



Subject: Business Finance 1

Chapter: Chapter 1

Category: Notes

BASIC OF FINANCE

1. Introduction to Corporate Finance / Business Finance

In simple terms, Corporate Finance refers to Financing of a Company's Operations –

- 1) keeping in mind the interests of all the business stakeholders;
- 2) appropriately dealing with conflicting interests of stakeholders; and
- 3) with the key objective of maximising Shareholder Value.

The Corporate Finance function can be understood by way of the below decision tree:

Chart 1: Corporate Finance Decision Tree



Tip to Remember:

Put yourself in a business owner shoes and evaluate how you would start a new business by evaluating your business' financial requirement, identifying ways in which the funds can be raised, arranging the funds and utilisation of funds as initially budgeted and monitoring its progress.

2. Relationship between Real Assets and Financial Assets

A. *What are Real Assets?*

Assets that are used in the normal course of business to generate profits. To run a company and carry on business as usual, company needs to employ various forms of real assets, both tangible and intangible.

For example:

Plant and Machinery, Factory space, computers, brand names, furniture and fixtures, trademarks, patents, etc.

B. *What are Financial Assets?*

Acquiring Real Assets requires Finance and instruments used to raise finance are known as Financial Assets.

For example:

Shares, bonds, debentures, convertibles, etc.

C. *Who is a 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.

For Example:

Nestlé is a Swiss company, but only a small proportion of its production takes place in Switzerland. Its 520 or more factories are located in 82 countries. Nestlé's managers must therefore know how to evaluate investments in countries with different currencies, interest rates, inflation rates, and tax systems.

Day-to-day cash management also becomes a complex task for firms that produce or sell in different countries. For example, think of the problems that Nestlé's financial managers face in keeping track of the cash receipts and payments in 82 countries. We admit that Nestlé is unusual, but few financial managers can close their eyes to international financial issues.

D. Role of a Financial Manager

These are managers who specialize in finance and their roles are summarized in *Chart 2*. The treasurer is responsible for looking after the firm's cash, raising new capital, and maintaining relationships with banks, stockholders, and other investors who hold the firm's securities.

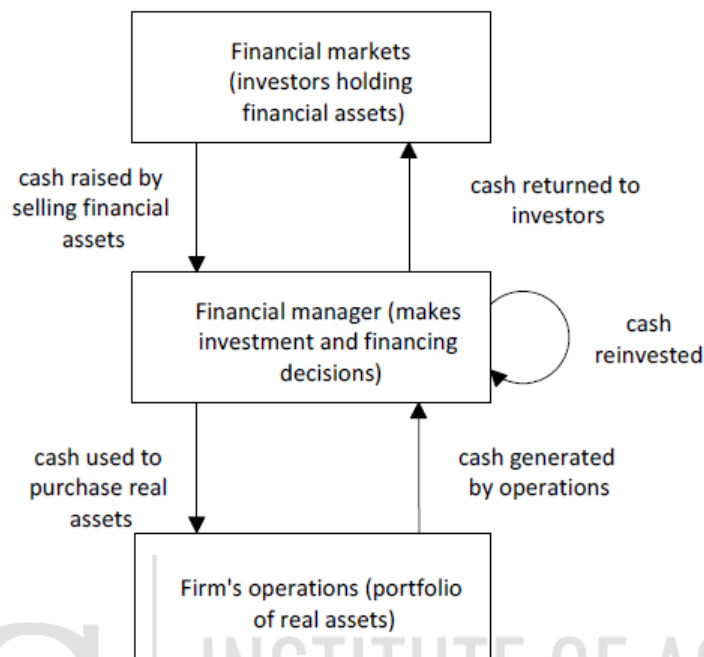
For small firms, the treasurer is likely to be the only financial executive. Larger corporations also have a controller, who prepares the financial statements, manages the firm's internal accounting, and looks after its tax obligations. You can see that the treasurer and controller have different functions: The treasurer's main responsibility is to obtain and manage the firm's capital, whereas the controller ensures that the money is used efficiently.

Chart 2: Role of a Financial Manager



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.

