Department of Accounting Education
Mabini Street, Tagum City
Davao del Norte
Telefax: (084) 655-9591, Local 116

Big Picture C

Week 6–7: Unit Learning Outcomes (ULO): At the end of the unit, you are expected to:

a. Explain the fundamental concept and the goals of finance.
b. Rationalize the concept of time value of money and compute the Present and Future value of different types of cash flow stream.

Big Picture in Focus: *ULOa*. Explain the fundamental concept and the goals of finance.

Metalanguage

Since the Unit Learning Outcome of this section is to define the fundamental concept and goals of finance, please proceed immediately to the essential knowledge section of this ULO.

Essential Knowledge

1. FINANCE

Finance is a body of facts, principles, and theories relating to raising and using money by individuals, businesses, and governments.

Finance may be defined as the study of the acquisition and investment of cash for the purpose of enhancing value and wealth.

Categories of Finance

1. Public Finance

Deals with the revenue and expenditure patterns of the government and their various effects on the economy.

2. Private Finance

This category deals with the area of general finance not classified under public finance. It is subdivided into the following:

1. Personal Finance
2. The finance of non-profit organizations; and

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3. Business Finance.

    - Provision of money for commercial use.
    - Concerned with the effective use of funds.
    - It covers the financial management of private profit-seeking concerns in the business.

    With the foregoing requirements, **business finance** may be defined as the procurement and administration of funds with the view of achieving the objective of the business.

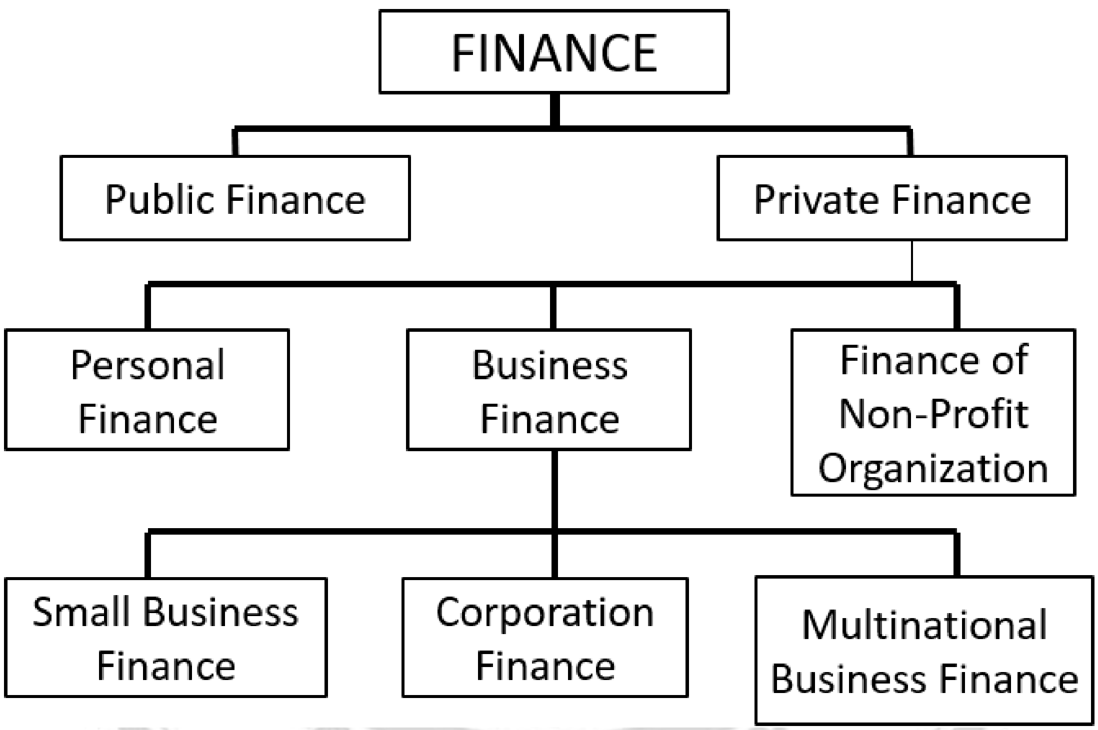

Figure 14. Categories of Finance

Goals of Business Finance

1. Maximizing profit;
2. Maximizing profitability;
3. Maximizing profit subject to cash constraints;
4. Maximizing net present worth ; and
5. Seeking an optimum position along a risk-return frontier.

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Maximizing profit

Means realizing the highest possible peso or dollar income. A firm, for instance, may seek to double its peso or dollar income for the current year. This framework, however, is not very useful in making sound financial decisions.

Maximizing Profitability

Profitability can be measured by computing *Return on Investment (ROI).*

$$ROI = \frac{Profit}{Investment}$$

Example 1: Calculation of ROI

MIKAELA COMPANY
(2006)

	2005	2006
Net Worth	₱100,000,000	₱200,000,000
Net Profit	10,000,000	50,000,000
Return on Investment	10%	25%

Profitability can be maximized by obtaining higher rate of ROI.

Maximizing Profit Subject to Cash Constraint

The ideal set-up is to maximize profits, while at the same time maintaining a cash balance that can take care of cash requirements anytime. This condition is especially critical in the operation of banks.

Maximizing the Net Present Worth

Under the net present worth concept, the objective of the firm is to maximize the current value of the company to its owners. The net present worth of the firm is equal to the value now of the firm plus values arising in the future. This concept considers the relevance of time value of money. This concept indicates that money increases in value with the passing of time.

