CHAPTER-1

INTRODUCTIO TO BUSINSS FINANCE

What is Finance

- Finance can be defined as the art and science of managing money. The proper management of money is called finance.
- Management of financial resources by individual is called personal finance.
- Management of financial resources by government is called public finance.
- Management of fund in the context of business is known as business finance.

Traditional Approach

- The traditional approach, which was popular in the early stage, limited the role of financial management to raising and administering of funds needed by the corporate enterprises to meet their financial needs.
- The responsibility of financial manager was limited only to estimate the financial requirements of a corporation and raise the funds to meet projected financial requirement of the corporation.
- *Main limitations of Traditional Approach*

• Ignored routine problems.

• Ignored finance manager’s viewpoint.

• Ignored non-corporate enterprise.

• No Emphasis on allocation of funds.

Modern Approach

- With the passage of time the scope of business finance widened. Now it is not limited to the fund raising activities, it has widened to cover the acquisition, financing, and management of a corporation's assets.

- According to modern approach the term financial management provides a conceptual and analytical framework for financial decision-making.

In short, business finance is the study of the ways to address the following issues in a firm.

- **What long-term investments should a firm take on?**
- **Where the firm will get the long-term funds for investments?**
- **How the firm will manage its everyday financial activities such as collecting from customers and paying suppliers?**
- **How the firm should go about deciding upon payment to shareholders?**

Types of Financial Decisions

- **Investment Decisions**
- **Financing Decisions**
- **Dividend Decisions**
- **Asset Management Decisions**

Investment Decisions:

These decisions relate to how the firm's funds are invested in different assets so that they are able to earn the highest possible return for their investors.

Factors Affecting

- Cash flows of the project.
- The rate of return.
- The investment criteria involved

Financing Decisions:

It involves identification of various sources of finance and the quantum of finance to be raised from long-term and short-term sources.

The main sources of funds are shareholders funds and borrowed funds.

Factors Affecting

- Cost
- Risk
- Floatation costs.
- Cash flow position of the business

Asset Management Decisions:

Financial Manager has varying degrees of operating responsibility over assets.

Greater emphasis on current asset management than fixed asset management.

Dividend Decision:

Dividend is that portion of profits, which is distributed to shareholders.

The decision made here is how much of the profit is to be distributed to the shareholders and how much of it should be retained to meet the investment requirements.

Factors Affecting

- Earnings.
- Stability of earnings.
- Stability of dividend.
- Growth opportunities.

Finance Function

Finance Function

Managerial Finance Function

- Investment decisions
- Financing decisions
- Dividend decisions
- Asset management decisions

Routine Finance Function

- Supervision of cash receipt & disbursements
- Safeguarding of cash balances
- Custody and safe guarding of valuable documents
- Taking care of mechanicals details of financing
- Record keeping of the financial performance of the firm
- Reporting to the top management
- Supervision of fixed assets & current assets

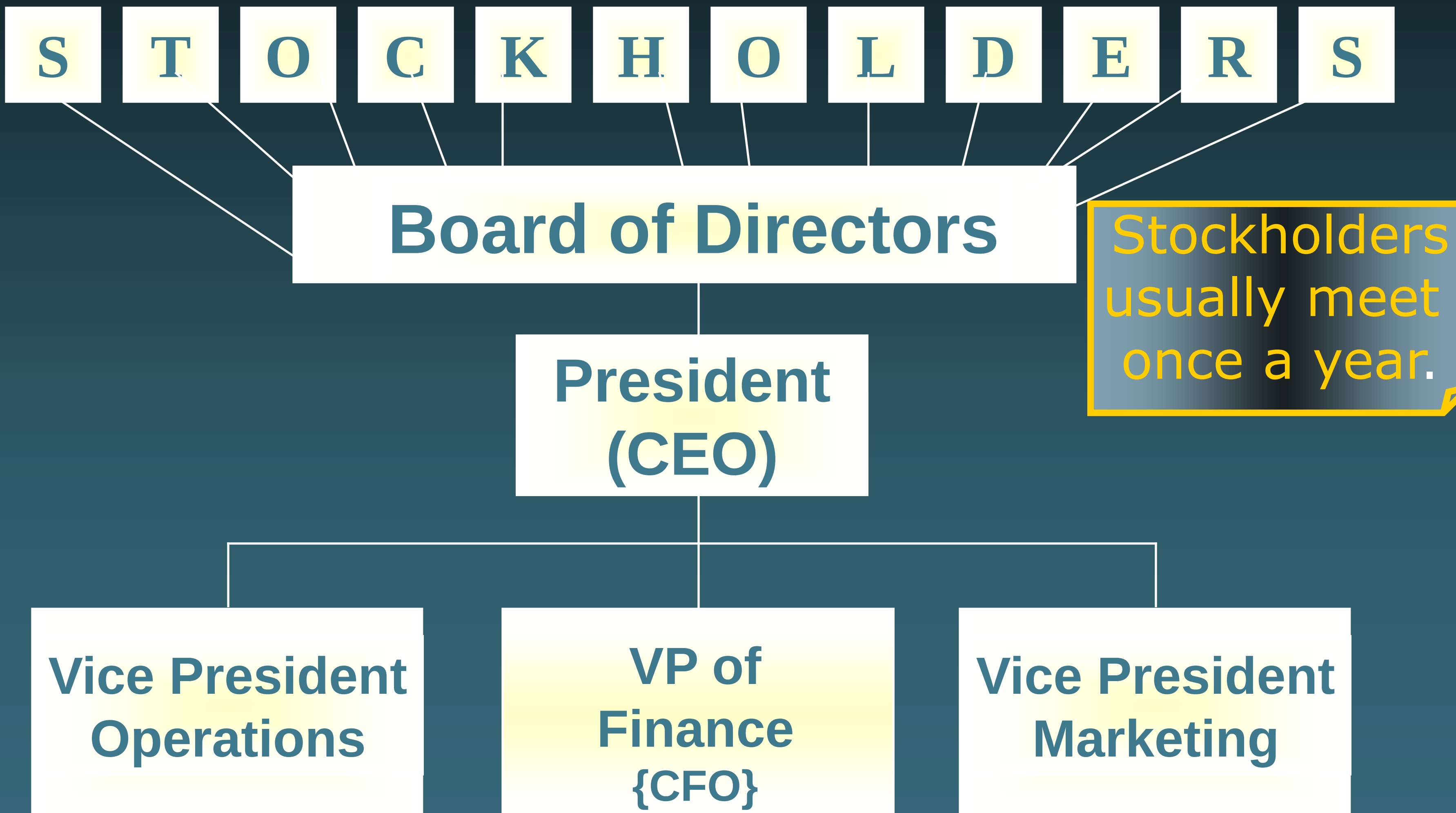
Career Opportunities

TABLE 1.3 Career Opportunities in Managerial Finance

Position	Description
Financial analyst	Primarily prepares the firm's financial plans and budgets. Other duties include financial forecasting, performing financial comparisons, and working closely with accounting.
Capital expenditures manager	Evaluates and recommends proposed asset investments. May be involved in the financial aspects of implementing approved investments.
Project finance manager	In large firms, arranges financing for approved asset investments. Coordinates consultants, investment bankers, and legal counsel.
Cash manager	Maintains and controls the firm's daily cash balances. Frequently manages the firm's cash collection and disbursement activities and short-term investments; coordinates short-term borrowing and banking relationships.
Credit analyst/manager	Administers the firm's credit policy by evaluating credit applications, extending credit, and monitoring and collecting accounts receivable.
Pension fund manager	In large companies, oversees or manages the assets and liabilities of the employees' pension fund.
Foreign exchange manager	Manages specific foreign operations and the firm's exposure to fluctuations in exchange rates.

