

Introduction to Finance

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MGM237

Lecture 1



Introduction To Finance

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MGM237 An Overview of Finance

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An Overview of Finance



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An Overview of Finance

What is Finance ?

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Stockholder–Manager Conflicts

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What Is Finance?

Finance is the study and management of **money, investments, and other financial instruments.**

It involves the **processes of raising capital, managing assets, and making decisions** about how to **allocate resources to optimize returns and minimize risks.**



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What Is Finance?

Finance encompasses a broad range of activities, including:

- **Personal Finance:** Managing individual or household budgets, savings, investments, and debt.
- **Corporate Finance:** Focusing on the financial decisions made by businesses, including capital structure, investment strategy, and financing decisions.



What Is Finance?

- **Public Finance:** Involves government expenditures, taxation, and budgeting to manage public funds and infrastructure investments.
- **Financial Markets:** Where financial instruments, such as stocks, bonds, and derivatives, are traded.

Overall, finance seeks to optimize the allocation of funds to achieve objectives such as profitability, liquidity, and solvency.



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What Is Finance?

Finance is defined by Webster's Dictionary as "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.



Key Components of Finance:

Circulation of Money:

- Involves the movement of funds between individuals, businesses, and financial institutions.
- Facilitates economic activities by ensuring that money flows smoothly within the economy.

Granting of Credit:

- Pertains to the provision of loans and credit facilities to individuals and businesses.
- Enables consumers to make purchases and businesses to invest and expand operations without needing immediate capital.

Key Components of Finance:

Making of Investments:

- Involves allocating funds into various assets such as stocks, bonds, real estate, and other investment vehicles.
- Aims to generate returns and grow wealth over time.

Provision of Banking Facilities:

- Encompasses a range of services provided by banks and financial institutions, including checking and savings accounts, mortgages, and financial advising.
- Supports both personal and business financial needs.

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Areas OF Finance

Finance as taught in universities is generally divided into three areas:

- (1) Financial management.
- (2) capital markets.
- (3) investments.

Financial management, also called corporate finance, focuses on decisions relating to how much and what types of assets to acquire, how to raise the capital needed to purchase assets, and how to run the firm to maximize its value.



Financial Management (Corporate Finance)

Key Areas:

•Operational Management:

- Managing the company's financial operations to ensure efficiency and profitability.
- Implementing budgeting processes, financial reporting, and performance monitoring to maintain and enhance the company's financial health.

Objectives:

- Optimize the capital structure to balance debt and equity.
- Ensure sufficient liquidity to meet short-term obligations.
- Enhance shareholder value through strategic financial decisions.

Financial Management (Corporate Finance)

Key Areas:

•Asset Acquisition:

- Determining the types and amounts of assets the company needs to acquire to achieve its business objectives.
- Evaluating potential investments in assets such as machinery, technology, real estate, and other capital goods.

•Capital Raising:

- Identifying and securing the necessary capital to purchase assets.
- Deciding between different sources of financing, such as equity (issuing stocks), debt (taking loans or issuing bonds), or internal funds (retained earnings).

Areas OF Finance

Capital markets relate to the markets where interest rates, along with stock and bond prices, are determined. Also studied here are the financial institutions that supply capital to businesses. Banks, investment banks, stockbrokers, mutual funds, insurance companies, and the like bring together “savers” who have money to invest and businesses, individuals, and other entities that need capital for various purposes.



Capital Markets

Focus: Capital Markets pertain to the venues where financial securities such as stocks and bonds are issued and traded. This area involves understanding how interest rates and security prices are determined and the role of various financial institutions in facilitating the flow of capital.

Key Areas:

•Interest Rates and Security Pricing:

- Analyzing how interest rates are set and how they influence the pricing of financial instruments like bonds and stocks.
- Understanding the factors that drive supply and demand in the markets, thereby affecting asset prices.

Key Areas:**•Financial Institutions:**

- Studying the roles of different financial institutions, including banks, investment banks, stockbrokers, mutual funds, and insurance companies.
- Understanding how these institutions mobilize savings from individuals ("savers") and channel them to businesses, individuals, and other entities in need of capital.

Capital Markets

Key Areas:

•Market Dynamics:

- Exploring how information, regulations, and economic indicators impact capital markets.
- Analyzing market trends, investor behavior, and the impact of global events on financial markets.

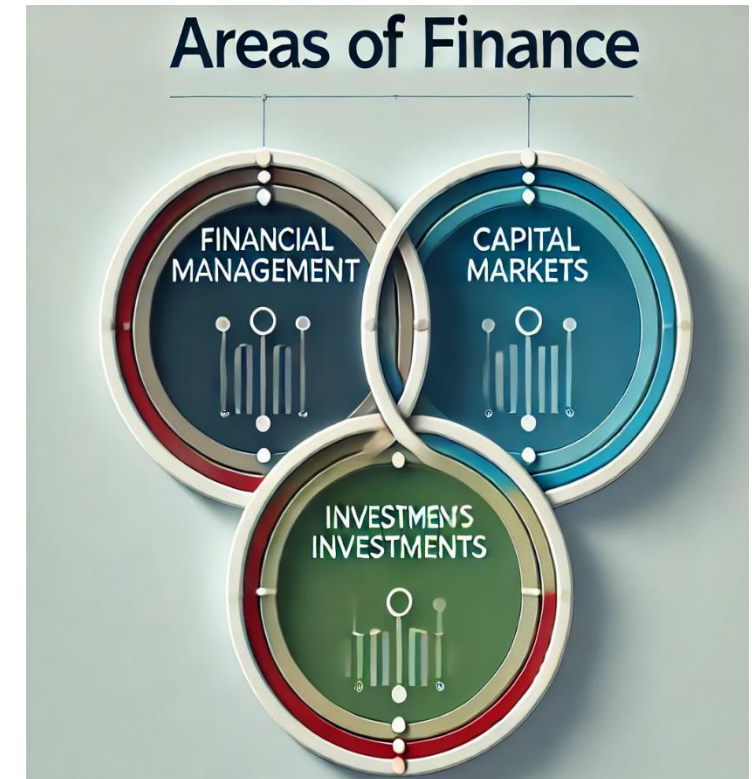
Objectives:

