ADMAS UNIVERSITY

COLLEGE OF POST GRADUATE STUDIES

Course: Advanced Financial Management

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CHAPTER ONE

Introduction: Basics of the Financial Management

Learning Objectives

- The purpose of this chapter is to give you an idea of **what financial management is all about.**
- After you finish the chapter, you should have a reasonably good idea of what finance majors might do after graduation.
- What are the most common decision criteria that are highly emphasized in financial management?
- Why is **wealth maximization** is considered to be **superior over profit maximization as a goal of a firm**?
- What are the threats to the wealth maximization goal of a firm?
- Explain the 10 principles that form the basics of financial management

MEANING OF FINANCE

- What finance is? Literally, finance means the money used in day-to-day activities of an individual or a business for exchange of goods and services.
- Finance is the art and science of managing money.
- According to Oxford dictionary, the word ‘finance’ connotes ‘management of money’.
- Finance is the application of economic principles and concepts to business decision-making and problem solving.

Con't…

Financial management. Sometimes called *corporate finance* or *business finance*, this area of finance is concerned primarily with financial decision-making within a business entity.

Financial Management is:

- A process of **planning**, **organizing**, **directing** and **controlling** the **financial activities** such as **procurement and utilization of funds of the enterprise**.
  - ✓ It is about applying general management principles to financial resources of the enterprise.
- Management of the finances of an organization in order to achieve financial objectives. Eg.
  - pay bills (materials, electricity, advertising),
  - Pay wages and salaries,
  - Acquire resources,
  - Develop new products, and etc.

Con't…

- **FM** is the management of financial resources – **how to best find and use investments** and financing opportunities in an ever-changing and increasingly complex environment.
- **Financial management** can also be defined as a decision making process concerned with planning for raising, and utilizing funds in a manner that achieves the goal of a firm.
- Financial management decisions includes:
  - ✓ maintaining optimum cash balances,
  - ✓ extending credit,
  - ✓ acquiring other firms,
  - ✓ borrowing from banks, and
  - ✓ issuing stocks and bonds.

Con't…

- Financial managers also have the responsibility for:
  - ✓ deciding the credit terms under which customers may buy,
  - ✓ how much inventory the firm should carry,
  - ✓ how much cash to keep on hand,
  - ✓ whether to acquire other firms (merger analysis), and
  - ✓ how much of the firm's earnings to plow back into the business versus pay out as dividends.

- Regardless of which area a finance major enters, he or she will need a knowledge of all these three areas

Con't…

- **In general;**
- **Financial management** is concerned with the maintenance and creation of **economic value or wealth for the firm.**
- **As such, we will deal with financial decisions such as:**
  - ✓When to introduce a new product,
  - ✓When to invest in new assets,
  - ✓When to replace existing assets,
  - ✓When to borrow from banks,
  - ✓When to issue stocks or bonds,
  - ✓ When to extend credit to a customer, and
  - ✓How much cash to maintain.

Con't...

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?**

These are not the only questions by any means, but they are among the most important.

The Functions of Financial Management

- **Imagine that you were to start your own business. No matter what type you started,**
- you would have to answer the following **Four** questions in some form or another:
- **1. Capital Budgeting:** 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. Capital Structure:** 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?

Con't….

- **3. Dividend Decision:** *the dividend decisions address the question how much of the cash a firm generates from operations should be distributed to owners in the form of dividends and how much should be retained by the business for further expansion.*

  - ✓ In this context, the finance manager must decide whether the firm should distribute all profits or retain them, or distribute a portion and retain the balance.

Con't….

- **4.Working Capital Management:** How will you manage your everyday financial activities such as collecting from customers and paying suppliers?

- These are not the only questions by any means, but they are among the most important.
- **Corporate finance**, broadly speaking, is the study of ways to answer **these four questions**. Accordingly, we'll be looking at each of them in the chapters ahead.

Con't…

- **Functions of Financial Management**: refers to the special activities or purposes of financial management.
- The functions of financial management are **planning for acquiring and utilizing funds** by a firm as well as distributing funds to the owners in ways that achieve goal of the firm.

