Topic 1: Introduction to Financial Management

- ❖ Understand the goal of financial management

To maximize firm value and act in shareholders' best interest.

- ❖ Understand the basic types of financial management decisions and the role of the financial manager

    - ✦ 3 key elements of any decision: cash, time, risk.

- Investment decision: the present value of the investment exceeds its cost. Because it involves the prediction of future cash flows there is uncertainty to the realisation of the predicted numbers, aka risk. Higher the risk, higher the return. Determines the assets the firm owns. Decision includes working capital.

- Financing decision: determines the mix of debt (borrowed money) and equity (owners' money) as the business raises money by issuing financial securities. Debt has contractual claim on the cash flows of the firm to pay interest and principal of borrowed funds. When issuing equity there is no obligation on the company to return the cash to shareholders or pay dividends. Equity owners have residual claims on the firm's cash flow. When a company raises money by issuing debt or equity it is creating a financial asset which asset has claims on the future cash flows of the company.

- Dividend decision: how much of the profits are retained for further investment in assets and how much is distributed to shareholders in the form of dividend as reward.

- ❖ Understand the basic Financial Statements

All organizations are required to keep accounts and produce financial statements. Traditionally, all accounts are based on double entry system of bookkeeping but the type and complexity of Financial Statements produced depends on the size and structure of the organization. The form of these statements is dictated by the users.

- ✦ For external users, analysts, creditors, banks, Financial or Statutory Accounts are produced to meet government and ASX regulations.
- ✦ For internal users only, Management Accounts are created.
- ✦ For the tax office, Tax Accounts.

Major Financial Statements are BS, PnL and CF

- ▪ BS

A snapshot of what the firm owns equals what the firm owes at a point in time. Assets – Liabilities = Equity

All items are recorded in monetary terms. The balance sheet values are generally historical costs although revaluation of some assets does occur. In Finance we are more concerned with market values than with book values.

Net working capital NWC is the difference between current assets and current liabilities.

What the firm owns must produce income, current assets and non-current assets (tangible, intangible)

Depreciation of assets represents the “recovery” of the cost of an asset over its life. The charge is dependent on the accounting method. Depreciation is not a cash flow. It does reduce profits and hence tax payable in increments over the lifetime of the asset. The reduction in tax payable is equivalent to a cash inflow.

What the firm owes is current liabilities and non-current liabilities, of which the latter, long term debt incurs costs + shareholders’ funds.

Reserves and provisions are adjustments based on accounting policies, not a cash flow, at the discretion of the management over industry-wide regulatory oversight.

- PnL

Records changes in the firm’s earnings and the expenses it incurred over a period of time.

Sales revenue less cost of goods sold is gross profit. Gross profit less selling, admin and depreciation expenses is EBIT. EBIT is earnings from operations. EBIT less interest is EBT or profit before tax (PBT). Profit before tax less tax is profit after tax (PAT) or net profit.

Note that interest is the result of the financing decision.

Core metrics:

EBITDA: earnings before interest, tax, depreciation and amortisation

earnings per share (EPS): (net profit-dividend on preference shares)/number of shares issued

dividend per share (DPS): dividend paid/number of shares issued

Accounting profit is not equal to cash flow, income earned may not be equal to cash inflows and expenses incurred may not be paid in cash e.g. due to depreciation and amortisation

- CF

The BS and PnL provide all information to analyse CF and for Finance the main concern is cash flow over time not accounting profit. Hence we’re more interested in CF.

CF is generated by 3 major activities: Operating, Investment and Financing Activities

PnL provides the information on Operating Activities, BS provides the information on Investment and Financing Activities, as it reveals the sources and uses of funds: an increase of assets will require the use of cash while an increase in liabilities will always represent a source of cash.

One of the key metrics of Operating Cash Flow (OCF) but unfortunately, Analysts and Accountants often use different definitions of OCF. Our OCF formula is OCF = EBIT (1-tax) + Depreciation

- ❖ Understand the different forms of business structure
  - ✦ Sole trader: business is owned by 1 person and the person has unlimited liability. The equity component is limited to the sole trader’s wealth, tends to be undercapitalized. Life is limited and least regulated.
  - ✦ Partnership: characterized by a partnership agreement as several individuals join together to run the business. All share in gains and losses and have unlimited liability.

The equity component is limited to the partners' wealth. Income is taxed as personal income of the partners.

- ✦ Company: separate legal entity. As the company grows management and shareholders are usually separated (see corporate governance and the agency problem). Unlimited life and limited liability for shareholders, ownership is easily transferred. Most regulated form of organization. Can be listed and if is that gives even greater access to both debt and equity finance.

❖ Be able to briefly describe the financial markets

Efficient financial markets are important to enable businesses to raise funds by issuing debt and equity securities. They enable price discovery and a mechanism for the transfer of ownership so that productive capital is created and allocated amongst competing uses. Ownership on claims is exchanged.

