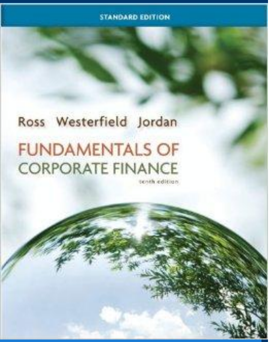
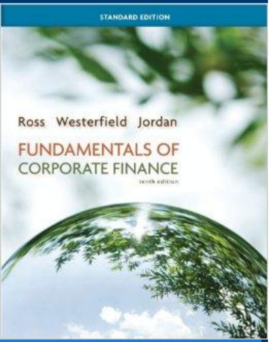


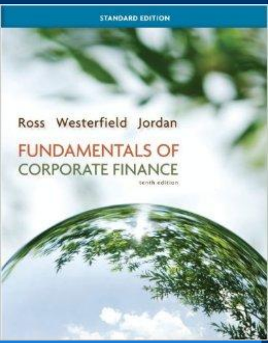

# Chapter One

## Introduction to Financial Management




# Chapter Objectives

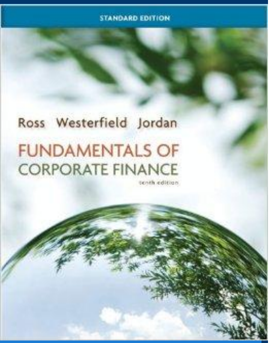
- Goal of the Firm
- Five Basic Principles of Finance and Business
- Understand the basic idea of corporate finance.
- Understand the importance of cash flows in financial decision making.
- Discuss the three main decisions facing financial managers.
- Know the financial implications of the three forms of business organisation.
- Explain the goal of financial management and why it is superior to other possible goals.
- Explain the agency problem, and how it can be can be controlled and reduced.
- Outline the various types of financial markets




# What is Finance?

- ***What is finance?***

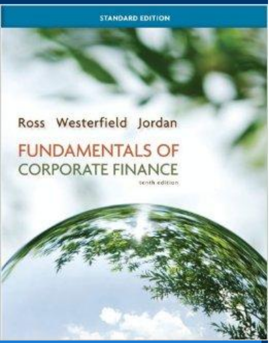
Finance is the study of the art and the science of money management; it is based on the Latin root *finis*, meaning the end. In managing ours or our firm’s money, we consider historical outcomes or “endings,” and we propose future results as a function of decisions made *today.* Those outcomes or results are typically portrayed using financial statements.




# WHAT IS CORPORATE FINANCE?

- Imagine that you were to start your own business. No matter what type you started, you would have to answer the following three questions in some form or another:

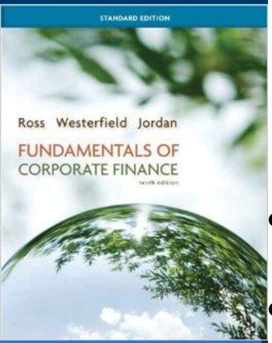
- 1. What long-term investments should you take on? That is, what lines of business will you be in and what sorts of buildings, machinery, and equipment will you need?
- 2. Where will you get the long-term financing to pay for your investment? Will you bring in other owners or will you borrow the money?
- 3. How will you manage your everyday financial activities such as collecting from customers and paying suppliers?




# The Goal of the Firm

The goal of the firm is to create value for the firm’s legal owners (shareholders). Thus the goal of the firm is to maximize shareholders wealth by maximizing the price of the existing common stock

# The Goal of the Firm

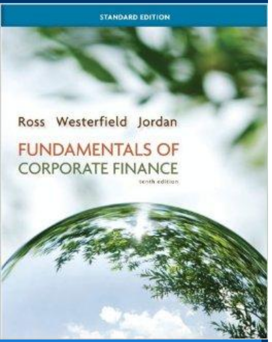



If we were to consider possible financial goals, we might come up with some ideas like the following:

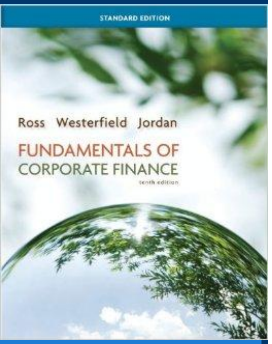
- Survive.
- Avoid financial distress and bankruptcy.
- Beat the competition.
- Maximize sales or market share.
- Minimize costs.
- Maximize profits.
- Maintain steady earnings growth.