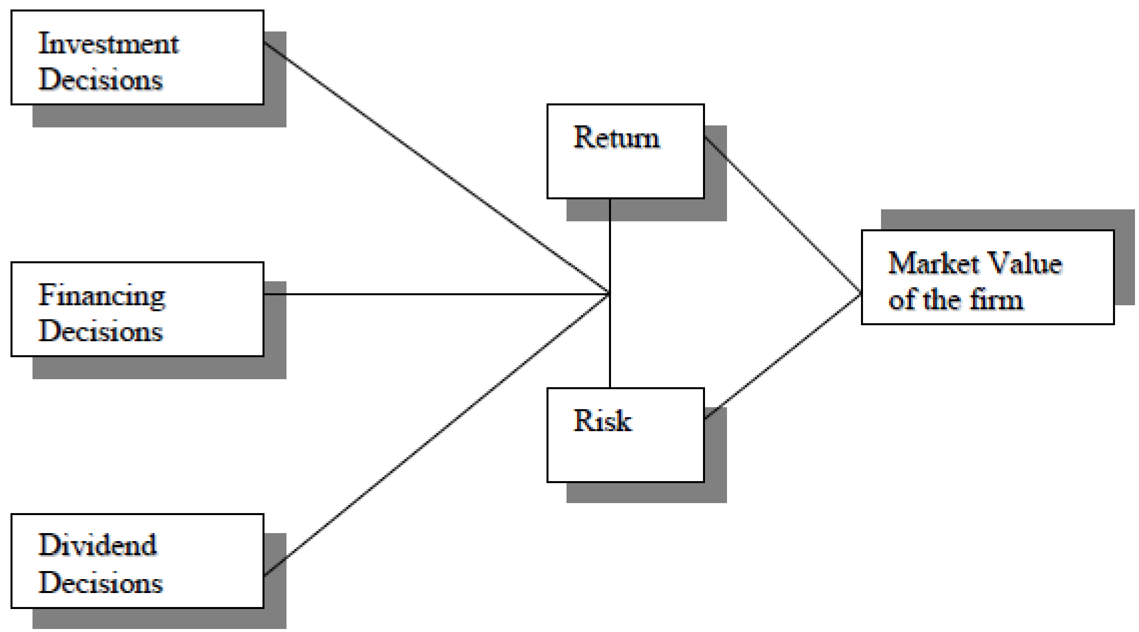
- Financial management encompasses many different types of decisions. We can classify these decisions into three groups:

1. **Investment decisions/Capital Budgeting**
2. **Financing decisions, /Capital Structure and**
3. **Dividend decision.**
4. **Working Capital Management**

Con't…

- The optimal combination of these **finance functions** will maximize the value of the firm to its shareholders.

Con't….



Investment Decisions
Financing Decisions
Dividend Decisions
Return
Risk
Market Value of the firm

1. Investment decisions :

The **investment** decision relates to the selection of **assets** in which funds will be invested by a firm.

- **Capital Budgeting:** the first question concerns the firm's long-term investments.
- The process of planning and managing a firm's long-term investments is called **capital budgeting.**
- **In capital budgeting, the financial manager tries to identify investment** opportunities that are worth more to the firm than they cost to acquire.

Con't….

- More Specifically, the investment decisions include:

i) ***Determining the asset mix or composition: -*** determining the total amount of the firm's finance to be invested in ***current and fixed assets***. i.e.

- (i) long-term assets which will yield a return over a period of time in future, and
- (ii) short-term or current assets defined as those assets which are convertible into cash usually within a year.

Con't…

Accordingly, the asset selection decision of a firm is of two types. The first of these involving fixed assets is popularly known **as 'Capital Budgeting'.**

- The aspect of financial decision-making with reference to current assets or short-term assets is designated as '**Working Capital Management.**
- The term ***working capital*** refers to a firm's short-term assets, such as **Cash, Receivables Supplies** and **inventory**, and its **short-term liabilities,** such as money owed to suppliers. Therefore;
- Managing the firm's working capital is a **day-to-day activity** that ensures the firm has sufficient resources to continue its operations and avoid costly interruptions.
  - ✓ This involves a number of activities related to the firm's receipt and disbursement of **cash.**

con't…

- **Some questions about working capital that must be answered are:**
  - (1) **How much cash and inventory should we keep on hand?**
  - (2) **Should we sell on credit? If so, what terms will we offer, and to whom will we extend them?**
  - (3) **How will we obtain any needed short-term financing?** Will we purchase on credit or will we borrow in the short term and pay cash? If we borrow in the short term, how and where should we do it?

ii) Determining the asset type: - determining which specific assets to maintain within the categories of **current and fixed assets.**

- **Generally,** the **investment decisions** of a firm deal with the **left side of the basic accounting equation**:

  A = L + OE (Assets = Liabilities + Owners' Equity).

