

Week 1 Lecture

What is Finance

- Decisions with money
- Vital to economy, households, individuals, businesses, politics
- The art and science to manage money
- Size
- Technology
- Engineering
- Mathematics
- Art of measuring and managing value over time and with uncertainty

Corporate objectives

- Focus on creating wealth for shareholders
- The future is more relevant than the past
- Share price reflects: timing, magnitude and risk of cash flows
- Market capitalization = share price x number of outstanding shares
- Provides long term benefits by maximizing shareholders wealth

Corporate Finance Functions

- **Capital budgeting (investment)**
- **Capital structure (financing)**
- **Payout policy**
- Corporate Governance
- Risk Management
- Financial Management

Capital Budgeting

- Selecting the best projects in which to invest the resources of a company, based on each project's received risk and expected return
- Real assets
- Can be intangible
- Identifying potential investments, analyzing set of investment opportunities (selecting those improving share value by estimating net present value NPV of projects) and implementing and monitoring these investments

Capital Structures

- Raising capital by selling financial assets to support operations and investment programs

- Financial assets – claims on cash flows (common shares, bank-accepted bills, corporate bonds)
- Two types of capital: Equity & Debt
- Equity: from shareholders
- Debt: borrowed money – interest must be paid

Payout Policy

- How to deal with surplus cash flows (retain cash for future investment, pay out the cash in dividends or share buyback)
- Taxation on different types of payout
- Australia adopts imputation taxation system to avoid double taxation on corporate profits (share buyback)
- Free cash flow problem – senior management may hoard cash for their personal benefit or reckless investment spree

Financial Intermediation

- An institution that raises capital by issues liabilities against itself and then lends capital to borrowers (e.g. Insurance companies, credit unions)

Corporate Governance

- Developing company ownership and corporate governance structures that ensure managers behave ethically and make decisions that benefit shareholder – avoid agency problem
- Dimensions of corporate governance: Board of directors, compensation packages, auditors, legislative environment and compliance requirements
- Agency costs: conflict between goal of company owners (shareholders) and managers
- Rely on market forces to exert managerial discipline
- Short term incentives: bonus
- Long-term incentive: performance shares

Risk Management

- Managing the company's exposure to all types of risk
- Modern risk management focuses on adverse interest rate movements, commodity price changes and currency value fluctuations

Financial Management

- Managing a company's internal cash flows, and its capital structure to maximise value of debt and equity claims
- Ensure company can meet obligations when they fall due

Legal Forms of Business organisations

Traditional: sole proprietorship, Partnership & Corporations

Emerging: limited partnership & proprietary limited company

Sole Proprietorship

- No distinction between business and person
- Subject to few regulations
- Taxed like an individual
- Unlimited liability
- Life is limited to life of the owner
- Transferring ownership is difficult
- Difficult to obtain large sums of capital

Partnership

- Easy and inexpensive to form
- Subject to few regulations
- Taxed like an individual
- Unlimited liability
- Transferring ownership is difficult
- Difficult for partners to obtain large sums of capital – but easier than sole proprietorship

Corporations

- Limited liability
- Separate and distinct from owners
- Unlimited life
- Easy to transfer ownership
- Easy to obtain capital
- Setting up and regulations are extensive

Limited Partnership

- General partner(s) operate the partnership and have unlimited liability
- Limited partner(s) contribute to the majority of capital and have limited liability
- Favors long term investment
- Non-cash loss in early years (tax benefit)
- Difficult to monitor general partners
- Hard to cash out if invested company is unlisted

Proprietary Limited Company

- Creates roles for employees, directors and shareholders

- Legal entity formed by one of more people
- Can separate the role of owners and employees
- Regulated under the Corporations Laws 2001

Taxation Income

- Depends on type of taxpayer, taxable income and tax rate
- Type of tax payer: individual, partnership, corporate
- Type of income: assessable income minus allowable deduction
- Tax rate: marginal (individuals) vs. flat (corporates)
- Taxable income = assessable income – allowable deductions
- Tax payable is the actual tax owed to the government
- Wages are taxed when paid (PAYG)