These are only a few of the goals we could list. Furthermore, each of these possibilities presents problems as a goal for the financial manager.

# The Goal of the Firm

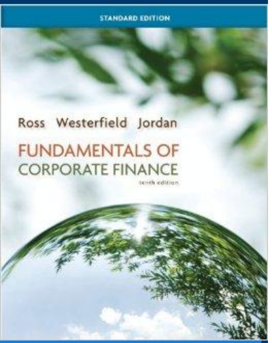



- For example, it’s easy to increase market share or unit sales: All we have to do is lower our prices or relax our credit terms. Similarly, we can always cut costs simply by doing away with things such as research and development. We can avoid bankruptcy by never borrowing any money or never taking any risks, and so on. It’s not clear that any of these actions are in the stockholders’ best interests.
- Profit maximization would probably be the most commonly cited goal, but even this is not a precise objective. Do we mean profits this year? If so, we should note that actions such as deferring maintenance, letting inventories run down, and taking other short-run cost-cutting measures will tend to increase profits now, but these activities aren’t necessarily desirable.
- The goal of maximizing profits may refer to some sort of “long-run” or “average” profits, but it’s still unclear exactly what this means.



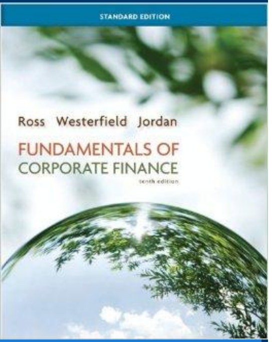

# Five Foundational Principles of Finance

- Cash flow is what matters
- Money has a time value
- Risk requires a reward
- Market price are generally right
- Conflicts of interest cause agency problems