2. Financing decisions

- **Capital Structure: the second question for the financial manager concerns ways in** which the firm obtains and manages the **long-term financing** it needs to support its long-term investments.
- A firm's **capital structure (or financial structure) is the specific mixture** of **long-term debt and equity** the firm uses to finance its operations.

✓ The financial manager has two concerns in this area:

  ✓ First, how much should the firm borrow? That is, what mixture of **debt and equity is best?** The mixture chosen will affect both the risk and the value of the firm.

  ✓ Second, what are the least expensive sources of funds for the firm?

Con't…

- The financing decisions deal with the financing of the firm's investments, i.e., decisions whether the firm should use **equity or debt funds** in order to finance its assets, after taking into account both the **fixed and working capital requirements.**
- In this context, the financial manager is required to determine the best financing mix or capital structure of the firm.
- They are also concerned with determining the most appropriate composition of short – term and long – term financing.

Con't…

- The **Financing Decisions** of a firm are generally concerned with the **right side of the basic accounting equation.**
  - ✓ **A = L + OE (Assets = Liabilities + Owners' Equity).**

- The central issue before the finance manager is to determine the proportion of **equity capital and debt capital. i.e.**
  - ✓ Should managers use the money raised through the firms' revenues?
  - ✓ Should they seek money from outside of the business?

Con't…

- The use of debt capital affects the return and risk of shareholders.
- As a general rule, there should be an appropriate mix of funds in the capital structure of a firm.

❖ The manner in which assets have been financed has a number of implications:

1. **Debt** is more risky from the firms point of view. The firm has legal obligation to pay to its bond holders at stipulated time both interest and principal, irrespective of the year's performance. If it fails, an action may be taken on firm's assets.
2. Highly burdened, or highly geared firms will find difficulty in raising additional funds from creditors and owners in the future.

✓ Always the owners' equity is assumed as margin of safety for the investment by creditors. If the base is thin, the creditor's risk will be high.

Con't….

- The following points are to be considered while determining the **appropriate capital structure of a firm:**
  - ✓Factors which have bearing on the capital structure.
  - ✓Relationship between earnings before interest and taxes (EBIT) and earnings per share (EPS).
  - ✓Relationship between return on investment (ROI) and return on equity (ROE).
  - ✓Debt capacity of the firm.
  - ✓Capital structure policies in practice.

4. Dividend Decision

- The dividend decisions address the question how much of the cash a firm generates from operations should be distributed to owners in the form of dividends and how much should be retained by the business for further expansion.

  - ✓ In this context, the finance manager must decide whether the firm should distribute all profits or retain them, or distribute a portion and retain the balance.

Con't..

- There are trade offs on the dividend policy of a firm.
- On the one hand, paying out more dividends will make the firm to be perceived strong and healthy by investors ; on the other hand, it will affect the future growth of the firm. So the dividend decision of a firm should be analyzed in relation to its **financing decisions. i.e.**

  - The finance manager has to develop such a dividend policy which divides the **net earnings into dividends and retained earnings** in an optimum way to achieve the objective of **maximizing the market value of firm.**

Functions of the Finance Manager and Jobs of Finance Staff

- **Finance** is one of the interrelated functions which deal with ***personal function, marketing function, production function and research and development activities*** of the business concern.
- Finance manager is one of the important role players in the field of finance function.
- He must have entire knowledge in the area of **accounting, finance, economics and management.** His position is highly critical and analytical to solve various problems related to finance.

Con't…

- A person who deals finance related activities may be called **finance manager**.
  - Finance manager performs the following major functions:

1. Forecasting Financial Requirements

- It is the primary function of the Finance Manager. He is responsible to estimate the financial requirement of the business concern. He should estimate, how much finances required to acquire fixed assets and forecast the amount needed to meet the working capital requirements in future.

Con't…

2. Acquiring Necessary Capital:

- After deciding the financial requirement, the finance manager should concentrate how the finance is mobilized and where it will be available.

3. Investment Decision:

- The finance manager must carefully select best investment alternatives and consider the reasonable and stable return from the investment.
  - He must be well versed in the field of capital budgeting techniques to determine the effective utilization of investment.
  - The finance manager must concentrate to principles of safety, liquidity and profitability while investing capital.

Con't…

4. Performing Financial Analysis: - financial analysis is concerned with obtaining of the basic:

- ✓ financial statements,
- ✓ applying some tools and techniques, and
- ✓ converting the raw information into a standardized form.

