CHAPTER 1 INTRODUCTION TO FINANCE

KEY CONCEPTS AND SKILLS

- Know the basic types of financial management decisions and the role of the financial manager.
- Know the financial implications of the different forms of business organization.
- Know the goal of financial management.

WHAT IS FINANCE?

- Finance is the study of how people and businesses evaluate investments and raise ***capital*** to fund them. (-- *How to get and use money)*
- Three questions addressed by the study of finance
    1. What long-term investments should the firm undertake? (*Capital budgeting decisions – how to spend the money?*)
    2. How should the firm fund these investments? (*Capital structure decisions -- How to get the money?*)
    3. How can the firm best manage its cash flows as they arise in its day-to-day operations? (*Working capital management decisions – how to manage cash (liquid) money?*)

4 BASIC AREAS OF FINANCE

- Corporate / Business of finance
- Investments
- Financial institutions
- International finance

1. CORPORATE / BUSINESS FINANCE

Some important questions that are answered using finance :

- What long-term investments should the firm take on?
- Where will we get the long-term financing to pay for the investments?
- How will we manage the everyday financial activities of the firm?

2. INVESTMENTS

- Work with financial assets such as stocks and bonds
- Value of financial assets, risk versus return, and asset allocation
- **Job opportunities :**

- **Stockbroker or financial advisor**
- **Portfolio manager**
- **Security analyst**

3. FINANCIAL INSTITUTIONS

- Companies that specialize in financial matters
  - **Banks – commercial and investment, credit unions, savings and loans**
  - **Insurance companies**
  - **Brokerage firms**

4. INTERNATIONAL FINANCE

- This is an area of specialization within each of the areas discussed so far
- It may allow you to work in other countries or at least travel on a regular basis
- Need to be familiar with exchange rates and political risk
- Need to understand the customs of other countries; speaking a foreign language fluently is also helpful – Cross culture

INTERNATIONAL FINANCE - SOURCE

INTERNATIONAL FINANCE - SOURCE

WHY STUDY FINANCE?

- **Marketing**

Budgets, marketing research, marketing financial products

- **Accounting**

Dual accounting and finance function, preparation of financial statements

- **Management**

Strategic thinking, job performance, profitability

- **Personal finance**

Budgeting, retirement planning, college planning, day-to-day cash flow issues

FINANCIAL MANAGER

- Financial managers try to answer some, or all, of these questions
- The top financial manager within a firm is usually the Chief Financial Officer (CFO)
  - **Treasurer** – oversees cash management, credit management, capital expenditures, and financial planning
  - **Controller** – oversees taxes, cost accounting, financial accounting, and data processing

FINANCIAL MANAGER

- The goal of the financial manager must be consistent with the mission of the corporation.
  - To maximize firm value shareholder's wealth (as measured by share prices).
  - While managers must cater to all the stakeholders (such as consumers, employees, suppliers etc.), they need to pay particular attention to the owners of the corporation, i.e., shareholders.
- If managers fail to pursue shareholder wealth maximization, they will lose the support of investors and lenders. The business may cease to exist and ultimately, the managers will lose their jobs!

FINANCIAL MANAGEMENT DECISIONS

Capital budgeting

- What long-term investments or projects should the business take on?

Capital structure

- How should we pay for our assets?
- Should we use debt or equity?

Working capital management

- How do we manage the day-to-day finances of the firm?

FORMS OF BUSINESS ORGANIZATION

Three major forms of business organization :

- **Sole proprietorship**
- **Partnership**
- **Corporation**

SOLE PROPRIETORSHIP

- It is a business owned by a single individual that is entitled to all the firm's profits and is responsible for all the firm's debt.
- There is no separation between the business and the owner when it comes to debts or being sued.
- Sole proprietorships are generally financed by personal loans from family and friends and business loans from banks.
- <u>Advantages</u>:
  - Easy to start
  - No need to consult others while making decisions

- ❖ Taxed at the personal tax rate
- ❑ Disadvantages:
  - ❖ Personally, liable for the business debts
  - ❖ Ceases on the death of the proprietor

PARTNERSHIP

- ❑ A **general partnership** is an association of two or more persons who come together as co-owners for the purpose of operating a business for profit.
- ❑ There is no separation between the partnership and the owners with respect to debts or being sued.
- ❑ Advantages:
  - ❑ Relatively easy to start
  - ❑ Taxed at the personal tax rate
  - ❑ Access to funds from multiple sources or partners
  - ❑ Disadvantages:
  - ❑ Partners jointly share unlimited liability

PARTNERSHIP_CONT.

- ❑ In **limited partnerships**, there are two classes of partners: general and limited.
- ❑ The general partners run the business and face unlimited liability for the firm's debts, while the limited partners are only liable on the amount invested.
- ❑ One of the drawbacks of this form is that it is difficult to transfer the ownership of the general partner.

CORPORATION

- ❑ Corporation is "an artificial being, invisible, intangible, and existing only in the contemplation of the law."
- ❑ Corporation can individually sue and be sued, purchase, sell or own property, and its personnel are subject to criminal punishment for crimes committed in the name of the corporation.
- ❑ Corporation is legally owned by its current stockholders.
- ❑ The Board of directors are elected by the firm's shareholders. One responsibility of the board of directors is to appoint the senior management of the firm.

CORPORATION

- ❑ Advantages
  - ❑ Liability of owners limited to invested funds

- Life of corporation is not tied to the owner
- Easier to transfer ownership
- Easier to raise Capital
- Disadvantages
- Greater regulation
- Double taxation of dividends

THE FOUR BASIC PRINCIPLES OF FINANCE

- **Money has a time value.**
  - A dollar received today is more valuable than a dollar received in the future (due to interests, investment returns)
- **There is a risk-return trade-off.**
  - One *shall* take extra risk only if one expects to be compensated for extra return.
- **Cash flows are the source of value.**
  - Profit is an accounting concept designed to measure a business's performance over an interval of time.
  - Cash flow is the amount of cash that can actually be taken out of the business over this same interval.
- **Market prices reflect information.**
  - Investors respond to new information by buying and selling their investments.

FINANCIAL MARKETS

- Cash flows to the firm
- Primary vs. secondary markets
  - Dealer vs. auction markets
  - Listed vs. over-the-counter securities

  NYSE

  NASDAQ

  ISE (IMKB)