INSTITUTE OF ACTUARIAL
& QUANTITATIVE STUDIES

Class: MSc

Subject : Business Finance

Chapter: Unit 1 Chapter 1

Chapter Name: Basics of finance

Today's Agenda

1. What is finance ?

2. Financial management
   1. Responsibilities for financial decisions
   2. Capital budgeting
   3. Financial analysis

3. Financial manager
   1. Goal of financial manager

4. Stakeholders
   1. Conflicting objectives of stakeholders
   2. Contractual theory
   3. Maximisation of shareholder wealth
   4. Maximisation of shareholder wealth & problems

5. Capital markets & Financing decisions

6. The value of company

7. Corporate governance
   1. UK corporate governance code

1 What is Finance?

Finance can be understood as a function of business that involves money circulation, the extension of credit, the provision of banking services, and the process of making investments.

- Finance has many facets, which makes it difficult to provide one concise definition.

- Finance as taught in universities is generally divided into three areas:
  1. Corporate Finance i.e financial management
  2. Capital markets
  3. Portfolio management i.e Investments

1 What is Finance?

- Every business needs real assets (tangible & intangible) to generate profits from its core products and services.

Real assets that are used in the normal line of business to generate profits.

- Tangible assets: Tangible assets are defined as the products which physically exist like buildings machinery, etc.
- Intangible assets: Intangible assets are the assets that do not have any physical appearance like brand name, goodwill, trademark, etc.

Financial assets are assets of the capital providers (eg shares are an asset of the investors who buy them) rather than the company raising the finance. E.g. shares, bonds, debentures, convertibles, etc.

2 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:
  1. What real assets should the firm invest in? (the investment or capital budgeting decision)
  2. 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.

2 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

2.1 Responsibilities for financial decisions

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.

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2.2 Capital budgeting

Capital budgeting is a process of assessing optimal projects having long-term business impact.

The importance of capital budgeting is due to the complexity of the analysis involved and the cost of poor decisions.

Investment in working capital (liquidity) 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.

These choices are both complex and critical, given the scope for (and very high cost of) making the wrong decisions. Moreover, fixed capital outlays often have a serious bearing on the direction and pace of a firm's growth. As such, they determine the opportunities open to a firm and the directions in which it can move.

2.3 Financial analysis

Progress in management depends on applying logic to experiences, to known or assumed facts in order to enhance understanding. Investment decisions are no exception.

Even where it is impossible for financial analysis to improve the actual fortunes of a project, it may nevertheless be able to:

- identify the risks involved in the project
- highlight the salient factors
- possibly suggest methods by which these risks might be reduced.

Financial analysis in capital budgeting involves bringing together estimates and ideas from a variety of disciplines – marketing, technology, accounting, tax, law – so as to reveal their financial implications.

3 Financial manager

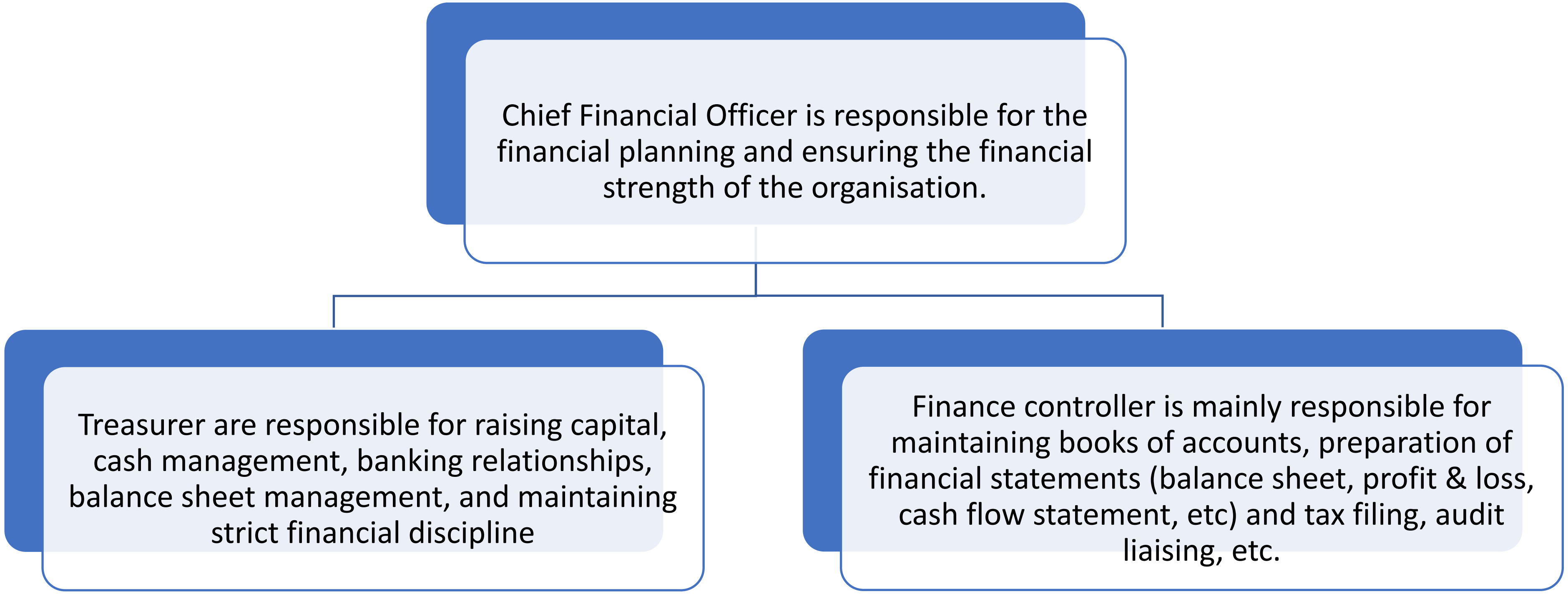
Financial Managers are the ones responsible for the financial health of the company and are responsible for major investment and financing decisions.