Con't…

5. *Performing Financial Forecasting: -* financial forecasting is concerned with forecasting of the firm's **sales for a given future period** upon which the firm projects its assets needs, and finally, it will evaluate whether additional finance is required.

6. *Making Financing Decision:-* as a financial staff, you should take part in deciding on the specific assets to acquire and the best way to finance those assets.

- **For example** should the firm finance with debt or equity, and if both on what proportion.

Con't…

- Examples include: borrowing decisions, decisions to issue shares of common stock and preferred stock, bonds, and other securities.

7. **Disposal of surplus:** The net profits decision have to be made by the finance manager. This can be done in two ways:
   - Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
   - Retained profits - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.

Con;t…

8. **Interrelation with Other Departments**:- because almost all decisions in the firm have financial implication; you as a financial management staff need to coordinate and control activities with other personnel.

- ✓ you as a financial staff are required to interact with people from other departments in order to lay plans which will shape the firm's future position and let other see the future.

Con't….

9. Dealing with the financial markets:- the financial staff must deal with money and capital market.

10. Management of Cash: Finance manager has to make decisions with regards to cash management.

- ✓ Cash management refers to planning, controlling and accounting for cash transactions and cash balances, Since efficient management of cash is essential to the survival and success of every business organization.
- ✓ Cash is required for many purposes like:
  - **payment of wages and salaries,**
  - **payment of electricity and water bills,**
  - **payment to creditors, meeting current liabilities,**
  - **maintainance of enough stock,**
  - **purchase of raw materials, etc.**

The Goal of a Business Firm/Financial Management

- Recall that financial management is concerned with decision making to achieve the goal of a firm.

- The firms **investment and financing** decision are unavoidable and continuous. So in order to make them rationally, the firm must have a **goal or objective.**
- ***But the question is what is this goal of a firm?*** Before trying to address the question, let us first describe the meaning of **a goal.**

✓ ***A goal is a well-known objective the firm strives in all its action to achieve it.***

Con't….

- Therefore there are two approaches for the goal of the firm:
  A. **Profit Maximization**
  B. **Wealth Maximization**

Profit maximization:

  - Considers **profit** as the most appropriate measure of a firm's performance.
  - Maximizing the birr income of firms.

➢ **Profit maximization:** implies either "producing maximum out put for the given amount of input or "use minimum input to produce a given level of out put.

- **Profit maximization** is a function of **maximizing revenue and /or minimizing costs.**
  - If a firm is able to maximize its revenues for a given level of costs or minimizing costs for a given level of revenues, it is considered **to be efficient.**

Con't…

- Under the **profit maximization** decision criteria, ***actions that increase profit of a firm should be undertaken;*** and ***actions that decrease profit should be rejected. B***ut it is not specific with respect to the ***time frame over which profits are to be measured.***

- Do we maximize profits over the current year, or do we **maximize profits over some longer period**? A financial manager could easily increase current profits by eliminating ***research and development expenditures and cutting down on' routine maintenance.***

Con't….

- There are various measures of profit that could be maximized, including the following:
  - Operating profit (profit before interest and taxation)
  - Net profit before tax
  - Net profit after tax
  - Net profit available to ordinary share holders
  - Net profit per ordinary share , and so on

Limitations of Profit Maximization

1. **Ambiguity:** The term profit or income is vague and ambiguous concept. It is **very illusive** and has no precise quonotation.

- Different people understand profit in different several ways. Because there are many different economic and accounting definitions of profit. i.e

✓ Does it mean an absolute figure expressed in dollar or a rate of profitability or
✓ Does it mean short-term or long-term profits?
✓ Does it refer to profit after tax or before tax?
✓ Net profit available to ordinary share holders
✓ Does it total profit or profit per share or

- ***Then, the question or the problem would be which profit is to be maximized?***

Con't…

2. It could increase current profits while harming the firm future survival .

- A business might **increase short term** profits at the **expense of long-term competitiveness and performance** of a business.
- It could be done by reducing operating expenses:
  - Cutting research and development expenditure
  - Defer/postpone important maintenance costs
  - Cutting staff training and development
  - Buying lower quality materials
  - Cutting quality control mechanisms
- These policies may all have a beneficial effect on **short term profits** but may undermine the **long term competitiveness and performance of a business.**

Con't….

3. Ignore time value of money concept/Timing of Benefits:

- The profit maximization criterion ignores the differences in the time pattern of benefits received from investment proposals.