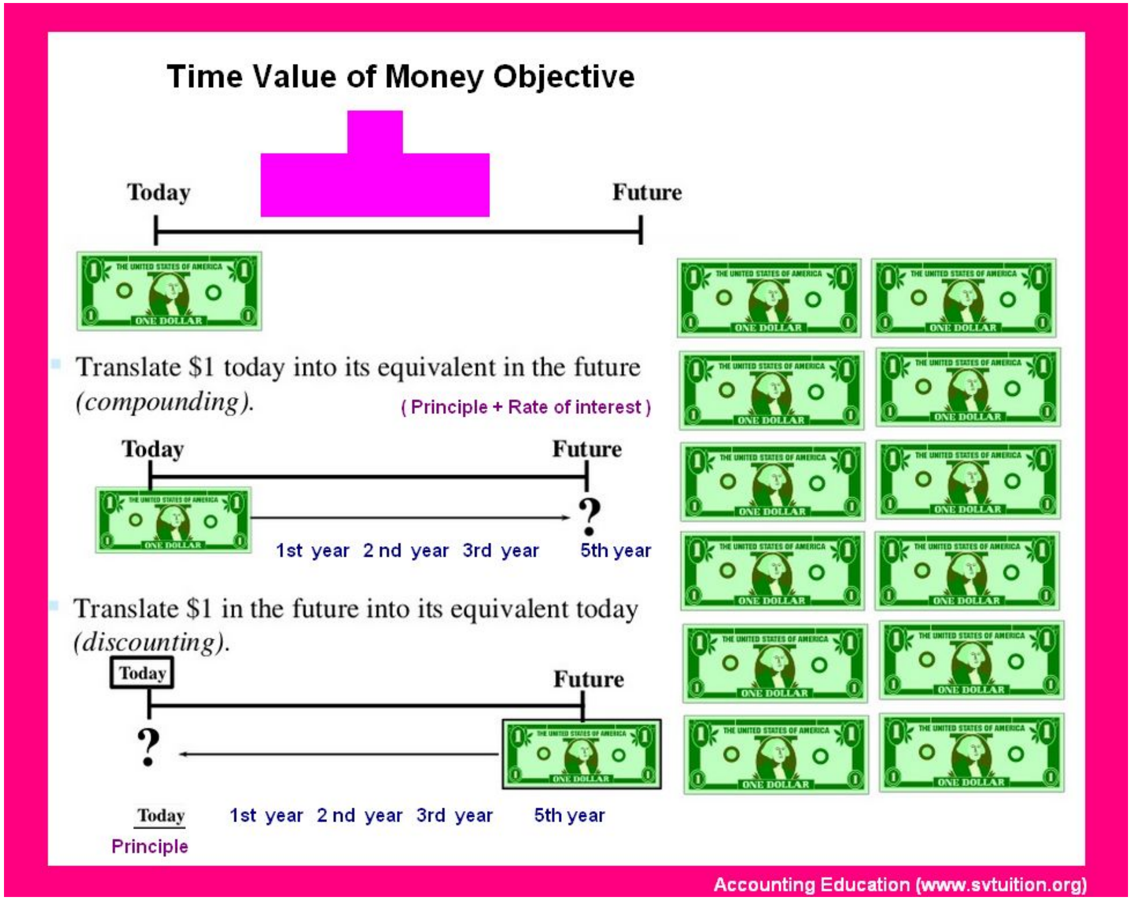

# Principle 1. Cash Flow is What Matters

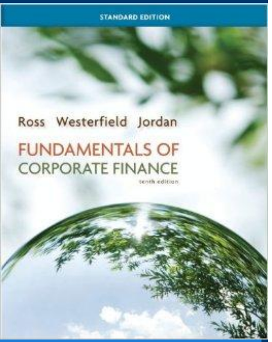
- Cash flow, and not profits, drive the value of a business.
- We must determine incremental cash flows when making financial decisions.
- Incremental cash flow is the additional operating cash flow that an organization receives from taking on a new project. A positive incremental cash flow means that the company's cash flow will increase with the acceptance of the project.




# Principle 2: Money has a Time Value

- A dollar received today is worth more than a dollar received in the future.
- Since we can earn interest on money received today, it is better to receive money earlier rather than later.

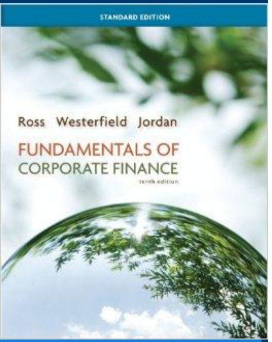





# Principle 3: Risk Requires a Reward

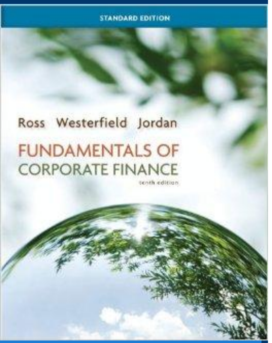
- We won’t take on additional risk unless we expect to be compensated with additional reward or return.
- Investors expect to be compensated for “delaying consumption” and “taking on risk”.

Thus investors expect a return when they put their savings in a bank (i.e. delay consumption) and they expect to earn a higher rate of return on stocks relative to bank savings account



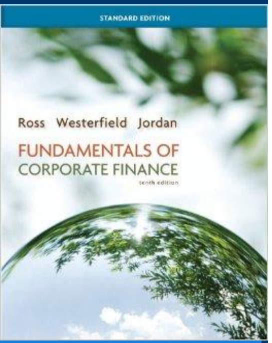

# Principle 4: Market Prices are Generally Right

- In an efficient market, the prices of all traded assets (such as stocks and bonds) at any instant in time fully reflect all available information.
- Thus, stock prices are a useful indicator of the value of the firm. Good decisions will tend to increase the stock prices and vice versa.