- 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.

3 Financial manager

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



3 Financial manager

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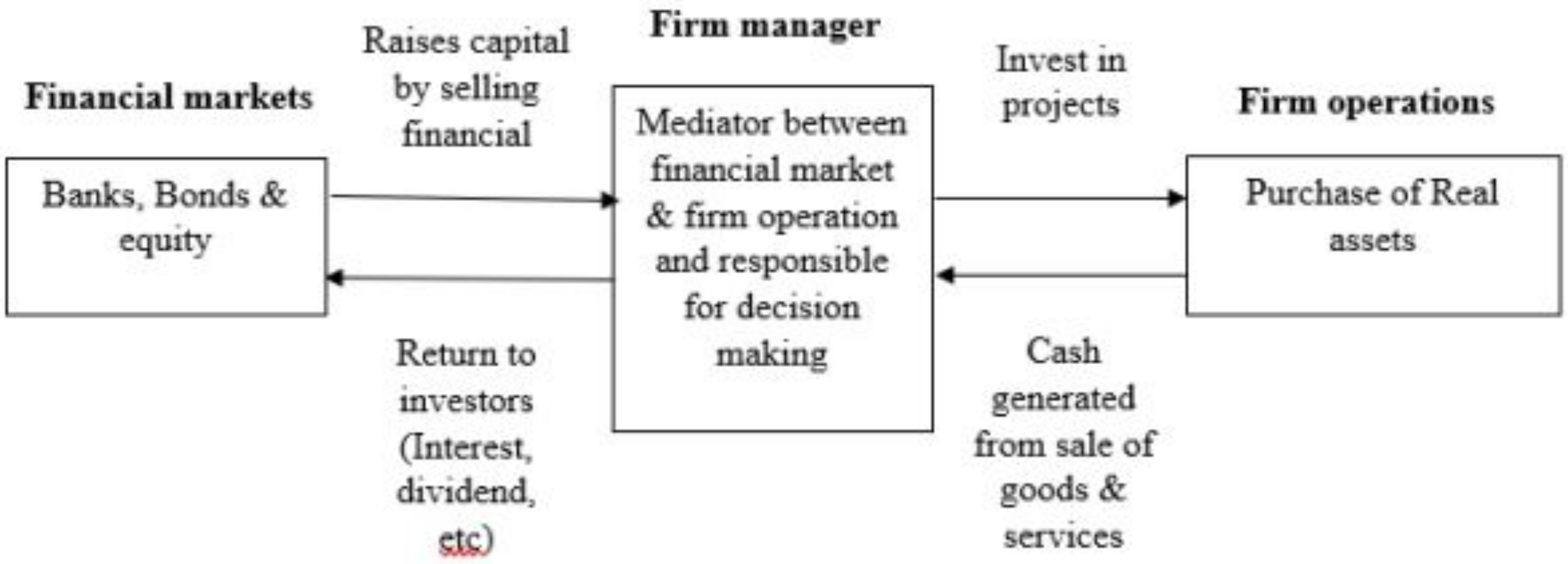
- the firm's operations and
- the financial markets (where investors hold the financial assets issued by the firm to obtain money).



