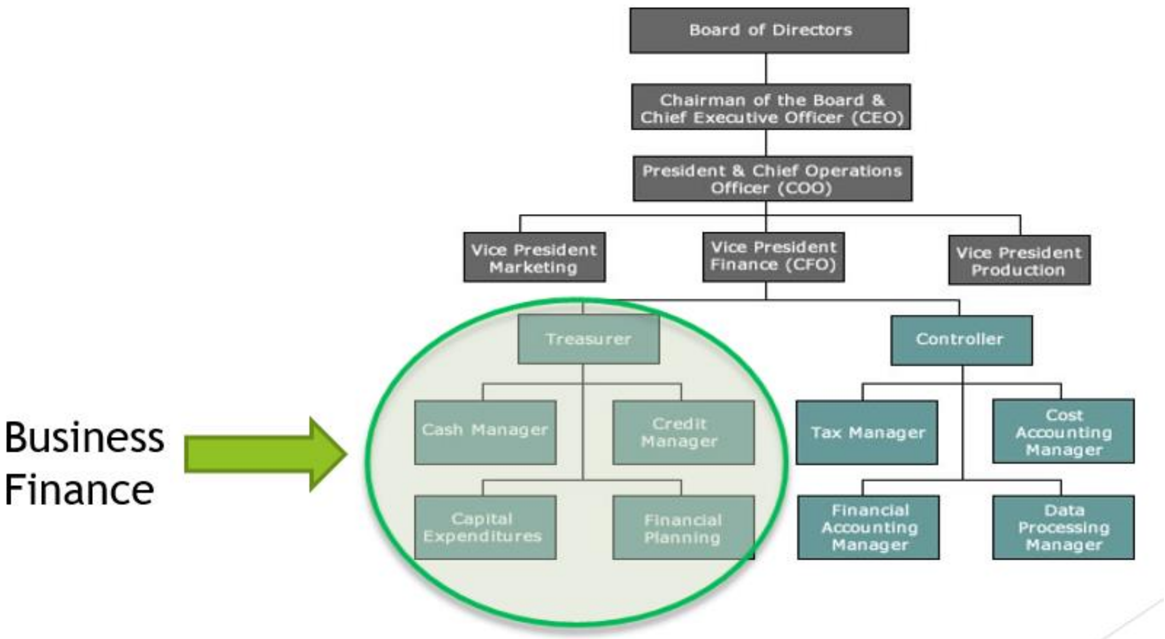
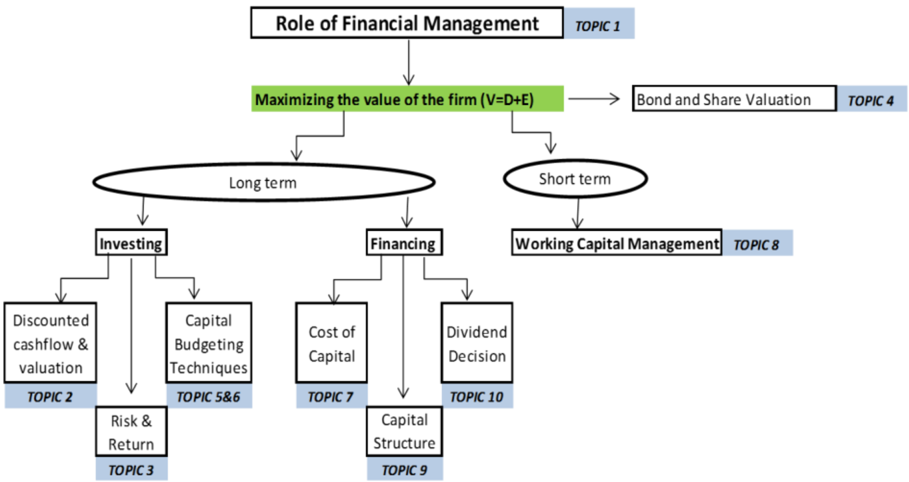
Business Finance Lecture

- Financial Activities related to running a business.
- A division or department that overseas the financial activities of a business.
- Business finance is primarily concerned with maximizing the value of a firm through long-term and short-term financial planning and the implementation of various strategies.





Topic 1: The Financial Manager and the Company (CHAPTER 1)

Forms of Business Organisation:

- Sole proprietorship
  - Business owned by one person
- Partnership
  - Business owned by two or more people acting as partners
- Company
  - Separate legal entity formed under the *Corporations Act 2001.*

Sole Trader:

- One person running the business.
- Is the simplest type of business to start and the least regulated
- Keeps all the profits from the business
- Doesn't share decision making
- All business income is taxed as personal income
- Has unlimited liability for all business debts and other obligations of the business

Partnerships:

- More than one person is involved in running the business
- Has the same basic advantages and disadvantages as a sole trader
- Has access to more capital, knowledge, experience and skills
- When a transfer of ownership takes place the partnership is terminated, and a new partnership is formed
- The problem of unlimited liability can be avoided in a limited partnership

Companies:

- Is a legal entity. In a legal sense, it is a "person" distinct from its owners.
  - A company has an indefinite life.
- The owners of a company are its shareholders.
- A major advantage of the company form of business is that shareholders have limited liability.

A company's financial objective

- The overriding objective is the maximisation of the market value of a company's shares.
- If the market value of a company's ordinary shares is maximised, then the opportunities open to the shareholders are also maximised—greater wealth implies more choices.
- For example, if a shareholder wishes to sell his or her shares in order to finance greater consumption, the higher the share price, the greater are his or her consumption opportunities.