# Principle 5: Conflicts of Interest Cause Agency Problems

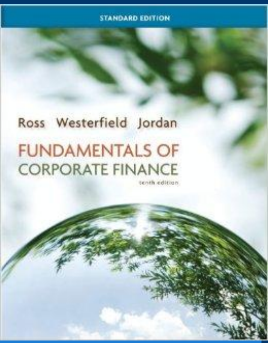
- The separation of management and the ownership of the firm creates an agency problem. Managers may make decisions that are not consistent with the goal of maximizing shareholder wealth.
- Agency conflict is reduced through monitoring (ex. Annual reports), compensation schemes (ex. stock options), and market mechanisms (ex. Takeovers)




# The Role of Finance in Business

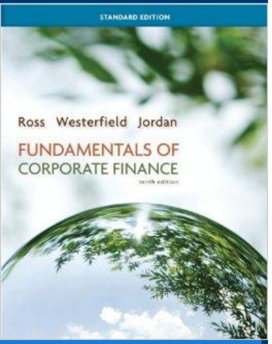
Three broad issues addressed by the study of finance:

- Where to Invest? (Capital budgeting decision)
- How to raise money to fund the investment? (Capital structure decision)
- How to manage cash flows from daily operations? (Working capital decision)



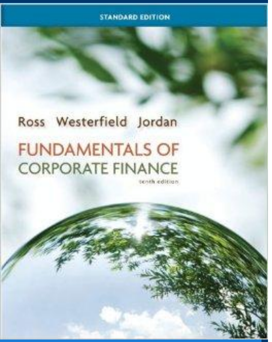

# The Role of Finance in Business (cont'd)

- Knowledge of financial tools is relevant for decision making in all areas of business (be it marketing, production etc.).
- Decisions involve an element of time and uncertainty … financial tools help adjust for time and risk.
- Decisions taken in business should be financially feasible … financial tools help determine the financial viability of decisions.



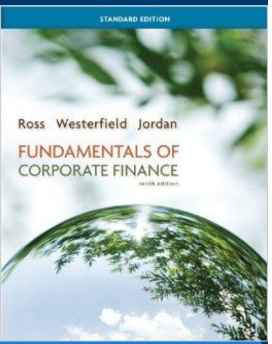

# Basic Areas of Finance

- Corporate finance
- Investments
- Financial institutions
- International finance



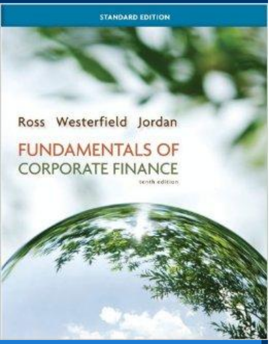

# What is Corporate Finance?

- Corporate finance attempts to find the answers to the following questions:
  - What investments should the business take on?
    THE INVESTMENT DECISION
  - How can finance be obtained to pay for the required investments?
    THE FINANCE DECISION
  - Should dividends be paid? If so, how much?
    THE DIVIDEND DECISION




# The Financial Manager

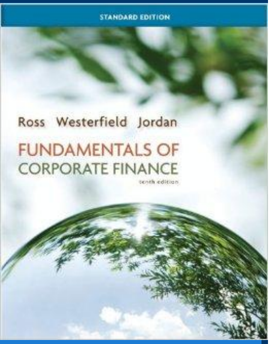
- Financial managers try to answer some or all of these questions.
- The top financial manager within a firm is usually the General Manager–Finance.
  - Corporate Treasurer or Financial Manager - oversees cash management, credit management, capital expenditures and financial planning.
  - Accountant - oversees taxes, cost accounting, financial accounting and data processing.




# The Investment Decision

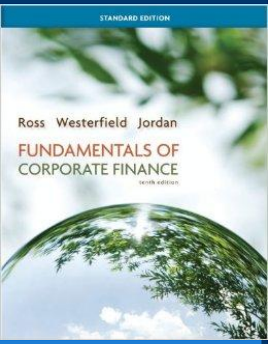
- **Capital budgeting** is the planning and control of cash outflows in the expectation of deriving future cash inflows from investments in non-current assets.