3.1 Goal of Financial manager

The needs (and objectives) of these shareholders will vary according to factors such as:

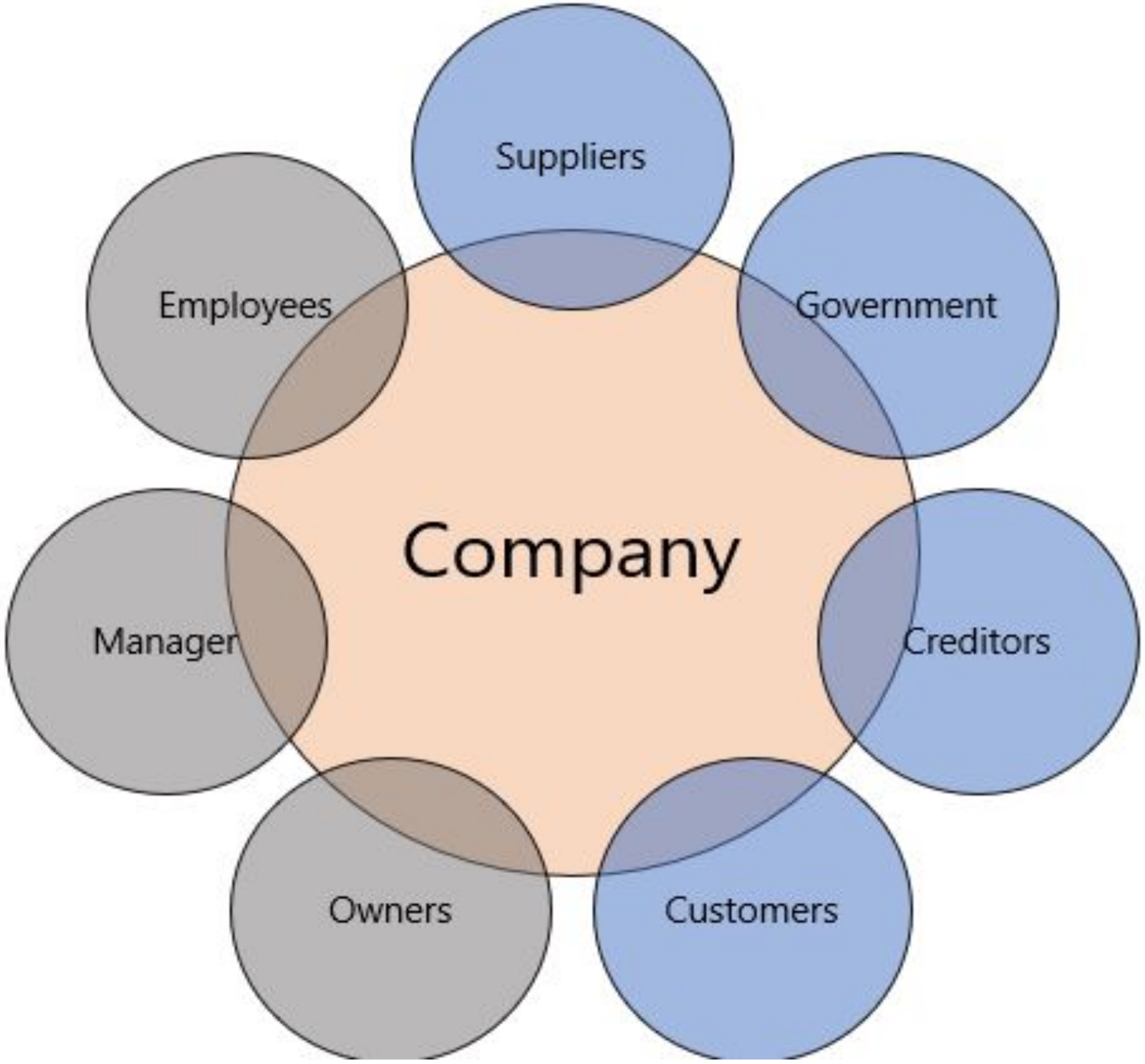
- attitude towards risk
- time preference and consumption needs For example, whether investment returns are required now or some time in the future.
- balance between the need for income and for capital growth
- tax position For example, allowances before paying tax, marginal rates of tax and how these differ for dividends and capital gains.

How can managers and directors, acting as agents for the ultimate owners, satisfy the different desires of these owners? Indeed, how can they even know what these desires are?

If we assume that all shareholders seek to be as rich as possible (ie that they seek to maximise current worth) then the goal of the financial manager is simply stated: to increase the market value of each shareholder’s stake in the firm.

4 Stakeholders

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



4 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.

4 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

4.1 Conflicting objectives of stakeholders

A conflict of interest can often arise between managers and owners of a firm due to different goals. These different goals drive different motivations, hence the focus area of managers could be different from what shareholders want.

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).

Conflict could also be possible between managers and employees due to differences in working style.

Conflicts can arise between finance providers i.e. lenders like bank holders or banks, and shareholders.

