

Fundamentals of Business Finance

Lecture 1

- Corporate finance- basic theories and ideas of finance
- Investments- financial assets such as shares and bonds
- Financial institutions- firms dealing in financial matters
- International finance- covers an area above in a global context

Goal of Financial Management

- Aim of the financial manager is to maximise shareholder wealth. This is done by maximising the share price.
- Profit maximisation is not an appropriate goal as it doesn't specify a time frame

Factors in any Financial Decision

- Dollar amount
- Time- time value of money
- Risk- investors require higher returns for higher risk

Financial Manager's Responsibilities

- Investment decision- What assets to buy? Capital budgeting decision
- Financing decision- Where does the money come from? Capital structure decision
- Working capital decision- Inventory, receivables, accounts payable

The Investment Decision

- Most important decision as incorrect decisions are costly to reverse
- To determine the value of a long term asset; evaluate size, time and risk of cash flows
- Select assets that create the most shareholder wealth

The Financing Decision

- How to finance an investment
- Determine the best mix between
 - Debt (loan funds)- contractual claim
 - Equity (owner's funds)- residual claim
- Trade-off between return and risk- use of debt is called clearing or leverage

The Working Capital Decision

- Managing short term assets and liabilities
- Inventory management- what is the optimal level of inventory?
- Receivables management- should credit sales be allowed?
- Accounts payable management- How long should suppliers have to wait before being paid?
- Cash- How much cash should a company hold?

Forms of Business

- Sole trader/proprietorship
 - Unlimited liability
 - Lasts as long as the owner is alive or sells
 - Raising finance usually from financial institutions
 - Equity component limited to sole trader's wealth- undercapitalised
- Partnership
 - Several individuals
 - All share in gains and losses
 - Characterised by a partnership agreement
 - If one wants to leave, partnership ends
- Company
 - Most important firm
 - Separate legal entity
 - Unlimited life
 - Limited liability for shareholders

Corporate Governance

- Objectives of management may differ from shareholders
- Managers may be satisfiers rather than maximisers- Essentially management play it safe instead of maximising the value of the firm
- Management are agents for the owners- agency problem, ethical decision making

Principal and Agent Law

- Agency law is part of commercial law
- It is a contractual relationship between a person (the agent) who is authorised to act on behalf of another (the principal)
- Agent can create legal relationship with third party
- Creation of Agency- Written or verbally expressed, implied by law

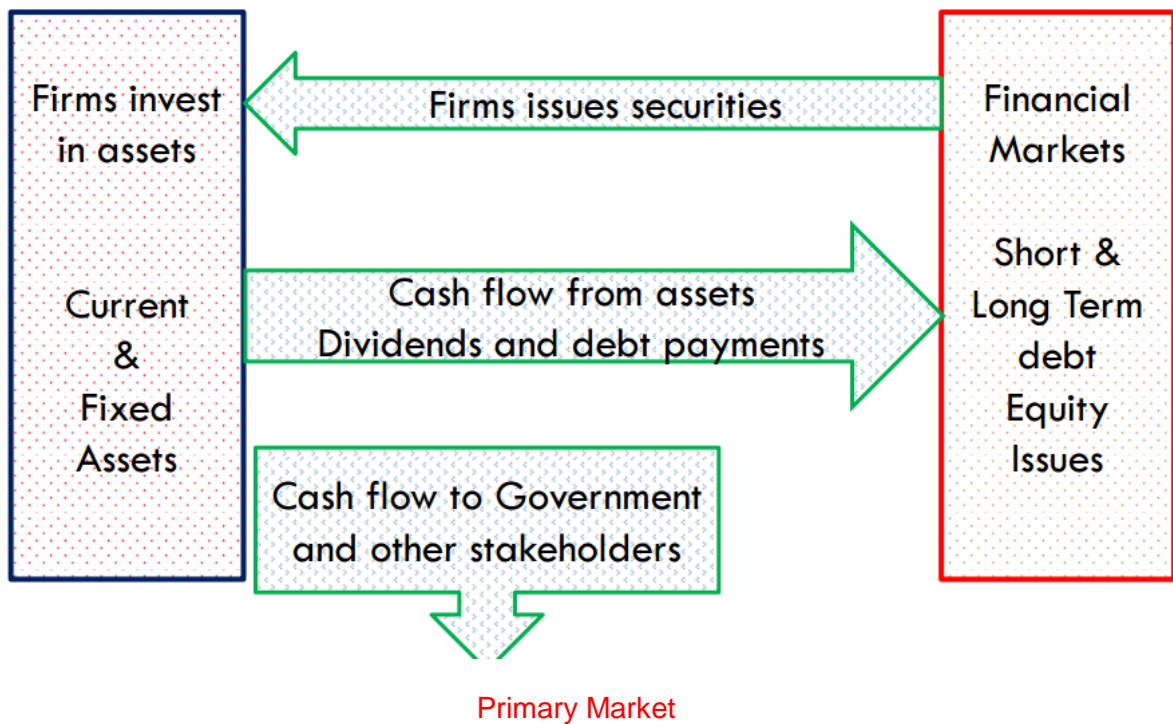
Principal and Agent Law II

- Employer-employee relationships
- Not all employees are agents for the employer- depends on the type of work
 - Sales people are as they are arranging sales
 - Managers are as they are entering into contracts for the employer
- Agents can be special, general or universal

Duties of an Agent

- Follow the principal's instructions
- Act personally (not delegate to another)
- Not to make a secret profit
- Not to divulge confidential information

Interaction between Firms and Financial Markets



- Security or instrument issued to an investor for the first time
- Funds are raised by the firm and flow to it
- Public offering or private placement
- Can be debt or equity funding
- Fundraising between investors and firm

Secondary Market

- Financial securities that are already issued are bought and sold
- Way of transferring ownership- Eg: Securities exchange
- Investor-to-investor trading
- No additional funds are raised by the firm

Market Values and Book Values

- Balance sheet is historical accounting
- Real or productive assets- produce the cash flow over time
- Financial or paper assets- claim on cash flows of productive assets
- Balance sheet for finance- not concerned with the past; concerned only with the value of the assets today- market value

Balance Sheet

<ul style="list-style-type: none">❖ What the Firm Owns❖ Current Assets<ul style="list-style-type: none">▣ cash▣ accounts receivable▣ inventory❖ Non-Current Assets<ul style="list-style-type: none">▣ Tangible assets<ul style="list-style-type: none">■ Land/Buildings▣ Intangible assets<ul style="list-style-type: none">■ Trade Marks	<ul style="list-style-type: none">❖ What the Firms Owes❖ Current Liabilities<ul style="list-style-type: none">■ accounts payable❖ Non-Current Liabilities<ul style="list-style-type: none">■ Includes long term debt❖ Shareholders Funds<ul style="list-style-type: none">■ Equity/Capital
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Income Statement

- ◆ Sales
- ◆ Other income
- ◆ Cost of Goods Sold
- ◆ Administration Expenses
- ◆ Other expenses
- ◆ Depreciation
- ◆ Operating Income
 - or Earnings Before Interest and Tax (EBIT)
- ◆ Interest expense
- ◆ Taxes
- ◆ Net Income or Profit after Tax

Lecture 2- Time Value of Money

- The financial manager makes decisions about proposals with cash flows over long periods of time
- An important consideration is the timing of these cash flows- thus the time value of money must be recognised
- It is based on the fact that a dollar today is worth more than a dollar tomorrow

Example 1

- ◆ You invest \$1,000 in a bank today for a period of one year
- ◆ The bank will pay interest at a rate of 5% pa.
- ◆ How much will you have in the bank next year?
- ◆ Solution
 - Interest = $\$1000 \times 5\%$ (or 0.05) = 50
 - Add interest to the original investment
 - $\$1000 + 50 = 1050$

Variables

- A dollar amount today- **present value**
- An interest rate
- A time period
- Gives a dollar amount in the future- **future value**

Terminology

- Time value of money has its own language:
 - PV= Present value, or principal
 - I= Interest rate, later we use 'r'
 - N= Number of periods, later we use 't'
 - FV= Future value
 - PMT= Periodic payment- Part 2

Simple Interest

- Calculated on the original principal
 - Takes no account of changes in principal
 - Sometimes called flat rate interest
- Used in the valuation of short term financial instruments traded in the money market
 - Term is under 12 months
 - Bill of exchange

Future Value with Simple Interest

- ◆ $INT = PV \times i \times n$
 - i = simple interest rate per year
 - n = number of years
- ◆ $FV = PV + INT$
 - FV = future value at end of term
 - PV = principal value at beginning
 - INT = interest amount over the time period
- ◆ $FV = PV + PV \times i \times n$
- ◆ $= PV(1 + i \times n)$

Present Value with Simple Interest

- The formula can be rearranged to calculate present values- $PV = FV / (1 + I \times N)$
- Can also be used to price short term financial instruments

Example 2

- ◆ What is the future value of \$100,000 invested for 180 days at 10% pa simple interest?
- ◆ Solution
- ◆ $FV = PV(1 + i \times n)$
 - $FV = 100,000(1 + 10\% \times 180/365)$
 - $= 100,000(1 + 0.0493)$
 - $= 104,930$
- Note the annual interest rate is adjusted for the number of days the funds are invested during the year