Chart 3: Relationship between Real Assets and Financial Assets



3. Two Basic Issues involved in Financial Management

**Sources of Capital
(Financing Decision)**



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

A. What Real Assets should the firm invest in? (the investment or capital budgeting decision)

A business will be required to invest in various real assets to undertake projects (for ease of understanding, a business is nothing but a collection of projects). These projects generate revenues and incur costs. The aim of the firm should be to undertake those projects for which the revenues exceed the costs in order to generate profits on behalf of the owners of the firm.

The capital budgeting decision considers the choice of projects, and hence real assets, in which the firms should invest with the overall objective to maximising shareholder value.

Capital Budgeting Decision Making

It is difficult to project the prospective cashflows arising from a particular project with any great confidence. Further complications arise when allowing for

- 1) different possible scenarios;
- 2) incorporating options into the analysis and
- 3) discounting the cashflows.

Complexity in decision making for investment in a Project:

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

B. How should the cash for the investment be raised?

revenues. A net investment will therefore be required to get the project off the ground. The financing decision considers how best to raise the required finance.

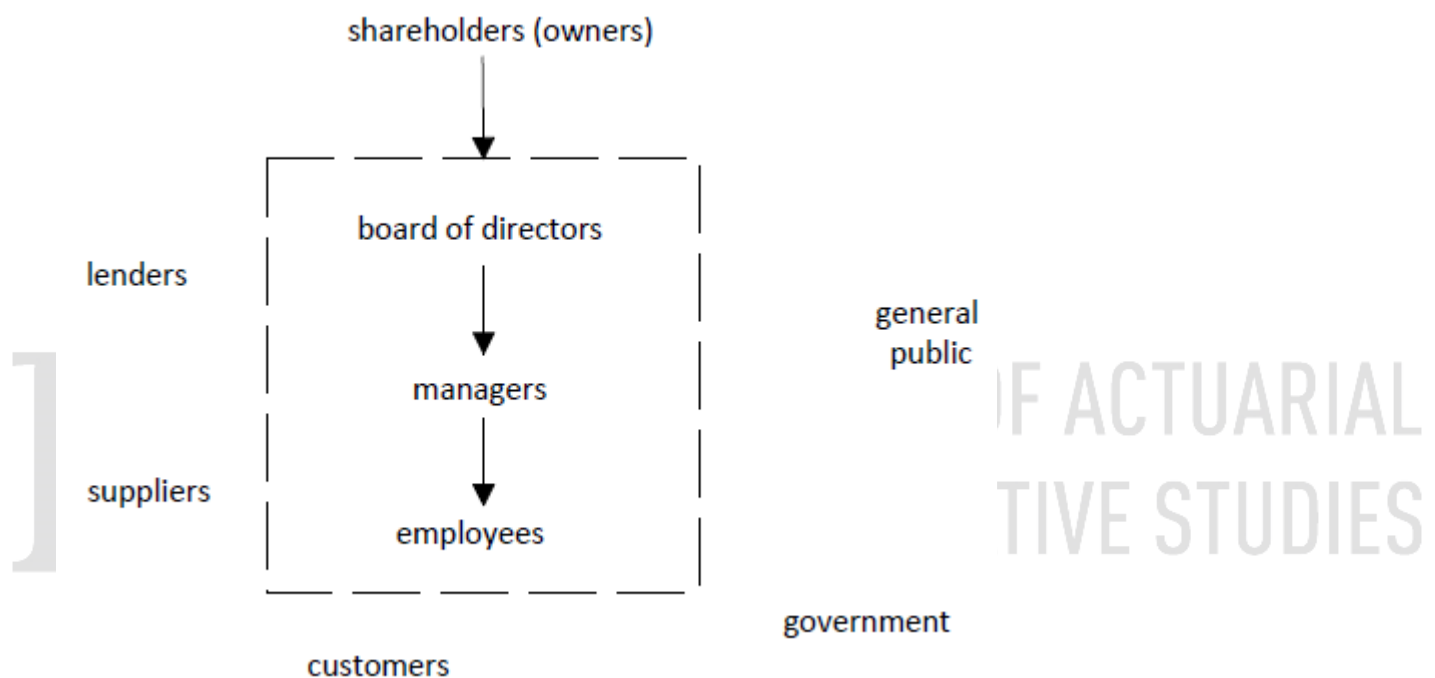
Key factors considered prior to finalising a Project and the sources of capital to fund the Project

- 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

4. Various Stakeholders involved in running a Company

There are many groups involved in running a company, e.g. shareholders, managers, employees, lenders, suppliers, customers, the Government. We must consider their interests and their role.

Chart 4: Stakeholder Tree in a Company



Possible Objectives for each Stakeholder interest are:

A. 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.

B. Managers

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

They may therefore wish the company to aim for:

- Growth (salary and prestige are often related to the size of the firm)
- Stability (and not to take unnecessary risks)
- A satisfactory level of profit (rather than a maximum level of profit).

C. 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.

D. Banks and Other Lenders

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

E. Customers

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

F. 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

5. Complications in Financial Decisions

Differences in Objectives and Information can complicate financial decisions.



Different Objectives

Shareholders V/s Managers

The main objective of shareholders will normally be to receive a high return on their investment in the company.

In contrast, some managers might instead wish to pursue projects of interest over more profitable projects:

- To take over management of other companies and so gain control of as large a business empire as possible;
- To have a more leisurely or luxurious working lifestyle;
- To aim for a satisfactory return (and secure job prospects) rather than a maximum return (and a higher risk of the company running into trouble)

Providers of Finance

Of particular interest is the potential for conflict between providers of finance, notably **Lenders** (such as banks and bondholders) and the **Providers of equity capital** (the shareholders).

Fundamentally, this can be characterised as the difference between the lenders' short-term desire

for security and the shareholders' long-term interest in the development of the company.

Contractual theory views a firm as a network of contracts, actual and implicit, which specify the roles of the various participants in the organisation (workers, managers, owners, lenders, etc) and define their rights, obligations and pay-offs under various conditions

Most participants bargain for limited risk and fixed pay-offs, whereas the firm's owners are liable for any residual risk (and thus hold a residual claim on any assets and earnings of the firm that remain after covering costs).

One such conflict between a firm's owners and its creditors is If managers/directors substantially alter the riskiness of a firm's product-market investment activities, this will benefit shareholders greatly (if the investments are successful). However, risky investments that fail will reduce the security of debt holders and reduce debt values. If a firm does not give strong assurances to debt holders that investment policies will not be changed to their disadvantage, it must pay interest rates high enough to compensate debt holders against the possibility of such adverse policy changes.

Theory of Maximisation of Shareholder Wealth

(Interplay between Managers and Shareholders)

In market-based financial systems, such as the UK and the US, there are large equity and bond markets, shareholders are owners of the company and the company's objective is to *maximise shareholder wealth* within external constraints. In these countries, 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.

Agency Theory

The practical problem in having a common objective of maximisation 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:

- 1) Monitor the actions of the Agent by the Principal; and
- 2) Putting in place measures to somehow align the interests of the Agent with that of the Principal.

For example: Manger Remuneration linked to Business growth

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.

A. Asymmetric Information

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.

Further, even on knowledge of information, evaluation or understanding of the information is dependent on each party's own judgement and prudence and thereafter each stakeholder's own objective.

For example:

The decision to increase a dividend payment is likely to lead to an increase in the share price if investors read this new information from managers and conclude that the management is confident of future earnings, whether or not this is in fact so.

Similarly, the employees of a company may demand large salary increases in response to the previous year's high profits. At the same time the financial manager may be reluctant to grant large increases because he knows that the firm is unlikely to sustain the current level of profits in the face of proposed tax and regulatory changes.

6. Conclusion

For a company to do well, it is pertinent to keep each stakeholders' interest in mind and undertake only well evaluated and analysed projects which ensures that the selection is basis objective and impartial judgement and all possible risk areas are identified and measures have been put in place to mitigate such risks.

Industry and government should co-operate in establishing rules for corporate behaviour, so that firms strive to maximise shareholder wealth within external constraints.