Fundamentals of Business Finance

Chapter 1 – Introduction to Financial Management

Four main areas of Finance

- Corporate finance
- Investment finance
- Financial institutions
- International finance

Financial management decisions

Most decisions made by a financial manager are around one of three topics – capital budgeting (investment decisions), capital structure (financing decisions), and working capital management (ability to meet financial obligations)

When making financial management decisions, the size, timing and risk of the decision must be considered:

- Dollar amount (size) → the dollar amount required

- Time → take into account cash inflows and outflows, and the time value of money

- Risk → take into account the level of risk or uncertainty

Capital Budgeting

Capital budgeting refers to the process of a business planning and managing their long-term assets (long-term investments)

In capital budgeting, the financial manager tries to identify investment opportunities that are worth more to the firm than they cost to acquire

Capital structure

A business's capital structure refers to the specific mixture of long-term debt and equity maintained by a firm. This concerns the financial manager as it affects the businesses ability to obtain the financing needed to support its long-term investment decisions

Working Capital Management

Working capital refers to a business's short-term assets and liabilities

The aim of working capital management is to ensure that a business can meet its short-term financial obligations. This ensures that the business has sufficient resources to continue its operations and avoids costly interruptions

Forms of business organisation

Sole Proprietor/Sole Trader

The simplest and most common way of conducting a business is as a sole trader. A sole proprietorship has the following characteristics:

- The business is owned and operated by one person
- The owner retains all of the profits and bears any loss

Advantages and disadvantages:

Advantages	Disadvantages
Formation is simple	Management Problems
Trader retains control	Limited expertise
Trader retains all profits	Limited capital
Tax benefits with small profits	Unlimited liability
Dissolution is simple	Limited existence
	Tax problems with large profits

Partnership

Refers to when there are two or more people conducting business together with a common view of creating profits.

Advantages and disadvantages:

Advantages	Disadvantages
Easy formation	Unlimited Liability
Flexibility in business	Possible conflict between partners
Pooled funds and talent	No separate legal entity
Sharing profits and losses	Limited capital
Diversity of management	

Company

A company structure for a business refers to when the business has a separate legal entity to its owners. This refers to an incorporated business. In order to form a company, the company needs to be registered through ASIC. The owners of a company are called shareholders. A company can either be a private or public company.

Private vs. Public company:

1. Private company – refers to a company whose ownership is not made available to the general public, but rather select shareholders

2. Public company – refers to a company whose ownership is made available to the general public. The shares of a public company are usually traded on open exchange such as the ASX

Advantages and disadvantages:

Advantages	Disadvantages
Separate legal entity	High establishment costs
May conduct business in own name	High compliance costs
May hold property in own name	Loss of control/takeover threat
Limited liability	
Fundraising capacity	
Taxation advantages	

The goal of financial management

Public company

The goal of financial management is to maximise the value of the businesses existing shares in order to maximise wealth for shareholders

Private company

The goal of financial management is to maximise the market value of the existing owner's equity (as the total value of owners equity = total value of shares)

Corporate governance

Corporate governance refers to the rules, relationships, policies and procedures that define and organize authority within an organisation

The Agency Problem

The agency problem refers to the possibility of conflict of interest between the owners and management of a business

The relationship between shareholders and management is called an agency relationship – Ie: the owners (the principal) hire managers (the agent) to represent his/her interest

Agency cost

Agency cost refers to when managers fail to take advantage of a valuable opportunity available to the business as a result of the managers attempting to avoid failure

Agency risk occurs when management's goals differ to the shareholders goals, and thus there is an agency problem

Financial markets

Financial markets connect corporations with investors. There are two types of financial markets – the primary market and the secondary market

Primary market

- Primary market → refers to the original sale of securities by governments and corporations
- Corporation's involved in two types of transactions – public offerings or private placements
- Funds raised by firm
- Public offering = selling securities to the general public
- Private placement = a negotiated sale involving a specific buyer

Secondary market

- Secondary markets → refers to markets in which securities are bought and sold after the original sale
- Sale of shares only between investors, not between an investor and a corporation
- No additional funding raised by a business

Chapter 2 – Financial Statements, Taxes and Cash Flow

Balance sheet (statement of financial position)

A balance sheet represents a business's assets, liabilities and equity at a specific point in time

Assets = Liabilities + Owners Equity

Net working capital = CA - CL

Key terms

1. Assets – refers to a resource of a business
2. Current assets – refers to any resources that are cash, or are expected to be concerted into cash within 12 months
3. Non-current assets – refers to any resources that are expected to be converted to cash in a period longer than 12 months
4. Intangible assets – refers to assets that have no physical form such as trademarks, copyright or goodwill
5. Liabilities – refers to an obligation of a business

6. Current liabilities – refers to a debts of a business that are expected to be paid within 12 months

7. Non-current liabilities – refers to debts of a business that are expected to be paid in longer than 12 months

8. Equity – refers to the difference between a businesses assets and it's liabilities, representing contributed capital and retained profits

9. Cost principle – the principle that assets should be recorded and reported at the cost paid to acquire them

10. Contributed capital – refers to the funds contributed by investors of a business in exchange for ownership

11. Retained profits/earnings – refers to profits that are not distributed to owners, but are instead kept within the business

12. Dividends – a distribution of profits to owners

13. Liquidity – refers to the ease and speed at which an asset can be converted into cash