Fundamentals of Business Finance Notes

(Week 1)

Four basic areas of finance

1) Corporate finance (i.e. **Business finance**)
    a. Basic theories and general concepts of finance
    b. Decisions related to the CFO i.e. investments (what assets to buy), financing (where the money comes from i.e. debt/gearing/leveraging vs equity) and working capital (short term running; inventory, acc receivables, payables)
2) Investments
    a. Financial assets such as shares and bonds
3) Financial institutions
    a. Firms dealing in financial matters
4) International finance
    a. Covers the above areas but in a global context
    b. Political risk, exchange rates etc.

Factors listed in a company's stock exchange profile:

Ticker (abbreviation code)	Market capitalisation (firm value)
Industry	Dividends
Share Price	Beta (measure of volatility

Role of the CFO/financial manager:

- To maximise shareholder return/wealth (via increasing share price)
    - Market capitalisation = share price * # of shares
    - Not maximising profits because this can be manipulated (e.g. depreciation choices and accrued revenues and expenses)
- Capital budgeting decisions: Allocate money to where return exceeds surplus capital
- Cost of capital: Maintain ROI above a certain goal
- Maintain capital structure: Maintain their debt to equity ratio

3 Key factors to make financial decisions

1. Dollar amount of the actual cash flow received or paid out
2. When cash flow is received or paid out (time value of money)
3. Amount of risk and uncertainty (higher return/interest rate for higher risk)

Two financial market transactions:

- Primary: capital raising between firm and investors via the initial sale of securities (e.g. shares, bonds via IPOs or private offering).
- Secondary: investor to investor trading of securities. Doesn't affect firm directly, but a strong secondary market increases demand should they want to list more on primary

Balance Sheet (what the firm owns and owes):

- Current assets (cash, receivables, inventory)
- Non–current assets (tangible/intangible)
- Current liabilities (payables)
- Non–current liabilities (long term debt)
- Equity/capital

Income statement (revenues, costs and profits):
Sales + other income – COGS – operating expenses – depreciation = Operating income (EBIT)
EBIT – interest expenses – tax = Net income/Profit after tax

Market value is the current value of things whereas book value is its historic value

Ways to measure cash:
1) Operating cash flow (not in balance sheet or income statement) = Net profit after tax + non–cash expenses (deprecation + accrued expenses) + working capital
2) Free cash flow = Operating cash flow – capital expenditure

Sole trader: Run by a single owner and only lasts as long as they live unless sold. It may employ a few others to help run it.
- Advantages: Easy and inexpensive to establish, minimal reporting required
- Disadvantages: Unlimited liability, equity is limited to the owner's personal wealth

Partnership: Multiple owners based on a partnership agreement which share in gains and loss, and only exists as long as all partners stay (if one leaves, a new agreement is needed)
- Advantages: Easy and inexpensive to establish, minimal reporting required
- Disadvantages: Unlimited liability

Company: Separate legal entity to its owners
- Advantages: Limited liability, unlimited life (doesn't depend on any one owner), easier to raise capital through securities
- Disadvantages: Expensive and difficult to establish, strict legal and reporting required

Corporate Governance: A set of rules that define the company and its decision makers act in the best interest of its shareholders, its partners the law and society.

Principal–agents relationship: Principals are the owners and the agents run the company (i.e. management). The agents should make decisions that act in the interest of the principal/ shareholders. But sometimes they act in their own personal interest i.e. *agency problem* (often when management and owners are disjoint and incentive systems)
- Governed by agency law (a type of commercial law) which contractually holds agents to act on the owners' behalf and in their best interest
- Different levels of power from agency law depending on role and agreements
- NB: Not all employees are agents for the employer

Interaction between firms and financial markets: