



Class: FY BSc

Subject : Business Finance - 1

Subject Code: PUSASQF 1.4

Chapter: Unit 1 Chp 1

Chapter Name: Basics of Finance

Topics to be covered

1. What is Finance?
2. Key Principles of Corporate Finance
3. Financial Management
4. Basic Issues involved in Financial Management
5. Financial Manager
6. Relationship between Real Asset and Financial Asset
7. Stakeholders and their expectations
8. Goals of principal stakeholders
9. Maximizing shareholder value
10. Agency Theory
11. Other stakeholder conflicts
12. Information Asymmetry
13. Capital Markets and Financing Decisions

1 What is Finance?



Finance is the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of banking facilities.

- Finance has many facets, which makes it difficult to provide one concise definition.
- Finance as taught in universities is generally divided into three areas:
 - i. financial management
 - ii. capital markets
 - iii. investments

2 Key Principles of Corporate Finance

- i. In simple terms - its financing of a company's operations
- ii. Keeping in mind interests of all the business stakeholders
- iii. Dealing with conflicting objectives of stakeholders
- iv. Key Objective – Maximise Shareholder Value



3 Financial Management



- To carry on business, companies need to employ real assets, both tangible and intangible. To acquire such assets, the company must raise finance. The financial manager stands between the firm's operations and the financial markets (where investors hold the financial assets issued by the firm to obtain money).
- Finance involves two basic issues:
 - i. What real assets should the firm invest in? (the investment or capital budgeting decision)
 - ii. How should the cash for the investment be raised? (the financing decision)
- The first question is normally the remit of a controller or, in many instances, the Chief Financial Officer (CFO). However, capital budgeting decisions will be tied into plans for product development, production and marketing and so will involve managers from these areas (as well as any staff specialising in corporate planning).
- The second question is the responsibility of the treasurer who looks after the company's cash, raises new capital and maintains relationships with banks, shareholders and other investors.
- Responsibility for financial issues will, ultimately, rest (by law or custom) with the board of directors. In practice, boards usually delegate decisions for small or medium-sized matters.

4 Basic Issues involved in Financial Management

**Sources of Capital
(Financing Decision)**



**Use of Capital
(Investments and
Capital Budgeting)**

**Risks involved and
Mitigation Strategies**

**Financial Analysis –
Estimates & Timing**

**Impartial & Objective
Decision Making**

5 Financial Manager



Financial Managers are the ones responsible for the financial health of the company and are responsible for major investment and financing decisions.

- The Financial Manager stands between:
 - The Firm's Operations; and
 - the financial markets (where investors hold the financial assets issued to obtain money)
- Financial Managers must decide not only which assets their firm should invest in but also where those assets should be located.

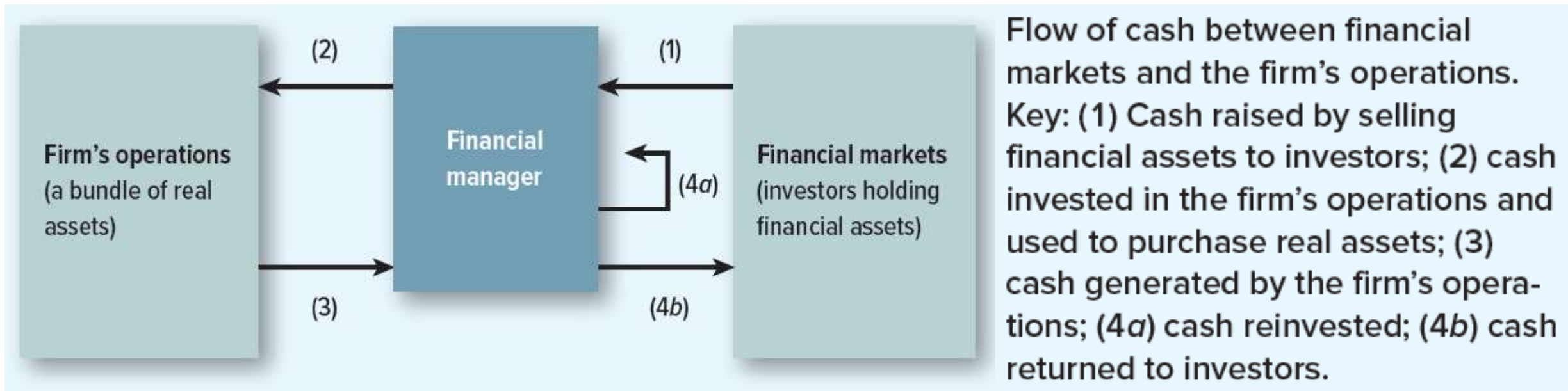
5 Financial Manager

- These are managers who specialize in finance and their roles are summarized in the chart below:



- The role of the financial manager explains the relation between Real and Financial assets and defines the linkage between firm's operations and the financial markets.

3 Financial Management



6 Relation between Real Asset & Financial Asset

Real Assets

- i. Assets that are used in the normal line of business to Generate Profits
- ii. And to carry on business, companies need to employ real assets, both Tangible and Intangible

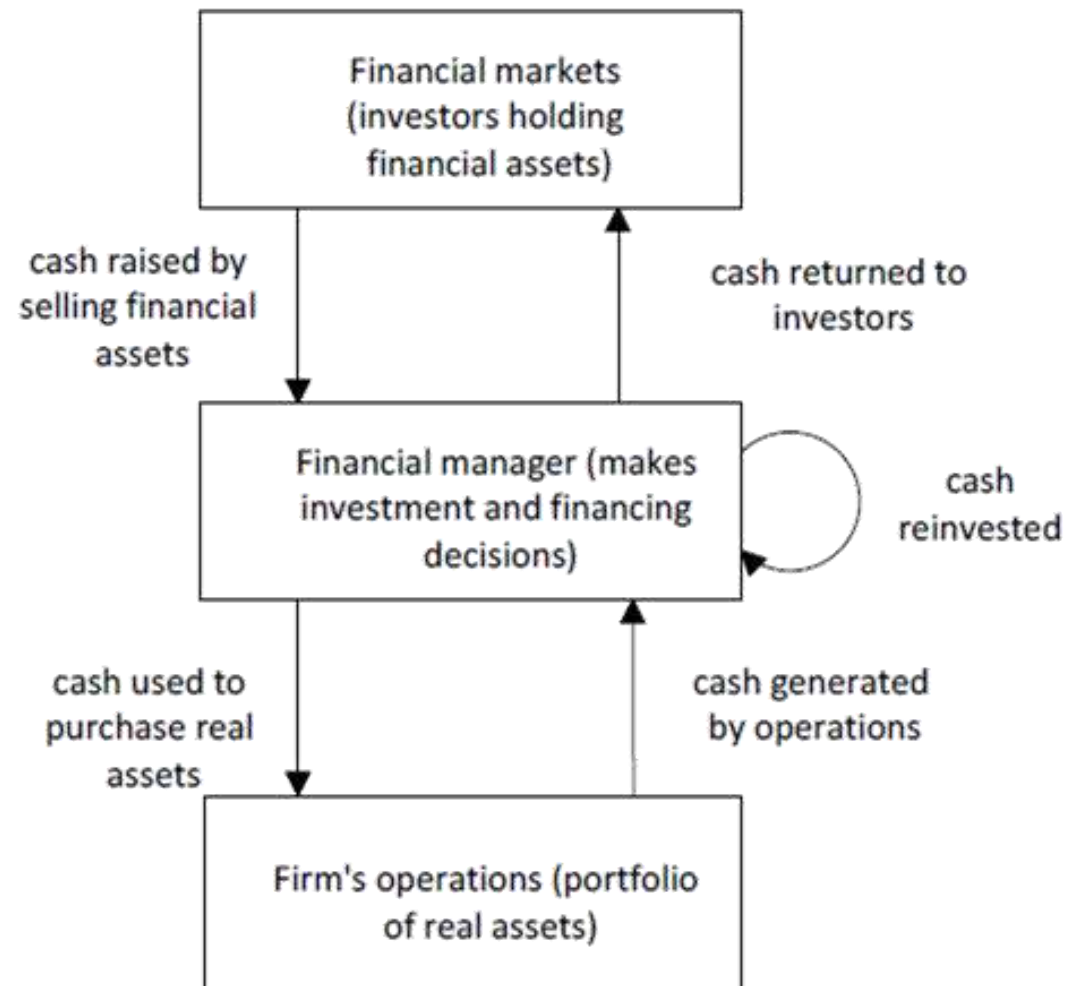
Financial Assets

- i. Acquiring Real Assets requires Finance – and instruments used to raise finance are known as Financial Assets E.g. shares, bonds, debentures, convertibles, etc.



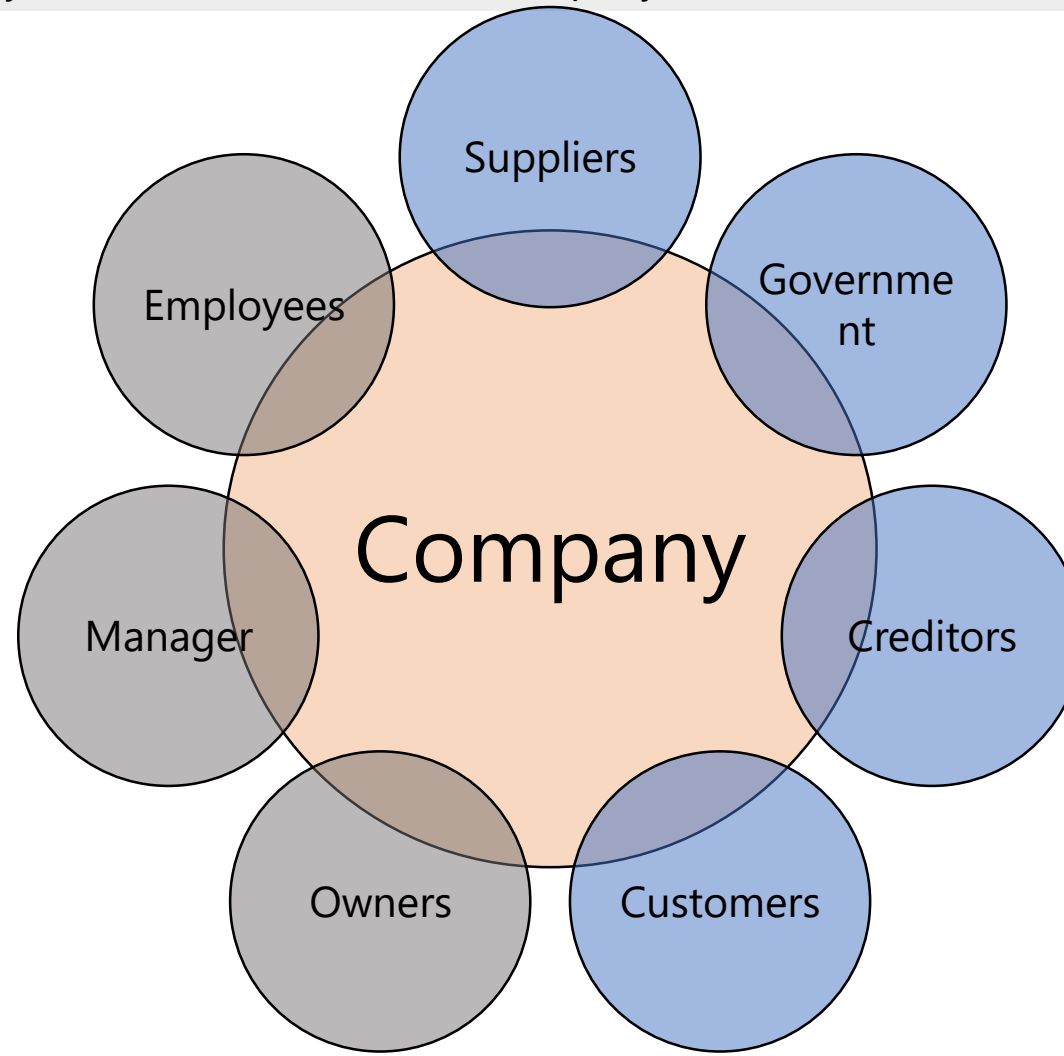
6 Relation between Real Asset & Financial Asset

Finance Manager : A Link between Firm's Operations and the Financial Markets.



7 Stakeholders and their expectations

A stakeholder is a party that has an interest in a company and can either affect or be affected by the business.



8 Goals of principal stakeholders

i. Shareholders

- To obtain an income from their investment, ie to obtain a regular dividend
- To make a capital gain, i.e. to sell the shares for more than they cost
- To maximise the overall return on their investment.

ii. Managers

- Job security
- Good pay
- Good benefits, e.g. perks such as company cars, long holidays
- Prestige and power.

iii. Employees

- Pay at least a market rate of pay for the work
- Stay in business
- Provide safe working conditions
- Provide training
- Provide a variety of benefits such as pensions, holidays etc.

8 Goals of principal stakeholders

iv. Banks and Other Lenders

- Remain in business
- To pay a market rate of return on the borrowed funds
- To meet the payment deadlines.

v. Customers

- Remain in business (for after-sales service etc)
- Provide goods at reasonable prices
- Provide goods of good quality
- Produce and market goods ethically.

vi. Government

- Perform well so that it pays more corporation tax
- Perform well so that it provides jobs to as many citizens as possible
- Act legally and morally, e.g. in line with consumer law and ethics

9 Maximizing shareholder wealth

- i. In market-based financial systems, there are large equity and bond markets, shareholders are owners of the company and the company's objective is to maximize shareholder wealth within external constraints.
- ii. In such economies, company managers are accountable to the shareholders. Managers are duty-bound to act in shareholders' interests, to protect the investors and to enable the financial markets to operate efficiently.
- iii. Maximizing shareholder wealth is a sensible goal when the shareholders have access to well-functioning financial markets. Financial markets allow them to adjust risks and transport savings across time.

10 Agency Theory

The practical problem in having a common objective of maximization of shareholder wealth is referred to as Agency Theory.

- Agency theory, which considers the relationship between a principal (the Shareholders) and an agent of that principal (the Managers or Directors), and the divergence witnessed in their individual objectives leads to the company incurring "Agency Costs".
- The Agency Costs refer to the additional costs incurred to:
 - i. Monitor the actions of the Agent by the Principal; and
 - ii. Putting in place measures to somehow align the interests of the Agent with that of the Principal.
- The interests of a company's management can be aligned with those of the shareholders by linking the management's remuneration to the company's earnings or share price.
- One way of doing this is by giving the managers a stake in the equity of the company, e.g. via a share option scheme. Another way is for managers to receive bonuses based on the company's earnings or on the share price.

11 Other Stakeholder conflicts

- Conflicts between Management and Employees – Management wish to motivate employees to work harder to ensure better profits thereby, higher bonus payout BUT Employees wish easy time at Work.
- Conflicts can also arise between stockholders and debtholders. Debtholders, which include the company's bankers and its bondholders, generally receive fixed payments regardless of how well the company does, while stockholders do better when the company does better.
- This situation leads to conflicts between these two groups, to the extent that stockholders are typically more willing to take on risky projects.

12 Information Asymmetry

- Problems relating to asymmetric information are fairly easier resolve by ensuring that all parties have the same insights of the business.
- However, practically, it is difficult considering the extent of information of a company to be available, timing of information dissemination and materiality of the information provided.
- Further, company decision-making often involves sensitive business information and the need to keep it from commercial rivals also restricts the ability to communicate it to stakeholders.
- A possible advantage of private debt and venture capital equity is that the small number of investors involved will often be much better informed about the issuing company than is the case where large numbers of investors hold small volumes of publicly quoted securities.

Examples of Information asymmetry:

- Dividend Payments by Company – Good or Bad for the Company?
- Higher Cash Holding by the Company
- Higher Profits by the Firm, leading to demand for higher salary raises
- Merger and Acquisition – L&T + Mindtree; Tata Motors + JLR; Walmart + Flipkart
- Dealing with Different expectations of the various Business Owners

13 Capital Markets and Financing Decisions

Capital markets are where savings and investments are channeled between suppliers—people or institutions with capital to lend or invest—and those in need.

- Suppliers typically include banks and investors while those who seek capital are businesses, governments, and individuals.
- Capital markets are composed of primary and secondary markets. The most common capital markets are the stock market and the bond market.
- Capital markets seek to improve transactional efficiencies. These markets bring suppliers together with those seeking capital and provide a place where they can exchange securities.
- Stock Markets serve as a Performance Monitor.
- Markets continuously determine the value of the Company and the perception of the market participants and the efficiency of delivery of results proves the success story of Finance Managers.

13 Capital Markets and Financing Decisions

Complexity in decision making for investment in a Project:

- i. Investment in Working Capital is largely routine and involves few complications or risks
- ii. Investment in Fixed Capital, however, often involves complex choices between:
 - Alternative Capital Assets
 - Dates of Commencement
 - Methods of Financing
 - Utilisation in future projects

Key factors considered prior to finalising a Project and the sources of capital to fund the Project:

- Risks involved in the Project and the strategies to be employed to mitigate the risks
- Detailed Financial Analysis with inputs from all concerned teams before finalising on the project - Estimation of revenues, associated expenses, timing of cash flows and profitability of the overall project
- Requirement of an impartial and objective decision making

Summary

- A firm or a corporation has one basic financial goal: maximization of shareholder wealth.
- While the firm engages in this pursuit, it has to balance interests of all stakeholders, ie shareholders, managers, employees, debtholders, suppliers, customers and government.
- Conflicts arise between them while still working together. These are principal-agent conflicts and information asymmetry is a major cause for it.
- The firm's financial managers have to decide on how to further the firm's goals by taking decisions on raising capital through various sources and how those resources must be allocated for efficient usage.
- Risk analysis must be carried out before any new project is started with and capital should be raised at the lowest cost possible.
- This capital is raised from capital markets : stock market and the bond market.
- The rates that a firm can raise funds at also serves as an indicator of the firm's financial health as perceived by the markets while also proving to be a reliable and consistent source of funding for good businesses.

Thank You