Read Only

Corporate Organization



Corporate Organization

VP of Finance

Treasurer

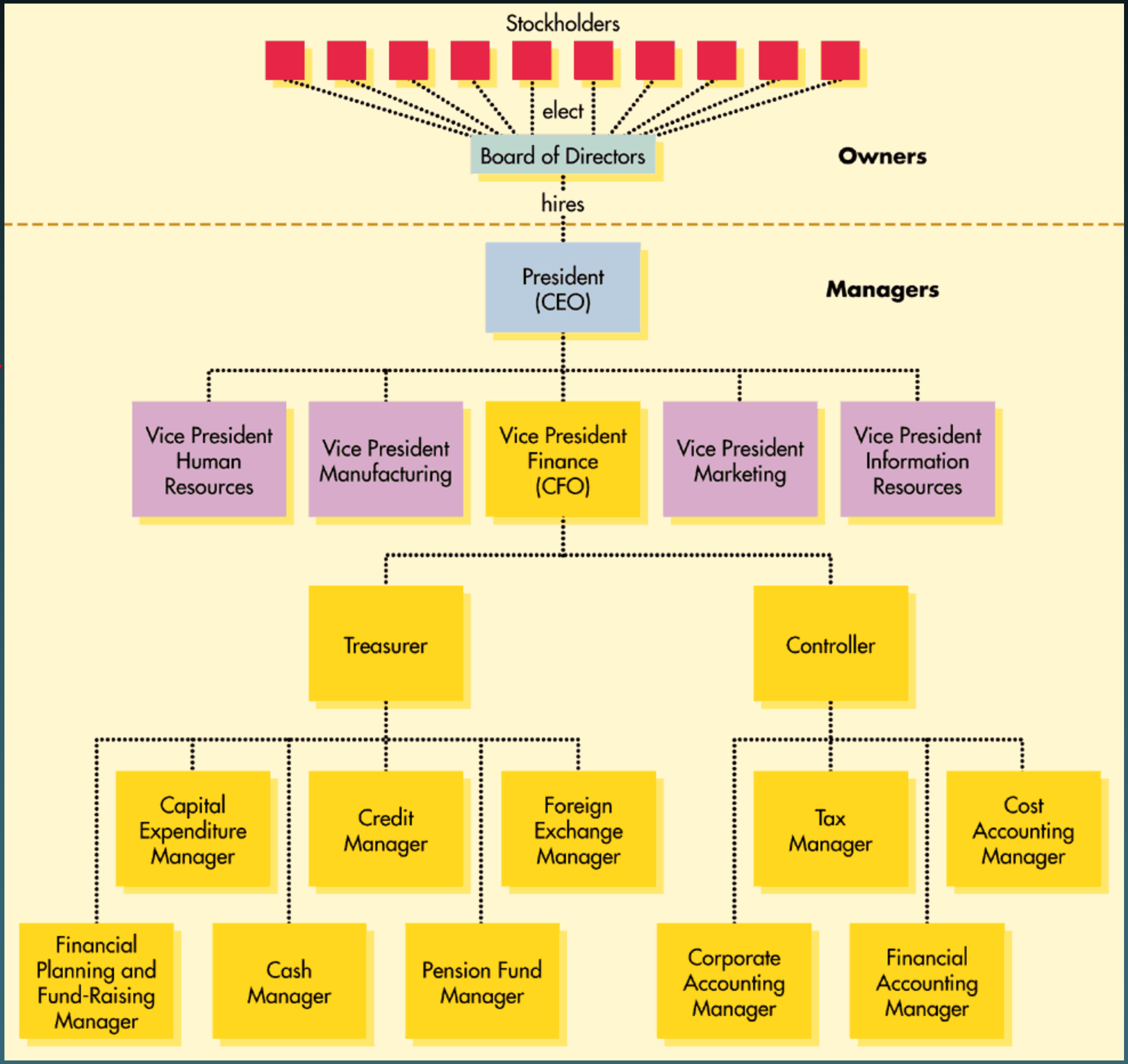
- Capital Budgeting
- Cash Management
- Credit Management
- Dividend Disbursement
- Fin Analysis/Planning
- Pension Management
- Insurance/Risk Mgmt
- Tax Analysis/Planning

