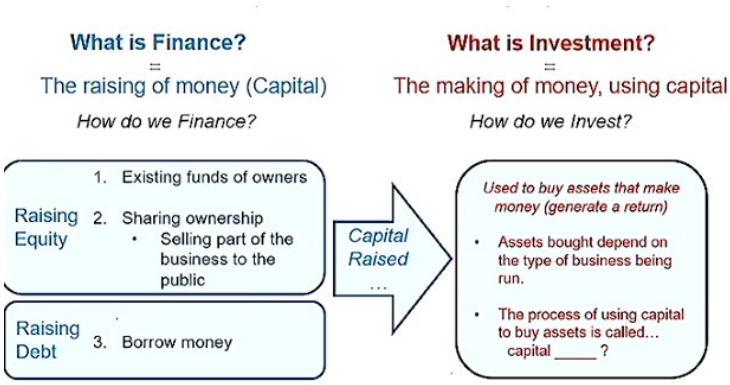
BFF1001 – FOUNDATIONS OF FINANCE NOTES

TOPIC 1 – WHAT IS FINANCE?

Finance – the raising of money (capital)

Investment – the making of money, using capital



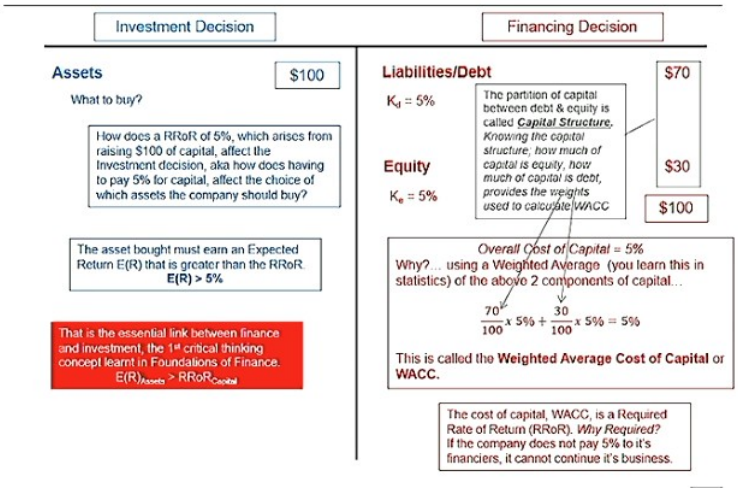
Balance sheet:

Assets on the left-hand side (investment decision)

Liabilities/debt and Equity on the right-hand side (financing decision)

We have a cost of debt (Kd) and a cost of equity (Ke).

Using the weights Average of the Ke and Kd components of capital, we calculate the overall cost of capital **Weighted Average Cost of Capital (WACC)**



Key aspects of finance:

- the flow of funds
- financial intermediation and direct financing
- financial markets
- rate of return

Flow of funds:

Where capital is transferred from surplus units to deficit units in an economy

- this is important as it enables money to be transferred from those who have excess capital to those who need it
- a well-functioning and developed financial system allows for the efficient flow of funds

There are 3 ways for the flow of funds to occur un an economy:

1. direct transfer between surplus and deficit units
2. indirect transfer using an investment bank (a type of financial intermediary)
3. indirect transfer; using a financial intermediary

The flow of funds occurs within the financial system of an economy, the components include:

1. Financial institutions – businesses that facilitate the flow and transfer of funds by providing intermediation
2. Financial instruments – primarily types of debt and equity that are vehicles for the flow/transfer of funds
3. Financial markets – where financial instruments are created and traded

Rates of return:

= the percentage earned on the capital invested

- E.g. if you invest $100, you earn $10 over 1 year, the rate of return is 10% p.a
- Needs to be qualified over a time period, e.g. per annum or over the holding period of the investment
- The rate of return in relevant to finance because it applies to financial instruments that are used to raise capital and assets that are brought as investments

** A financial instrument can be both an asset and a liability:

Example: the interest on the home loan is 10%.

Bank – home loan is an asset that earns a rate of return of 10%

Borrower (you) – home loan is a liability, the cost of which is what the bank earns as interest, therefore the cost of debt is 10%

The home loan is both an asset and a liability, as asset to the lender and a liability to the borrower. ** the rate of return is how to objectively compare and evaluate the performance of financial instruments both; both as assets and liabilities by what is earns or what it costs, as a % on capital

TOPIC 2 – FINANCIAL MARKETS AND REGULATION

Why regulate?

The concept of regulation VS a complete free market

 free market economics is where prices for goods and services are freely set by supply and demand without the influence of government policy or rules

Contrast complete regulation vs. a completely free market

- Complete regulation = all prices are set by the government
- Neither extreme is desirable in the effort to maximise economic growth and achieve an efficient flow of funds
- In Aus. we have a balance of regulation in a free market to protect consumers and taxpayers from excessive risk taking and provide an equitable outcome for all stakeholders

Monetary authorities

- The **RBA** is responsible for monetary policy, the payments system and the stability of the entire financial system
- **APRA** is responsible for prudential supervision of financial institutions including banks, credit unions, building societies, insurance and superannuation companies
- **ASIC** is responsible for the enforcement of company and financial services laws. The objective is to protect consumers, investors and creditors
- **ASIC** is also responsible for licensing and monitoring financial markets, financial instruments and advisors as well as monitoring the disclosure and conduct of Australian companies and services providers

What does the RBA do?

It is Australia's Central bank.

- The determination and implementation of monetary policy
- Issuing Australian currency not4es
- Overseeing the payments system
- Acting as the government's banker
- Issuing and providing the market for treasury securities
- Managing financial system liquidity and the government's holding of foreign exchange

Why is the RBA important to finance?

It plays a prime role in determining the cost of debt capital in the economy