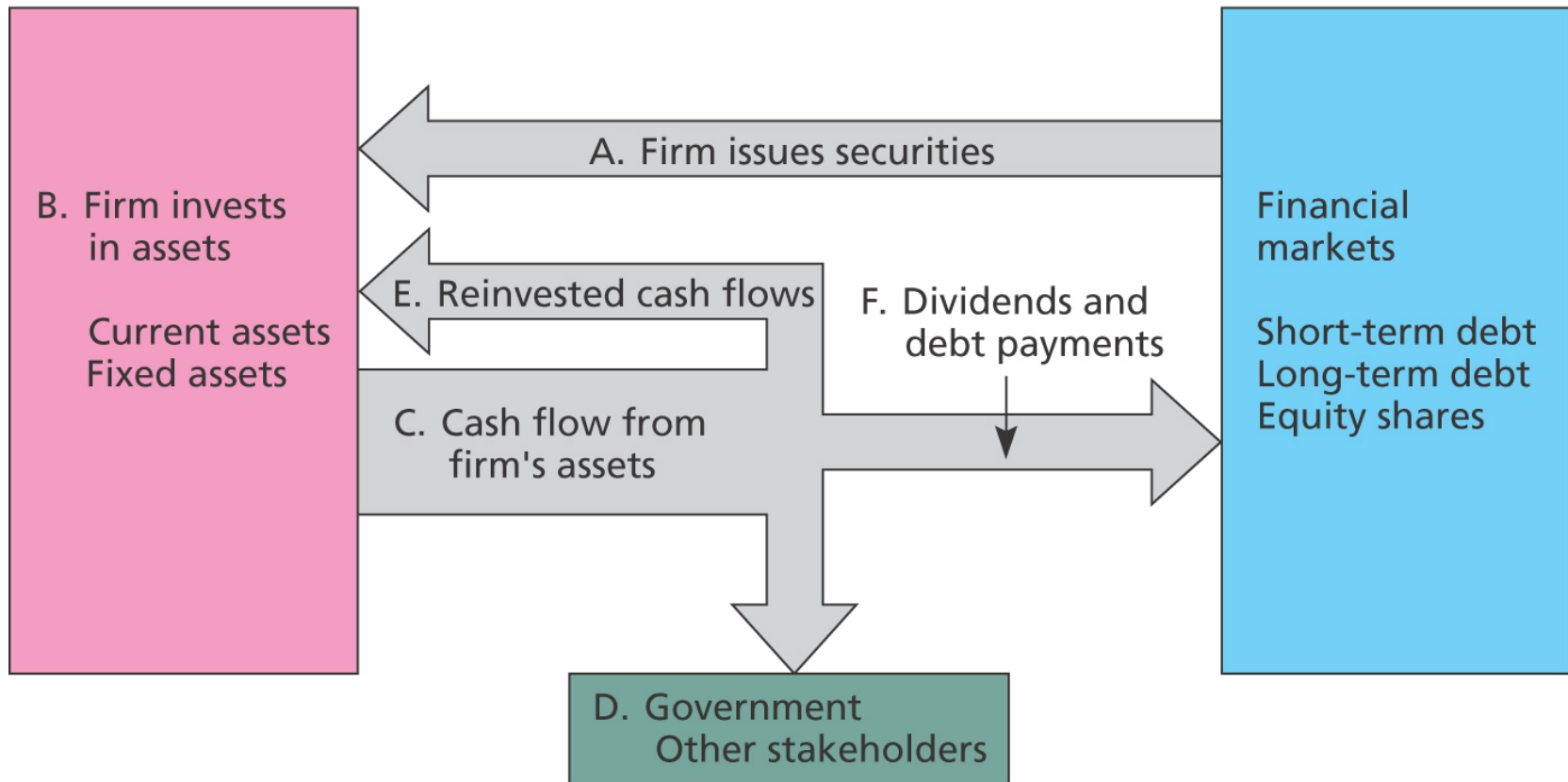
**Corporations**  
**(net borrowers)**

**Cash**

# With FIs



# Cash Flows to and from the Firm



A. Firm issues securities to raise cash.  
B. Firm invests in assets

D. Cash is paid to government as taxes. Other stakeholders may receive cash

# Functions of FIs

- Brokerage function
  - Acting as an agent for investors:
    - e.g. RBC Dominion Securities, CIBC World Markets
    - Reduce costs through economies of scale
    - Encourages higher rate of savings
  - Asset transformer:
    - Purchase primary securities by selling financial claims to households
      - These secondary securities often more marketable
- Information costs:
  - Investors exposed to Agency Costs
    - Role of FI as Delegated Monitor (Diamond, 1984)
      - Shorter term debt contracts easier to monitor than bonds
      - FI likely to have informational advantage

# Corporate Finance

- Some important questions that are answered using finance
  - What long-term investments should the firm take on?
  - Where will we get the long-term financing to pay for the investment?
  - How will we manage the everyday financial activities of the firm?

# Financial Manager

- Financial managers try to answer some or all of these questions
- The top financial manager within a firm is usually the Chief Financial Officer (CFO)
  - Treasurer – oversees cash management, capital expenditures and financial planning
  - Controller – oversees taxes, cost accounting, financial accounting and data processing



# Financial Management Decisions

- Capital budgeting
  - What long-term investments or projects should the business take on?
- Capital structure
  - How should we pay for our assets?
  - Should we use debt or equity?
- Working capital management
  - How do we manage the day-to-day finances of the firm?

# Forms of Business Organization

- Three major forms in Canada
  - Sole proprietorship
  - Partnership
    - General
    - Limited
  - Corporation
    - In other countries, corporations are also called joint stock companies, public limited companies and limited liability companies

# Sole Proprietorship

- Advantages

- Easiest to start
- Least regulated