Controller

- Cost Accounting
- Cost Management
- Data Processing
- General Ledger
- Government Reporting
- Internal Control
- Preparing Financial Statements
- Preparing Budgets
- Preparing Forecasts

Corporate Organization

Another Example



The Financial Environment

Financial Institutions

- Financial institutions are *intermediaries* that channel the savings of individuals, businesses, and governments into loans or investments. These institutions accepts money from savers and use those funds to make loans and other financial investments in their own name. They include commercial banks, saving institutions, mutual funds etc

The Financial Environment

Financial Markets

- *Financial markets* provide a forum in which suppliers of funds and demanders of funds can transact business directly.
- The two key financial markets are the *money market* and the *capital market*. Transactions in short term marketable securities take place in the money market while transactions in long-term securities take place in the capital market.
- Within the money and capital markets are the *primary & secondary market*.(Refer to the next slide)

Primary & Secondary Markets

- Primary Market

  The *primary market* is the one in which a corporation or government is directly involved in and receives the proceeds from the transaction. When a corporation issues securities, cash flows from investors to the firm. (Usually an underwriter is involved)

- Secondary Markets

  The *secondary markets* involve the sale of "used" securities from one investor to another. Once issued, securities then trade on the secondary markets such as the Karachi Stock Exchange or NASDAQ.Securities may be exchange traded or trade over-the-counter in a dealer market.

The Goal of the Firm?

- Profit Maximization
- Maximization of Shareholder Wealth

Profit Maximization objective:

- Profit maximization simply refers to the maximization of rupee income of the firm.
- Under this objective, firms attempt to adopt those investment projects, which yield larger profits and drop all other unprofitable activities.
- In maximizing profit, input-out relationship is crucial, either input is minimized to achieve a given amount of out or the output is maximized with a given amount of input.

The arguments in favor of this approach is:

- Understandable - Simple and straight forward to understand.
- Decision criterion – Every alternative is evaluated on the basis of maximizing profit.
- Incentive to work – Profit is better incentive to work.
- Measurement of efficiency – Maximum profit indicates high efficiency.
- Maximize social welfare - It can be maximized by providing better good & services, surplus generation, reinvestment opportunities etc.

Drawbacks of profit maximization objective:

- Vague/Ambiguity: The term "profit" it self is vague. Maximization of profit conveys different meaning to different stakeholders. Profit may be long-term or short-term, after tax or before tax, total profit or profit per share, which of these profits is to maximized is not clear in this objective.

- Ignores time value of money: Under this objective total profit earned during the life of assets is taken into account and timing of their realization is ignored. It equates a rupee received today with a rupee received in the future. In fact Rs. 100 today is more valuable than Rs. 100 received after one year. It is because the money received in earlier period may be reinvest able to earn more.

Year	CFs of Project A	CFs of Project B
1	Rs. 10,000	Rs. 2,000
2	8,000	4,000
3	6,000	6,000
4	4,000	8,000
5	2,000	10,000
Total	Rs. 30,000	Rs. 30,000

When profit maximization criterion is used both are equally attractive. However, if we consider time value of money, project A is better than project B, because it offers larger cash flows in earlier periods.

- Ignores Risk Elements/ Ignores Quality of Benefits: It ignores the risk associated with the stream of cash flow of the project. For example, the total profit from two projects may be the same but the profit from one project may be fluctuating widely than the profit form the other project.

year	CFs of Project X	CFs of Project Y
1	Rs.2,000	Rs. 3,000
2	2,000	500
3	2,000	1,500
4	2,000	0
5	2,000	5,000
Total	Rs. 10,000	Rs. 10,000

- As per the above table, the total expected cash flows from project X & Y during their life are equal. However, project X provides consistent cash flows over the life, whereas project Y has more fluctuating cash flows. Hence, project Y is more risky than project X.

- Stakeholders: In today's large scale type corporations, there exist different stakeholders such as owners, managers, customers, creditors and employees. The interest of each member in this organizational structure cannot be achieved with the sole objective of profit maximization.