4.2 Contractual theory

The contractual theory considers that organizations as separate legal entities enter into various types of agreements and contracts for the smooth functioning of their businesses. Such interventions in form of legally enforceable contracts are mandatory because stating and implementing the laid down and agreed terms and procedures are imperative for both parties.

The contractual theory is the need of modern corporations as firms do not want resource wastage and due to high competitiveness in the market, contractual obligations bring accuracy and efficiency to the firms.

Some of the factors impacting the need for contractual theory have been mentioned below:

- The efficiency of the transaction, and market coordination improves.
- Easy monitoring under changing circumstances.
- Transparency of relationship and protection against undecided customizations and manipulations.
- Establishes morale and ethical governance in businesses.

4.3 Maximisation of shareholder wealth

- For large, publicly quoted companies, the stock market serves as a performance monitor. While share prices may react to the general economy or industry-wide factors, the basic component of the share price is the market's perception of the particular firm's current and expected future performance.
- 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.
- 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.
- 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.

4.4 Maximisation of shareholder wealth & problems

Financial managers are seen as agents of shareholders, responsible for maximizing shareholder wealth. However, a conflict often arises between the notion of solely pursuing wealth maximization and the broader responsibility of financial managers to act in the best interest of the company as a whole.
Thus, the objective of maximizing shareholders' wealth does not involve having unethical practices for just serving the welfare of shareholders but instead abiding by all laws and regulations to work towards the profitability of the company and raising the price of the share.

1. Agency theory
2. The role of information
3. The role of agreements
4. Social responsibility

4.4 Maximisation of shareholder wealth & problems

1. **Agency theory**

Agency theory, which considers the relationship between a principal and an agent of that principal, includes issues such as the nature of the agency costs, conflicts of interest (and how to avoid them) and how agents may be motivated and incentivised.

- 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.

4.4 Maximisation of shareholder wealth & problems

- 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.

2. 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?

4.4 Maximisation of shareholder wealth & problems

3. Role of agreements

Written agreements between the various classes of stakeholder may specify key aspects of the relationship between them, but cannot realistically cover all possible future eventualities. Such agreements therefore need to be supplemented by less formal understandings and arrangements.

4. Social responsibility

Social responsibility must also be considered. Efficient, well-managed operations (relative to consumer demand patterns) lead to new products, new technologies and greater employment. But firms must take into account the effects of their policies and actions on society as a whole. The expectations of workers, consumers and various interest groups create other dimensions of the external environment that firms must respond to. 'Externalities' (such as pollution, product safety and job security) must be considered when formulating policy.

5 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.

5 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

6 The Value of company

Generally the value of an asset is the present value of its expected returns. To convert the stream of returns over the life of a security to a value for the security, these must be discounted at the required rate of return for the security.

The valuation requires:

- the stream of expected returns
- the required rate of return on the investment (the discount rate).

To determine the (intrinsic) value of a company, a variety of discounted cashflow (DCF) (also known as present value cashflow (PVCF)) techniques can be used. These techniques use different cashflows and assume different growth rates for cashflows but all use a discount rate very close to the required rate of return; a rate of return that compensates the shareholder for investing in the risky stock.

7 Corporate governance

Corporate governance is the system by which companies are directed and controlled.

7.1 UK Corporate governance code

In order to carry out its responsibilities effectively, the board must follow the Code's guidance on the underlying principles of good practice:

- accountability
- transparency
- probity
- focus on the long-term success of the company.

The Code consists of a set of main and supporting principles and provisions. The principles form the core of the Code. However it allows some flexibility so that companies can adopt their practices to suit their business circumstances.

The requirement to 'comply or explain' allows the board to determine how it complies with the code in carrying out its duties. Where the board, in its aim to achieve good governance, is able to justify following an alternative to a provision, it must clearly and carefully explain to the shareholders the reasons for doing so

7.1 UK Corporate governance code

Principles of the Code

The main principles of the UK Corporate Governance Code are set out under five headings:

- Leadership: The Code's requirement is that 'every company should be governed by an effective board which is collectively responsible for the long-term success of the company'.

- Effectiveness : This principle requires the board and its committees to 'have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively'.

- Accountability: The board 'should present a fair, balanced and understandable assessment of the company's position and prospects'. In meeting this requirement, the board needs to put in place appropriate formal and transparent arrangements to ensure corporate reporting, risk management and internal control principles are adhered to. The board is also required to assess the risk involved in achieving its aims and maintain sound risk management systems.

7.1 UK Corporate governance code

- Remuneration: According to this principle: 'Executive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be transparent, stretching and rigorously applied.'

- Relations with shareholders: Under this principle: 'There should be a dialogue with shareholders based on the mutual understanding of objectives.' The board is responsible for ensuring a satisfactory dialogue with shareholders and must encourage shareholder participation in general meetings.