- **Profit Maximization** criterion does not consider the distinction between returns (benefits) received in different time periods and treats all benefits as equally valuable irrespective of the time pattern differences in benefits.

Con't…

- In other words, the **profit maximization** ignores the time value of money concept, i.e.,
  - ✓ Money today is better than money tomorrow.
  - ✓ Also it does not consider the sooner, the better principle.

con't…

4. **Does not consider Quality of Benefits (Risk of Benefits):** Profit maximization assumes that risk or uncertainty of future benefits is of on concern to stockholders.

Risk is defined as the ***probability that actual benefit will differ from the expected benefit.***

Financial decision making involves a risk-return trade-off. This means that in exchange for taking greater risk, the firm expects a **higher return.** The higher the risk, the higher the expected return.

Con't…

5. It doesn't show cash flow available to shareholders

- **Profit does not** represent cash flow available to shareholders.
  - ✓ Owners receive returns either through **cash dividends** or by **selling their shares for a better price.** Higher Earning per Share (EPS) doesn't necessarily mean **dividend payments will increase.**

- Above all, accounting profit is affected by the accounting method followed and is prone to manipulation by the management.

Shareholders Wealth Maximization

- The contemporary view of the goal of the firm is **maximizing shareholders value.**
  - **Wealth maximization** means maximization of the value of a firm. Hence wealth maximization is also ***called value maximization or net present value (NPV) maximization.***
  - To understand and appreciate the essence of **wealth maximization,** we need to consider the various stakeholders in a given corporation.
    - ✓ Stakeholders are all individuals or group of individuals who have a direct or indirect interest in the firm.
  - They include stockholders, debtors, managers, employees, customers, governmental agencies and others.

Con't…

- Financial managers are charged with the responsibility of making decisions that maximize owners' wealth. i.e. managers should give priority to stockholders.

- **There are two ways in which the ownership of common stocks can change a person's wealth:**
- (a) dividends can be paid to the stockholder and;
- (b) the market price of the stocks can change.

Con’t….

- **During any period of time, the change in a person's wealth due to ownership of common stock may be calculated as follows:**
  - i. Multiply the dividend per share paid during the period by the number of shares owned.
  - ii. Multiply the change in the stock's price during the period by the number of shares owned or stock price appreciation.
  - iii. Add the dividends and the change in the market value computed to obtain the change in the shareholders wealth during the period.

Con't…

- Shareholders Wealth Maximization (SHWM) means maximizing the net present value of a course of action to shareholders.
- Net Present Value or wealth of course of action is the difference between the present value of its benefits and the present value of its costs.

- A financial action resulting in positive NPV creates wealth for shareholders and therefore it is desirable.
- A financial action resulting in negative NPV should be rejected because it would destroy the shareholders wealth.

❑ NPV = PV of cash inflows less PV of cash out flows.

W =

$$\frac{A_1}{(1+k)^1} + \frac{A_2}{(1+k)^2} + \ldots\ldots + \frac{A_n}{(1+k)^n} - C$$

Con't…

Where:

- W = Net Present Wealth
- A_1, A_2, ….. A_n = Stream of cash inflows expected to occur from a course of action over a period of time.
- K = Appropriate discount rate to measure risk and timing.
- C = Initial outlay to acquire that asset or pursue the course of action.

Con't…

- ***There are several reasons why wealth maximization decision criterion is superior to Profit Maximization criteria.***
  - **First**, it has an exact measurement unlike profit maximization. It depends on cash flows ***(inflows and outflows).***
  - **Second,** wealth maximization as a decision criterion consider the quality as well as the time pattern of benefits.
  - **Third,** it emphasizes on the ***long-term and sustainable maximization of a firm's common stock price in the financial market.***
  - **Fourth,** wealth maximization gives a recognition to the interest of other stakeholders and to the societal welfare on the long- term basis.

Example:

- Shaba Agro Industry Company intends to open a branch either in Goba or Jijiga. Opening of both branches cost Br. 135,000 each and the expected cash inflows from each branch over the next ten years is Br. 25,000 per year. However, the required rates of return are 9% and 10% respectively for Goba and Jijiga respectively.

1. Under profit maximization decision rule, where should Sehaba open a branch?
2. If the goal of Shaba is wealth maximization, which town is providing more value?