Shareholders' wealth maximization objective

- Under this objective, the managers should take decisions that maximizes the shareholders wealth.
- Shareholders' wealth is maximized when a decision generates "net present value" (NPV)
- NPV = Present value of future cash flow – present value of its cost
- A decision that has a positive net present value creates wealth of shareholders.

- Stockholders’ wealth maximization means the maximization of the market value to their stock. Thus, the maximization of the value of the firm and stockholders' wealth maximization is the same.
- Management is guided by this objective, if they do not follow this objective, then they will be replaced by the electing new management.
- This objective maximizes the value of the firm, therefore, it is superior to the profit maximization goal

Wealth Maximization a Superior Decision Criterion

The justification for this goal are as under:

- Recognizes Time Value of Money: Time value of money is an important concept in financial decision making. Wealth maximization objective recognizes this concept. According to this concept, all cash flows generated over the life of the project are discounted back to present value using required rate of return as discount rate, and the decision is based on the Present Value (PV) of future cash flow.

Year	Cash flow of Project X	Cash flow of Project Y	PVIF @ 10%	PV of cash flow Project X	PV of cash flow Project Y
1	RS. 10,000	RS. 2,000	0.9091	RS.9,091.00	RS. 1,818.20
2	8,000	4,000	0.8264	6,611.20	3,305.60
3	6,000	6,000	0.7513	4,507.80	4,507.80
4	4,000	8,000	0.6830	2,732.00	5,464.00
5	2,000	10,000	0.6209	1,241.80	6,209.00
Total	RS. 30,000	RS.30,000		RS. 24,183.80	RS. 21,304.60

Considering the time value of money and assuming a 10% required rate of return for both projects, the total PV of project X is Rs.24,183.80 is greater than that of Y i.e. RS. 21,304.60. Therefore, project X is better than project Y.

- Considers Risk Elements in cash flow: This objective is also justifiable from this view point. The project with fluctuating cash flow poses risk than the project with constant cash flow. Therefore, higher required rate of return is used to discount the cash flow of the project with high fluctuation in cash flow.

year	CFs of Project X	CFs of Project Y
1	Rs.2,000	Rs. 3,000
2	2,000	500
3	2,000	1,500
4	2,000	0
5	2,000	5,000
Total	Rs. 10,000	Rs. 10,000

If we do not consider the risk associated to streams of cash flows given in above table, both projects are equally likely because both of them produce total cash flow of RS. 10,000 over their five years of life. However, the cash flows from project Y are fluctuating each year, hence it is riskier than project X. Therefore, a higher required rate of return is used to discount the cash flow of project Y than that of project X.

- Separation between ownership and Management: Shareholders provide funds to operate a business firm and they appoint a team of management to run the firm. Therefore, on the investment of shareholders there must be return. Shareholders wealth maximization is reflected only in terms of high market price of the shares which maximizes the shareholders wealth.

- Residual Owners: Shareholders get residual earnings and assets (in case of liquidation of the company). Therefore, if shareholders’ wealth is maximized, the all others with prior claim than shareholders could be satisfied.

The Agency Problem

- Agency problem is a conflict of interest inherent in any relationship where one party is expected to act in the best interest of another.
- Agency problem arises when incentives or motivations present themselves to an agent to not act in the full best interest of a principal.
- In business finance, the agency problem usually refers to a conflict of interest between a company's management and the company's stockholders. The manager, acting as the agent for the shareholders, or principals, is supposed to make decisions that will maximize shareholder wealth even though it is in the manager's best interest to maximize his own wealth.

What About Other Stakeholders

Stakeholders include all groups of individuals who have a direct economic link to the firm including:

- Employees
- Customers
- Suppliers
- Creditors
- Owners

Goals of the Corporation

- As discussed before, the primary goal is shareholder wealth maximization, which translates to maximizing stock price.

- Should firms behave ethically? YES!

- Do firms have any responsibilities to society at large? YES! Shareholders are also members of society.