- Involves evaluating the:
  - size of future cash flows
  - timing of future cash flows
  - risk of future cash flows



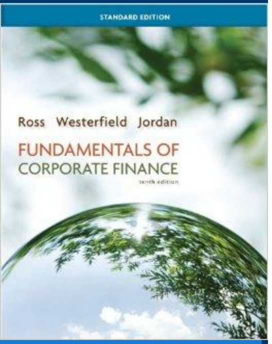

# Cash Flow Size

- Accounting income does not mean cash flow.




# Cash Flow Timing

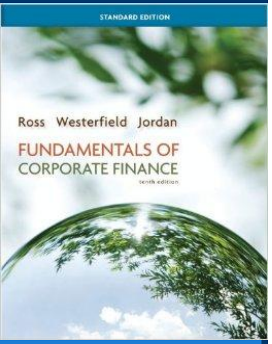
- A dollar today is worth more than a dollar at some future date.
- There is a trade-off between the size of an investment’s cash flow and when the cash flow is received.




# Cash Flow Timing

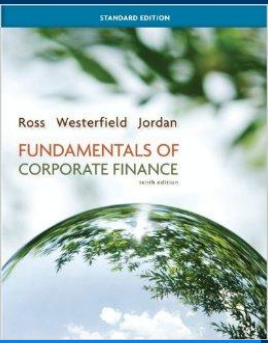
Which is the better project?

| | Future Cash Flows | |
|---|---|---|
| **Year** | **Project A** | **Project B** |
| 1 | $0 | $20 000 |
| 2 | $10 000 | $10 000 |
| 3 | $20 000 | $0 |
| Total | $30 000 | $30 000 |



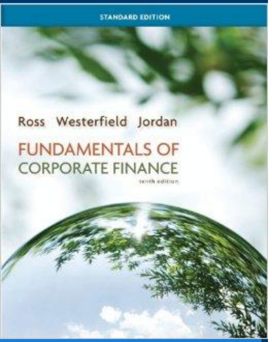

# Cash Flow Risk

- The role of the financial manager is to deal with the uncertainty associated with investment decisions.
- Assessing the risk associated with the size and timing of expected future cash flows is critical to investment decisions.



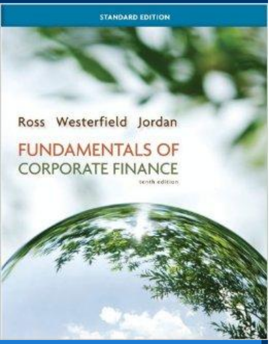

# Capital Structure

- 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 the money.




# Working Capital Management

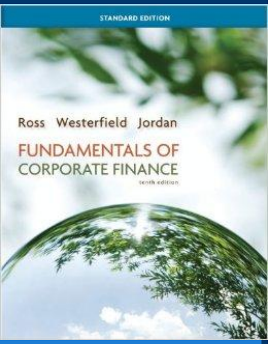
- How much cash and inventory should be kept on hand?
- Should credit terms be extended? If so, what are the conditions?
- How is short-term financing acquired?




# Dividend Decision

- Involves the decision of whether to pay a dividend to shareholders or maintain the funds within the firm for internal growth.

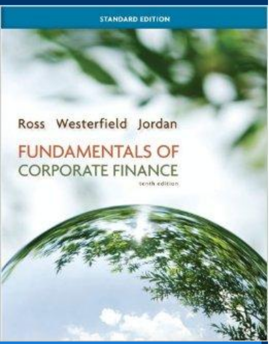
- Factors important to this decision include growth opportunities, taxation and shareholders' preferences.




