FINANCE FINALS

L1: INTRODUCTION TO FUNDAMENTALS OF BUSINESS FINANCE

Identify the basic areas of finance

Four Basic Areas of Finance

1. Corporate finance: basic theories and ideas of finance
   - The big major companies, larger firms
   - Deals with the companies and the decisions that they make
2. Investments: financial assets such as shares and bonds
   - Shares and debt
   - Investing in the ASX
   - To decide how to invest (i.e. superannuation, bonds, etc.)
   - Major area of finance
   - What determines price of a financial asset such as a share?
   - What are the potential risks and rewards associated with investing finances?
   - What is the best mixture of different types of financial assets to hold?
3. Financial institutions: firms dealing in financial matters
4. International finance: covers above areas in a global context

What is Business Finance?

- What long term investments to be made? What equipment to buy?
- Where to get long-term financing to pay for investment?
- When to pay suppliers?
- Financial managers coordinate treasury and accounting activities

Distinguish the goals of financial management from other corporate goals

Goals of Financial Management

- To maximize shareholder wealth
- Maximization of share price/value
- Profit maximization is not an appropriate goal
  - There is no time frame
  - Profit measures are dependent on accounting standards
  - Doesn't account for risks
  - If you only want to increase profits, you could take excessive risks
  - Short term: increased profits, long term: taking the appropriate risks for what your shareholders want
- Other goals (such as maximization of sales) are also inappropriate

Cash

- Any business needs cash to survive
- Important to not confuse accounting income with cash flow
- Q: Your firm sold a bus $300,000 on 90 days' credit. The bus cost $230,000. When do you get paid?
  - Accounting terminology: the $70,000 profit is locked in immediately on the finance statement
  - Cash flow p/o/v: you'll receive the money in around 90 days
  - You cannot ever guarantee that if you sell something on credit, that the person will definitely pay the money; they will sometimes pay earlier, later, or even never

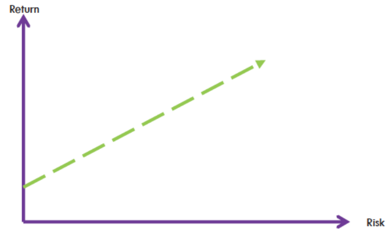
Identify the three factors of any financial decision

- Dollar amount: dollar amount of cash flow received or paid out
  - The larger the dollar amount, the more time is spent
  - The capital budgeting decisions
  - Investments in long term assets
- Time: when cash flow is received or paid
  - Time value of money (TVM)

- Time around the decision of dollar amount
- Time when money is received is crucial

- Risk: amount of uncertainty
    - Investors require higher returns for higher risks
    - The return should compensate for amount of risks
    - If you make a decision that returns in a very high risk endeavor, you should be compensated more than low risk

Trade-off between return and risk



- Linear relationship
- The higher the risk, the higher the potential return
- "Risk Aversion" doesn't mean that someone doesn't want to take risks, it means that you are willing to take risks but only if the compensation for it is equal to the same amount of risk
- On green line = risk adverse
- You are willing to take the risk but you must be compensated for it
- "Risk Avoidance" is when you don't want risks at all

Understand the basic types of financial management decisions

The Investment Decision

- Most important decision – incorrect decisions are costly to reverse
- How to determine value of long-term asset
- Evaluate size, time and risk of cash flows
- Select assets that create most shareholder wealth
- DOES NOT mean investing in stock exchange; it means when company invests in long-term assets
- Capital budgeting decision – where most of the time in financial management is spent
- How are we going to invest the money in the company?

<u>Capital Budgeting</u>

- Process of planning and managing a firm's long-term investments
- Financial managers identify investment opportunities that worth are more to firm than they cost to acquire
- Value of cash flow generated by project exceeds cost of undertaking project

<u>Capital Structure</u>

- Mixture of LT debt and equity maintained by firm
- How firm obtains financial needs to support long-term investments
- How much should firm borrow? What are the least expensive sources of funds?

The Financing Decision

- How to finance an investment?
- Determining the best mix between
    - Debt (loan funds) – contractual claim
    - Equity (owner's funds) – residual claim
    - Linked to assets
    - Investors want a certain return on their money, and their assets will produce the returns
- Trade-off between return and risk – use of debt is called "gearing" or "leverage"

The Working Capital Decision

- Managing short-term assets and liabilities
- Manages day-to-day activities to ensure firm has sufficient resources to continue operations
- Forms part of investment decisions

    - Inventory management – optimal level of inventory
    - Receivables management – should credit sales be allowed?
    - Accounts payable management – how long should suppliers wait before being paid?
    - Cash – how much cash should a company hold
- Account payable, cash, etc.

Identify ethical dimensions in financial decision making

Corporate Governance
- Objectives of management may differ from shareholders
- Managers may be satisfiers rather than maximisers
- Management play it safe rather than maximizing value of firm
- Management are agents for owners
- Introduces potential conflict
- Agency problem
    - You've appointed an agent to do the job on your behalf
    - You are giving agency authority to act on your behalf
    - Manager wants to keep their job and earn a decent salary
    - Conflict: shareholders and managers
    - The decision maker is the manager, and they cater for the shareholders' interests
    - How to get these interests aligned?
- Ethical decision making
- Making sure the company is run in the best interest of society as a whole

Distinguish the advantages and disadvantages of various forms of business organisation

Sole Trader / Proprietorship
- Individual (may employ others)
- Least regulated, simplest to start
- Unlimited liability; creditors could look at owner's personal assets for payment
- Business income taxed as personal income
- Lasts as long as owner is alive or sells
- Raising finance from financial institutions
- Equity component limited to sole trader's wealth

Partnership
- All share in gains and losses
- Characterized by partnership agreement
- If one leaves, partnership ends

Company
- Separate legal entity
- Unlimited life
- Formal and legal requirements
- Limited liability for shareholders
- Few companies are listed
- Superior form when raising capital
- As soon as a company gets registered, and listed on stock exchange, the owner steps away from the company, and now potentially may be a shareholder of the company, but the business has a life of its own
- Advantages:
    - Owner is not responsible for debt
    - Bankruptcy > insolvent > owner not responsible