In financial management perspective, the primary goal of finance is not to maximize the profit, but rather maximizing the shareholder's wealth is of primary concern.

Example 2: Calculation of Present Worth:

What is the value of today of P100,000 to be received next year assuming that the prevailing rate of interest is 10% per annum?

Solution:

$$\text{Value today of next year's P100,000} = \frac{\text{amount}}{1 + \text{rate of interest}} = \frac{₱100{,}000}{1.10} = \underline{\underline{₱90{,}909.09}}$$

Seeking an Optimum Position along the Risk-Return Frontier.

A firm can set a goal of achieving the best possible combination of risk and return.

Figure 15. Risk – Return Frontier

A little more risk may be accepted, for instance, for an expected additional rate of return.

Return on Investment is the net income generated by the use of investments or the net worth of a firm. When it is expressed in percentage, it is called the *rate of return. Risk mean*s uncertainty as to loss. When used in finance, the term applies to the potential incurrence of loss of money or its equivalent.

Calculation of Expected Value Using Risk and Return Factors.

The expected value of a return on investment is equal to the return times the percentage of probability that it will happen (called the risk factor).

Example 3. Calculation of Expected Value

Alternative	Return on Net Worth *(A)*	Probability *(B)*	Expected Value *(A x B)*
1	P 100 million	60%	P 60 million
2	P 200 million	50%	P 100 million (optimum position)
3	P 300 million	30%	P 90 million

2. THE FINANCIAL STATEMENTS

Financial Statements are those that present financial information to various interested parties. Two important financial statements in the point of view of business finance: (1) the balance sheet; and (2) the profit and loss statement.

The Balance Sheet

The Balance Sheet shows:

1. Assets
   a. Current Assets
   b. Trade Investments
   c. Fixed Assets
   d. Intangible Assets

2. Liabilities
    a. Accounts Payable
    b. Loans and Notes Payable
    c. Advances from Customers
    d. Accrued Expenses
    e. Mortgage Payable
    f. Bonds Payable
3. Net Worth

The Income Statement

Represents the revenues realized form the sale of commodities and services produced by the company, as well as the costs and expenses incurred in connection with the realization of said revenues. Also referred to as *profit and loss statement.*

3. THE BUDGETS

Budget is defined as an estimate of income and expenditure for a future period.

The Sales Budget

The *sales budget* is the starting point of company budgets. It shows an estimate of sales in units and dollars or pesos for each major subdivision of sales.

The Materials and Purchases Budget

Refers to the estimate of the materials required by the firm, specified in quantities, costs, timing of purchase, the required delivery dates, and other requirements.

Production Budget

Is an estimate of the quantity of products that should be produced in accordance with the sales budget. It also shows the monthly breakdown of quantities to be produced for each product depending upon the firm’s seasonal sales index.

The total units to be produced could be derived using the following equation:

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	Budget Sales
-	Starting Finished Goods Inventory (Expected)
+	Ending Finished Goods Inventory (Planned)
=	Total Units to be Produced

Significance of Financial Statements and Budgets

Financial statement and budgets are significant in terms of decision making of various users of information derived from these reports.

There are five distinct groups interested in knowing the financial standing of the firm.

1. The owners
2. The management
3. The creditors
4. The government
5. Prospective investors.

4. THE ANNUAL REPORT

The report sent out each year by the company to its stockholders or members. It normally contains the following:

1. The balance sheet;
2. The profit and loss statement;
3. The auditor's report; and
4. The chairman's report.

In case the firm is part of a group, the report must also contain a consolidated balance sheet and a consolidated profit and loss statement.

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Self-Help: You can also refer to the sources below to help you further

*Dela Cruz, M.(2011). *Business Finance(Philippine Environment)*.Rex Printing Company Inc.,Sta. Mesa Heights Manila

*Francisco, E. (2016). *Fundamentals of business finance. Manila*: Mindshapers Co., Inc.

Let's Check

Questions:

1. What is finance? Explain how this field affects all of the activities in which businesses engage.

2. What is the goal of the firm and, therefore, of all managers and employees? Discuss how one measures achievement of this goal.
3. For what basic reasons is profit maximization inconsistent with wealth maximization?

4. What is risk? Why must risk as well as return be considered by the financial manager who is evaluating a decision alternative or action?

5. What is the difference of public finance and private finance in terms of its purpose?

Let's Analyze

Questions:

Asset A

Possible Outcomes	Probability	Returns (%)
Pessimistic	0.25	10
Most likely	0.45	12
Optimistic	0.30	16

1. Compute the expected value.

Investment	100,000
Return on Investment	20%
Return on Equity	25%

2. What is the net profit?

Asset	A	B	C	D
Initial investment	$15,000	$15,000	$15,000	$15,000
Annual rate of return				
Pessimistic	8%	5%	3%	11%
Most likely	12%	12%	12%	12%
Optimistic	14%	13%	15%	14%

3. If you are a risk-averse financial manager, which asset would you prefer?

In a Nutshell

Question:

1. Why is the study of finance important to your professional life regardless of the specific area of responsibility you may have within the business firm? Why is it important to your personal life?

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2. Define the purpose of financial statement in the point of view of each group interested on it.

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3. Define and ellaborate the term “wealth maximization”.

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Q&A Lists

Do you have any clarifications?	
Issues/Questions	Answers

Keyword Index

Balance Sheet
Expected Value
Finance
Income Statement
Materials and Purchases Budget
Production Budget
Return
Return on Investment
Risk
Sales Budget
Wealth Maximization