Answer

1. The total benefits (cash flows) over a period of ten years is Br. 250,000 (Br. 25,000 x 10) for each project. Therefore, it is all the same for Shaba Agro Industry whether it opens its branch in Goba or Jijiga under **profit maximization decision rule.**

2. Both projects have equal cash flows and costs; but the required rate of return for investment in Jijiga (10%) is higher than that of investment in Goba (9%). In financial management, the more return expected from investments of equal cost and cash flows indicates it is more risky. Hence, under **wealth maximization criterion,** investment in Goba provides more value than investment in Jijiga

Limitations of Wealth Maximization

- The limitations of wealth maximization refer to the potential side costs of wealth maximization if adopted as a decision criterion.

1. If wealth maximization is taken as the sole decision rule, there is a possibility that the benefits of the society at large might be forgone. Fortunately, however, this problem is not unique to wealth maximization. Even if an alternative goal is used, still this problem continues to persist.
2. When managers of a corporation are separate from owners, there is a potential for a conflict of interest between them. This conflict of interest can lead to the maximization of manages' interest instead of the welfare of stockholders.

Con't…

3. When the goal of a firm is stated in terms of stockholders wealth, actions that increase the wealth of stockholders could be taken as the expense of other stakeholders like debt holdlers.

4. Wealth maximization is normally reflected in the firm's stock price. But if there are inefficiencies in financial markets, wealth maximization decision rule may lead to misallocation of scarce resources.

Con't…

- **Check your progress:**

✓ The wealth maximization goal is generally preferred to other decision criteria regardless of the above limitations. What short and precise explanation do you have for this?

The Corporation and Financial Markets

- **Financial securities** are simply pieces of papers with contractual provisions that entitle their owners to specific **rights and claims** on specific cash flows or values.

- A **security is a document that gives the owner a claim on future cash** flows. A security may represent an ownership claim on an asset (such as a share of stock) or a claim on the repayment of borrowed funds, with interest (such as a bond).

- A **securities market is an arrangement for buying** and **selling securities**. It may be a physical location or simply a computer or telephone network.

Con't…..

- Based on their maturity and the source of their value securities are classified into Two groups:
  - **Money market securities,**
  - **Capital market securities, and**

Con’t….

I. **Capital Market :**

- ***Capital market securities are long-term securities issued by* corporations and governments**. Here “long-term securities” refers to securities with original maturities greater than 1 year and perpetual securities (those with no maturity).

- There are two types of capital market securities: those that represent shares of ownership interest, also called ***equity,*** issued by corporations, ***and*** those that represent ***indebtedness,*** issued by corporations and by the **U.S. and state and local** governments

con't…

2. Money Markets

- Money market generally is a market where there is buying and selling of **short term liquid debt instruments.**
- (Short term means one year or less).
- Liquid means something which is easily en-cashable; an instrument that can be easily exchanged for cash.

Con't…

- **Primary Market**
  - **Market in which new issues of a security are sold to initial buyers.**
- **Secondary Market**
  - **Market in which previously issued securities are traded.**

Ten Principles That Form The Foundations of Financial Management

1. **Risk-Return Trade-off:**

- We won't take on additional risk unless we expect to be compensated with additional return.
- Investment alternatives have different amounts of risk and expected returns.
- The more risk an investment has, the higher will be its expected return.

Con't…

2. Time value of money

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

Con't

- **3. Cash—Not Profits—is King**
- Cash Flow, not accounting profit, is used to measure wealth.
- Cash flows, not profits, are actually received by the firm and can be reinvested.

4. Incremental Cash flow

- It is only what changes that counts;
- The **incremental cash flow** is the difference between the projected cash flows if the project is accepted, versus what they will be, if the project is not accepted.

Con't…

5. Efficient capital market

- The values of all assets and securities at any instant in time fully reflect **all available information.**

6. The curse of competitive markets

- Why it is hard to find exceptionally profitable projects;

7. Taxes affect business decisions

The cash flows we consider are the after-tax incremental cash flows to the firm as a whole.

Con't…

8. The agency problem

- Managers won't work for the owners unless it is in their best interest.
- The separation of management and the ownership of the firm creates an agency problem.
- Managers may make decisions that are not in line with the goal of maximization of shareholder wealth.

Con't…

9. All risks are not equal

- Some risk can be diversified away, and some cannot.

10. Ethical Behavior Is Doing The Right Thing, and Ethical

- Dilemmas Are Everywhere In Finance;
- Each person has his or her own set of values, which forms the basis for personal judgments about what is the right thing.

Thank you