

Topic 1 Introduction to Finance

Business / Corporate Finance

1. Capital Budgeting

- The process of planning and managing a firm's long-term investments
- Should we expand our manufacturing plant?
- What long-term Investments should the business make?
- What Machinery, land, building, or business should we buy?

Future Cash Flows from Investment Projects

Financial managers need to consider:

1. Size: how much will I receive?
2. Timing: When and how often will I receive them?
3. Risk: What is the likelihood that I will receive the cash flow? 100%? 0%?

2. Capital Structure

- What businesses use to finance its operations/investments
- Mix of debt and equity

Managers need to consider:

- What is the least expensive source of funds for the firm?
- Should we issue new equity and use the proceeds to retire outstanding debt?
- where are we getting the money from?

3. Working Capital Management

- capital within a business which is used in its day-to-day operations
- How will the business manage everyday financial activities?
- modifying the firm's credit collection policy with its customers
- Collecting payments from customers
- paying suppliers

Managers need to decide:

1. How much Cash and Inventory should we hold?
2. Should we sell on credit to our customers?
3. What Short-Term Financing options do we have, and should we use it?

3 Forms of Business Organisation

1. Sole Proprietorship / Sole Trader

- Owned by 1 person

😊 Easiest to start

😊 Least regulated

😊 the owner keeps all the profits

😊 Taxed once as personal income as opposed to business income

☹ Limited to life of owner

☹ Equity capital limited to owner's personal wealth

☹ Unlimited liability

☹ Difficult to sell ownership interest

2. Partnership

- Business owned by two or more persons
- 😊 2 or more owners
- 😊 More capital available
- 😊 Relatively easy to start
- 😊 Income taxed once as personal income
- 😞 Unlimited liability
- 😞 Partnership ends when one partner dies or wishes to sell
- 😞 Difficult to transfer ownership

3. Corporation

- A legal 'person' distinct from owners
- 😊 Limited liability
- 😊 Unlimited life
- 😊 Separation of ownership and management
- 😊 Transfer of ownership is easy
- 😊 Easier to raise capital
- 😞 Separation of ownership and management
- 😞 Taxation of company profits can be an issue

Goal of Financial Management

- Maximise the market value of the existing owners' equity
- Good Decisions increase value of Owner Equity
- Bad Decisions decrease value of Owners Equity

Primary market

- When a security is created

Secondary market

- When securities are traded between investors
- Securities are old

The Agency Problem

- The possibility that there is a conflict of interest between the owners and management of a firm
- Something that might benefit the managers but not the business
- Actions by managers that reduce the value of the existing owners' equity are Agency Costs
- How do we make sure managers act in the best interests of shareholders?
 - Build incentives into compensation
 - Shareholders have control through election of directors