- Single owner keeps all the profits
- Taxed once as personal income

- Disadvantages

- Unlimited liability
- Limited to life of owner
- Equity capital limited to owner's personal wealth
- Difficult to sell ownership interest

# Partnership

- Advantages

- Two or more owners
- More capital available
- Relatively easy to start
- Income taxed once as personal income

- Disadvantages

- Unlimited liability
  - General partnership
  - Limited partnership
- Partnership dissolves when one partner dies or wishes to sell
- Difficult to transfer ownership

# Corporation

- Advantages

- Limited liability
- Unlimited life
- Separation of ownership and management
- Transfer of ownership is easy
- Easier to raise capital

- Disadvantages

- Separation of ownership and management
- Double taxation (income is taxed at the corporate rate and then dividends are taxed at the personal rate)

# An International Perspective

**TABLE 1.1**

ational  
rations

Company	Country of Origin	Type of Company	
		In Original Language	Translated
Bayerische Motorenwerke (BMW) AG	Germany	Aktiengesellschaft	Corporation
Dornier GmbH	Germany	Gesellschaft mit Beschraenkter Haftung	Limited liability company
Rolls-Royce PLC	United Kingdom	Public limited company	Public limited company
Shell UK Ltd.	United Kingdom	Limited	Corporation
Unilever NV	Netherlands	Naamloze Vennootschap	Joint stock company
Fiat SpA	Italy	Societa per Azioni	Joint stock company
Volvo AB	Sweden	Aktiebolag	Joint stock company
Peugeot SA	France	Société Anonyme	Joint stock company

# The Agency Problem

- Agency relationship
  - Principal hires an agent to represent their interests
  - Stockholders (principals) hire managers (agents) to run the company
- Agency problem
  - Conflicts of interest can exist between the principal and the agent
- Agency costs
  - Direct agency costs
  - Indirect agency costs

# Managing Managers

- Managerial compensation
  - Incentives can be used to align management and stockholder interests
  - The incentives need to be structured carefully to make sure that they achieve their goal
- Corporate control
  - The threat of a takeover may result in better management
- Conflicts with other stakeholders