# Corporate Forms of Business Organisation

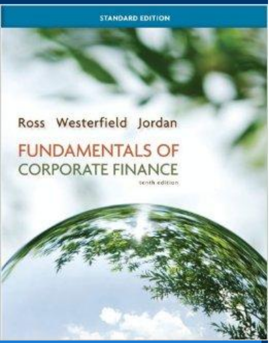
The three different legal forms of business organisation are:

- sole proprietorship
- partnership
- corporation



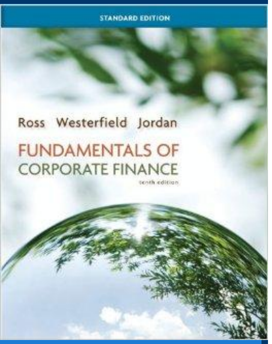

# Sole Proprietorship

- The business is owned by one person.
- The least regulated form of organisation.
- Owner keeps all the profits but assumes unlimited liability for the business’s debts.
- Life of the business is limited to the owner’s life span.
- Amount of equity raised is limited to owner’s personal wealth.



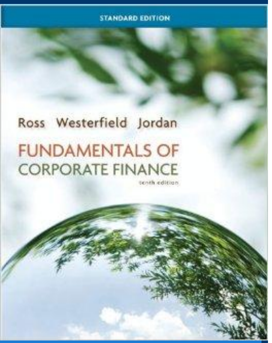

# Partnership

- The business is formed by two or more owners.
- All partners share in profits and losses of the business and have unlimited liability for debts.
- Easy and inexpensive form of organisation.
- Partnership dissolves if one partner sells out or dies.
- Amount of equity raised is limited to the combined personal wealth of the partners.
- Income is taxed as personal income to partners.



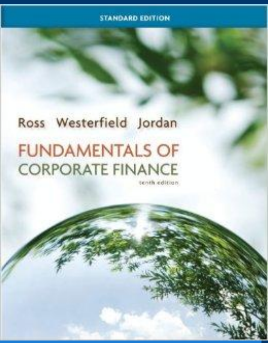

# Corporation

- A business created as a distinct legal entity composed of one of more individuals or entities.
- Most complex and expensive form of organisation.
- Shareholders and management are usually separated.
- Ownership can be readily transferred.
- Both equity and debt finance are easier to raise.
- Life of a company is not limited.
- Owners (shareholders) have limited liability.



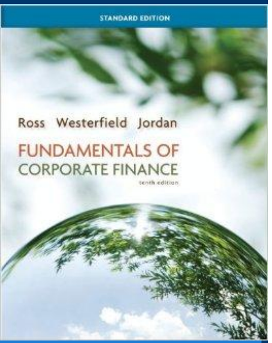

# Possible Goals of Financial Management

- Survival
- Avoid financial distress and bankruptcy
- Beat the competition
- Maximise sales or market share
- Minimise costs
- Maximise profits
- Maintain steady earnings growth



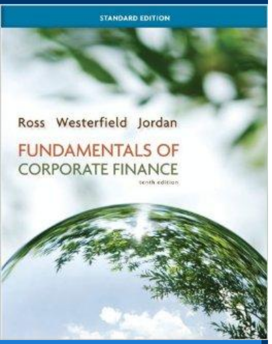

# The Firm's Objective

- The goal of financial management is to maximise shareholders' wealth.
- Shareholders' wealth can be measured as the current value per share of existing shares.
- This goal overcomes the problems encountered with the goals outlined above.




# Agency Relationships

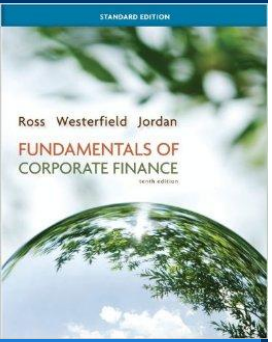
- The **agency relationship** is the relationship between the shareholders (owners) and the management of a firm.
- The **agency problem** is the possibility of conflict of interests between these two parties.
- **Agency costs** refer to the direct and indirect costs arising from this conflict of interest.




# Do Managers Act in Shareholders' Interests?

The answer to this will depend on two factors:

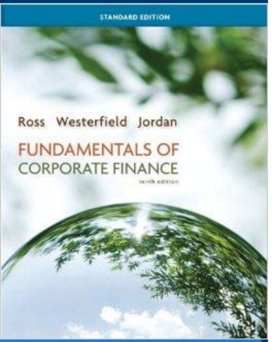
- how closely management goals are aligned with shareholder goals
- the ease with which management can be replaced if it does not act in shareholders' best interests.