The financial system consists of 4 parties:

- Firms (in borrowing sector) maximise their market value
- ✦ Individuals (in savings sector) maximise their utility from consumption
- ✦ Governments promote that capital markets serve economic growth and use the financial system to transmit monetary policy
- ✦ Financial intermediaries operate the valve of funds from the savings sector to the borrowing sector, which is a product of supply and demand. Also, they charge interest rates as cash rate setting effects reverberate

  - ✦ Primary market is original issues of securities where the issuer receives cash, can be private or public.
  - ✦ Secondary market facilitates the transfer of ownership, which does not involve the company issuing the financial asset. If the secondary markets are liquid for a company's security then the company can issue on better terms in the primary market. The financial asset is more sought after if it is marketable i.e. liquid means many buyers and sellers.

❖ Understand a prescriptive approach to ethics

Ethics is a set of moral principles or values. Business ethics are "the principles, norms and standards of conduct that operate within business" often mentioned as "doing the right thing". E.g. some companies would forbid accepting gifts (or discounts) for an employee if such are not available to all employees. It is society that will determine what is right, but there are 3 distinct basis for theories regarding ethical decision making: 1) focus on consequences, the net balance of good over bad, greater good to society, economic benefits outweighting costs. 2) certain moral principles and values are binding over consequences 3) focus on integrity following professional bodies' codes set to guide the intentions and the purpose of individual members.

A prescriptive 8-step approach to sound ethical decision making:

1. Gather the facts
2. Spot the issue/s
3. Identify affected parties (the stakeholders)
4. Identify the consequences
5. Identify the obligations

6. Consider your character and identity (act with integrity)
7. Think creatively about potential actions
8. Listen to your conscience (check your gut)

When the business is a sole trader the manager of the business is also going to be the owner and is only going to make business decisions that he believes will increase his wealth. However, in the corporate form of business shareholders and management are separated. When the two are separated, do managers always act in the best interest of shareholders?

- The answer to this depends on two factors: how closely management goals are aligned with shareholder goals + the ease with which management can be replaced if it does not act in shareholders' best interest.
- The agency problem is the possibility of conflict between the two parties. Agency cost refers to the cost arising from this conflict of interest e.g. the cost of monitoring.
- The agency problem can be alleviated by the alignment of goals. This can be achieved through management compensation schemes, management job prospects and the threat of takeover.
- It has been found that some managers do not always act in the best interest of shareholders and laws have been introduced to reduce this. Accounts must be audited and presented to shareholders (monitoring). Directors have fiduciary responsibility to creditors and must not allow their organisation to trade whilst insolvent. "Good corporate citizens" do not pursue financial success by breaking laws. The Australian Securities and Investment Commission (ASIC) is responsible for the enforcement of corporations law and regulation
    - Corporations Act 2001 is the most important law for corporations in Australia. History shows past corporate failures are often associated with deficiencies in auditing and financial reporting. The law does not cover all situations and sometimes there is conflict: whose law do you follow if a subsidiary operates in a country where the laws are different to those of the parent company?
    - Since the GFC there has been elevated interest in ethics in business
    - ASX has issued a statement of core principles of corporate governance
        - In particular in finance related issues

Some tools and techniques to make financial decisions are available that will increase the market value of owners' equity. A concern over the costs and benefits, financial sustainability is key to manage a business for the long term benefit of the shareholders.

When agents are used for advice it is expected that their advice is unbiased and is in the best interest of their clients, in accordance with their fiduciary duty.

Key concepts

- Understand the difference between Accounting Profit and Cash Flows

A sells B for $400,000 on 60 days credit. Fast Freighters makes a $200,000 profit on the sale of the truck. When does Fast get paid? Hopefully in around 60 days time. When did the profit get recorded? On sales day.

- Risk and return

The trade-off between expected return and risk has an upward slope.

- Principal-agent problem

An example would be when managers hang on to badly performing operations when new managers could run them more profitably.

- Financial intermediaries

Are firms whose principal business is taking deposits, making loans and buying securities.

- Elements of Financial statements

Assets: cash at bank, accounts receivable, inventory (beginning of the year), accumulated depreciation, office buildings, closing stock (end of year), fixtures and fixings

Liabilities: creditors, long term bank loan

Capital: asset revaluation reserve, preference shares issued

Revenue: sales, sales on credit, rent received

Expenditure: power and heating costs, freight expense (cost of selling), interest paid, sales personnel salaries, purchases, insurance paid, advertising

Topic 2: Long term Debt and Equity Financing

- In this lecture we will review characteristics of debt and equity and understand the difference between debt and equity

Equity is an ownership unit of the company, no contractual claim on assets in bankruptcy, only residual. Returns made on the capital directly contributed to the firm by shareholders can either be paid out as dividend or held back as retained earnings (funds the directors have elected to hold back from shareholders to finance future expansion).