# LECTURE01

Finance

- Financial management is the study of how people and businesses evaluate investments and raise funds to finance them.
- Three questions addressed by the study of financial management are:
    - What investments should the business take on? (Investment decision)
    - How can finance be obtained to pay for the required investments? (Financing decision)
    - Should dividends be paid? If so, how much? (Dividend decision)

Legal forms of business organisation: Comparison of organisational forms

- Consider:
    - Organisation requirements and costs
    - Liability of owners
    - Continuity of business
    - Transferability of ownership
    - Management control
    - Ease of capital raising
    - Income taxes
- Forms:
    - Sole proprietorship: A business owned by a single individual
    - Partnership: An association of two or more individuals joining together as co-owners to operate a business for profit
    - Company: An entity that legally functions separately and apart from its owners

Goal of the firm = Profit maximisation

- Problems:
    - Timing of returns
    - Uncertainty of returns
- The goal is consistent with:
    - Maximising firm value
    - Maximising share value

Goal of the financial manager:

- Interaction between the company and the financial markets
    - Making investment decisions (**Capital budgeting decisions**)
    - Making decisions on how to finance these investments (**capital structure decisions**)
    - Managing funding for the company's day-to-day operations (**working capital management**)
- THE INVESTMENT DECISION
    - What asset should the firm acquire to operate its business and generate cash flows
        - Decisions regarding <u>type and quantity</u>
            - Acquisition of 'real' assets such as buildings or machinery used to manufacture a product for sale or to provide a particular service
            - Purchase of intangible assets such as patents or shares in another company
    - Development of a process to evaluate the desirability of asset purchases
        - **Capital budgeting evaluation**
            - Risk of future cash flows
            - Timing of future cash flows
            - Size of future cash flows
- 10 Principles of Financial Management
    1) The risk return trade-off
        - We won't take on additional risks unless we expect to be compensated with additional return
        - **<u>Cash Flow Risk</u>**
            - The future can only be predicted: the degree of certainty associated with future cash flows varies with each investment
            - Variability of an outcome is otherwise known as risk;
                - Assessing the relevant risk associated with expected future cash flows is critical to investment decisions
            - The relationship is: Risk and Return
    2) The time value of money
        - A dollar received today is worth more than a dollar received in the future
    3) Cash – not profits – is king
        - Cash flows, not accounting profits, are used for measuring wealth

        - **Cash Flow Size**
            - Accounting information does not mean cash flow
            - Under accrual accounting; Accounting information and earnings can be very different to cash flows.
                - A sale is recorded at the time of sale and a cost is recorded when it is incurred (not when cash is settled)
                - Includes non-cash transactions e.g. Depreciation
                - Presented in annual reports and used to calculate taxation obligations
            - A company can make an accounting profit and yet be insolvent
    4) Incremental Cash flows
        - It's only what changes that counts
        - Incremental Cash Flow; is the difference between the cash flows if a new project was taken on and the cash flows if the project was not taken on
    5) The curse of competitive markets
        - Why: It's hard to find exceptionally profitable projects
        - Two most common ways of making markets less competitive are to:
            - Differentiate the product
            - Achieve a cost advantage over competitors
    6) Efficient capital markets
        - The markets are quick and the prices are right
        - Efficient markets are market in which the values of all assets and securities at any instant in time fully reflect all available information
        - Assumptions underlying the finance paradigm
            - Economic agents are rational and seek to maximise individual utility
                - Enables the concentration on market forces
            - Perfect Capital Markets
                - Avoids initial complications and allows the establishment of equilibrium
                - Market imperfections can then be introduced to examine the effect on the underlying theory
    7) The agency problem
        - Managers won't work for owners unless it's in the managers' best interest
        - Agency costs = cost (such as reduced share price), associated with potential conflict between managers and investors, when these are not the same
            - Residual loss: reduced value due to managers acting in own best interest
            - Monitoring Cost: costs incurred by the principal associated with monitoring managers' behaviour
            - Bonding Cost: costs incurred by the agent associated with demonstrating their alignment with principals
    8) Taxes bias business decisions
        - Tax obligations and benefits can have a significant impact on investments
    9) All risk is not equal
        - Some risk can be diversified away, and some cannot
    10) Ethical behaviour is doing the right thing
        - Ethical errors and careers
        - Businesses need the public's confidence
        - Firms have a social responsibility
- FINANCING DECISION
    - A firm's capital structure is the specific mix of debt and equity used to finance the firm's operations
    - Decisions need to be made on both;
        - The financing mix, and
        - How and where to raise money
    - Financial markets; A complex of institutions, procedures and arrangements that facilitate a transfer of funds from one entity in the economy to another
        - Examples of financial sub-markets; debt market and share market
    - The flow of funds:
        - An economic entity will be either a 'savings deficit unit' or a 'savings surplus unit'
        - The financial markets provide a forum to facilitate the transfer of funds from the savings surplus units to the savings deficit unit