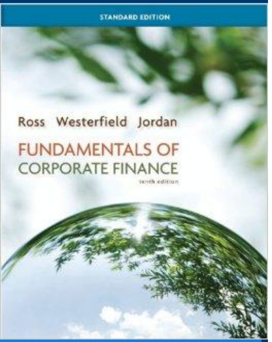

# Financial Markets

- **Financial markets** bring together the buyers and sellers of debt and equity securities.
- **Money markets** involve the trading of short-term debt securities.
- **Capital markets** involve the trading of long-term debt securities.
- **Primary markets** involve the original sale of securities.
- **Secondary markets** involve the continual buying and selling of issued securities.
- **Dealers vs. brokers and underwriters.**

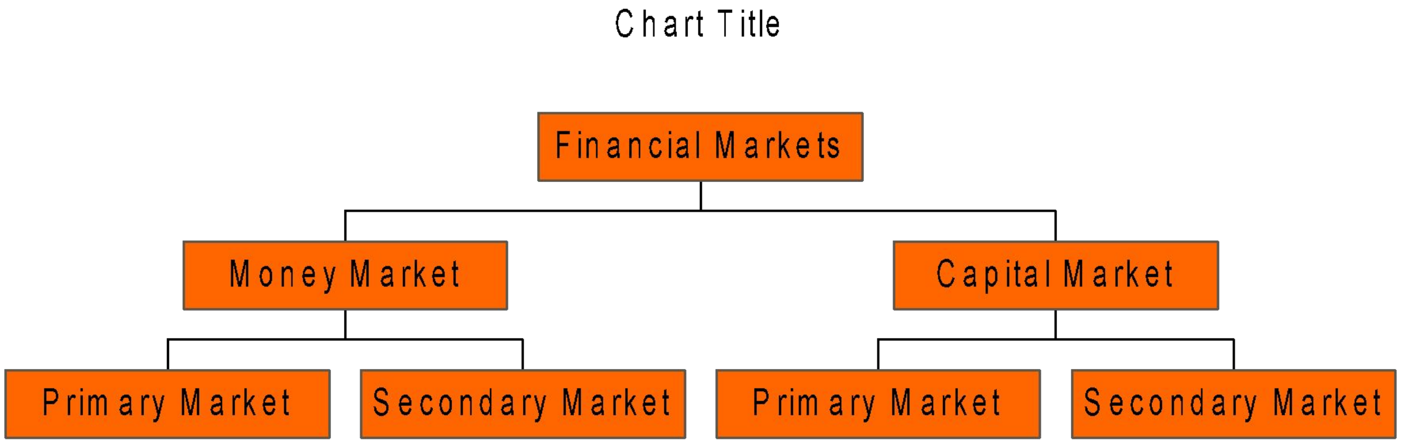
# Auction market vc. Dealer market

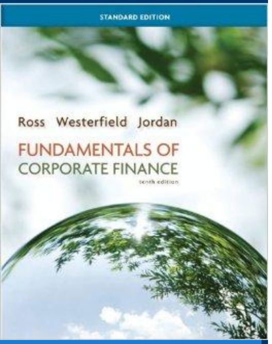



- Dealer markets in stocks and long-term debt are called *over-the-counter* (OTC) markets. Most trading in debt securities takes place over the counter. The expression *over the counter* refers to days of old when securities were literally bought and sold at counters in offices around the country. Today, a significant fraction of the market for stocks and almost all of the market for long-term debt have no central location; the many dealers are connected electronically.
- Auction markets differ from dealer markets in two ways. First, an auction market or exchange has a physical location (like Wall Street). Second, in a dealer market, most of the buying and selling is done by the dealer. The primary purpose of an auction market, on the other hand, is to match those who wish to sell with those who wish to buy. Dealers play a limited role.




# Structure of Financial Markets






# End of chapter