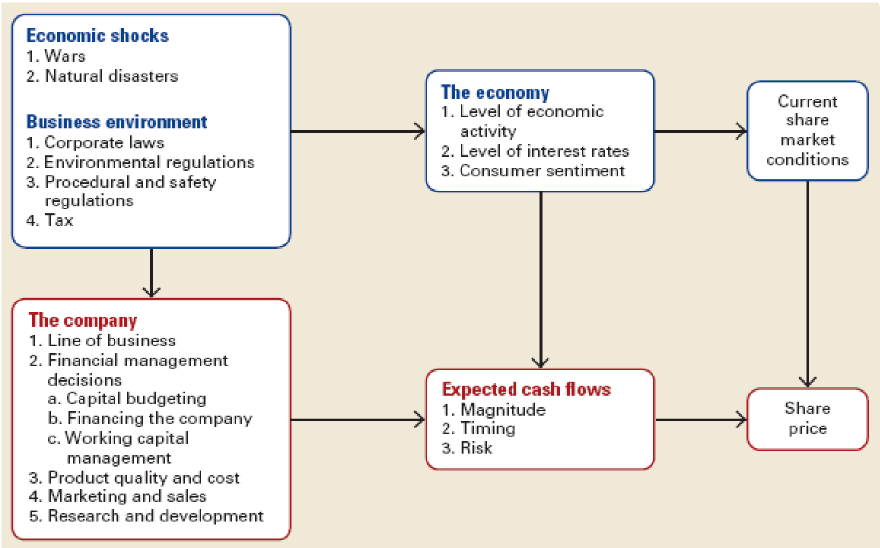
- When analysts and investors determine the value of a company's share price, they consider

- The size of the expected cash flows
- The timing of the cash flows
- The riskiness of the cash flows.

What are the underlying assumptions here?

- Investors and analysts are rational
- Investors and analysts have complete information

Factors affecting share prices



The Role of Finance Manager

- The finance manager (or finance director, or CFO) of a company takes care of the financial function of the company.
- The finance function is involved in making the following main financial decisions:
  - Investing
  - Financing decision
  - Working capital management

Investing Decision

- Identifying productive assets/investment options that the company should invest in.

  - The investing decision affects the asset side of the balance sheet and are concerned with long term investments (In accounting we call these Non-Current Assets).
  - This decision is important for a business's success or failure:
  - Capital assets generate more of the future cash flows of a company.
  - The investing decision is irreversible in nature.
  - The emphasis should be on "future cash inflows" and "future market value of the company".

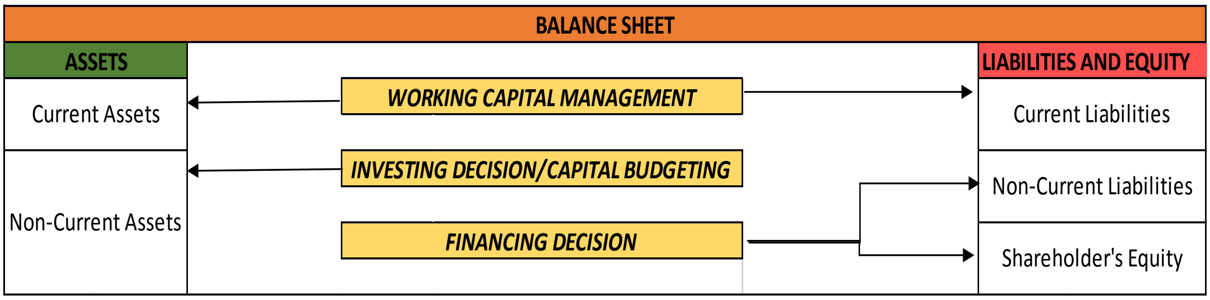
Financing Decision

- How the company should raise finance for their investments?
- Concerned with long term finance sources (In accounting we call these long term liabilities and shareholder's equity)
- Trade of between Debt and Equity.
- Debt finance:
  - Interest payments are tax deductible, therefore cheaper
  - Debt payments create contractual obligations and are riskier for the business
- Equity finance:
  - Equity is not tax deductible, therefore relatively expensive
  - Equity is less risker for the business because the directors decide on the amount of dividends paid
- The mix of debt and equity that is used to finance the business is called the "capital structure"
- Finance managers must determine the mix of debt and equity that minimises the cost of financing.

Working Capital Management

- Determining how day-to-day financial matters should be managed so that the company can pay its bills and how surplus cash should be invested.
- Current Assets are assets that is likely to be converted in to cash within the next 12 months (e.g: cash, accounts receivable, inventory)
- Current Liabilities are liabilities that is likely to be paid within the next 12 months (e.g: accounts payable)
- Net Working Capital=Current Assets-Current Liabilities
- Working capital issues include:
  - Selling goods and services on credit but is not careful enough about collecting accounts receivables.
  - A company having more (or less) inventory that it's necessary for their needs
  - A company having too much (or too little) cash reserves

How financial decisions affect the balance sheet?



Agency Conflicts: Arise from Separation of Ownership and Control

- Shareholder Interests (Called the Principal) vs. Management Interests (Called the Agent)

- For large companies, the ownership of the firm is spread over a number of shareholders and the company’s owners may effectively have little control over management
- Managers mange/control the company.
- Management may make decisions that benefit their self-interest rather than those of the shareholders (i.e.: They may not maximize shareholder’s wealth)

A Revision on Discounted Cash Flows and Valuation

Calculating FV
Example:

- In the following example we are calculating FV of a 3-year investment horizon.
- Each investment is $1000 and the current interest rate is 10%.
- Time 0 denotes beginning of the year (now). See the details on PP 180-181 of the book.