- Facilitate efficient allocation of capital within the economy.
- Provide mechanisms for risk management and liquidity.
- Support economic growth by enabling businesses to raise funds for expansion and innovation.

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Investments, relate to decisions concerning stocks and bonds and include a number of activities:

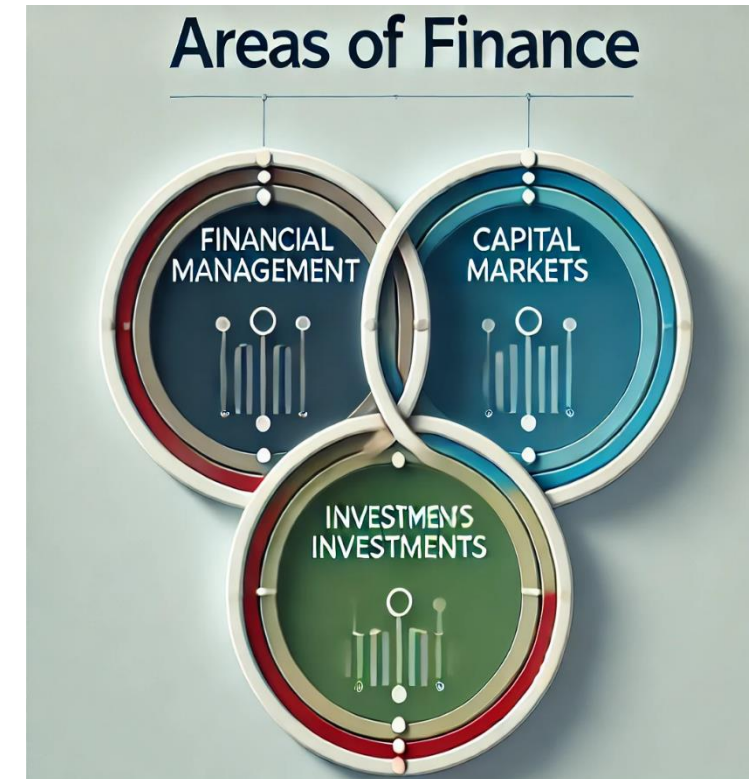
- (1) Security analysis deals with finding the proper values of individual securities (i.e., stocks and bonds).
- (2) Portfolio theory deals with the best way to structure portfolios, or “baskets,” of stocks and bonds.



Areas OF Finance

Rational investors want to hold diversified portfolios in order to limit risks, so choosing a properly balanced portfolio is an important issue for any investor.

(3) Market analysis deals with the issue of whether stock and bond markets at any given time are “too high,” “too low,” or “about right.”



Focus: The Investments area concentrates on how individuals and institutions allocate their capital into various financial instruments to achieve desired returns. It involves analyzing different types of investment vehicles, assessing their risk and return profiles, and making informed investment decisions.

Key Areas:

• **Investment Vehicles:**

- Studying a range of investment options including stocks, bonds, real estate, mutual funds, exchange-traded funds (ETFs), and alternative investments.
- Understanding the characteristics, advantages, and disadvantages of each investment type.

Portfolio Management:

- Learning how to construct and manage investment portfolios to optimize returns while managing risk.
- Implementing diversification strategies to spread risk across different asset classes and securities.

Risk and Return Analysis:

- Evaluating the relationship between risk and expected returns.
- Utilizing financial models and metrics to assess the performance of investments and make data-driven decisions.

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Finance Versus Economics and Accounting

- Primary Focus
- Main Areas
- Core Objectives



Finance Versus Economics and Accounting

Criteria	Finance	Economics	Accounting
Primary Focus	Managing money, investments, and the allocation of financial resources to maximize value.	Studying how societies allocate scarce resources to produce and distribute goods and services.	Recording, classifying, and summarizing financial transactions to provide accurate financial information for decision-making.

Finance Versus Economics and Accounting

Criteria	Finance	Economics	Accounting
Main Areas	- Financial management. - Capital Markets - Investments	- Microeconomics - Macroeconomics - International Economics - Development Economics	- Financial Accounting - Management Accounting - Tax Accounting - Auditing

Finance Versus Economics and Accounting

Criteria	Finance	Economics	Accounting
Core Objectives	- Maximizing investment returns - Minimizing financial risks - Optimizing capital structure	- Understanding economic growth and development - Analyzing the impact of economic policies - Studying resource and wealth distribution	- Ensuring accuracy of financial records - Compliance with financial regulations and standards - Providing useful information for management decisions

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FORMS OF BUSINESS ORGANIZATION

The basics of financial management are the same for all businesses, large or small, regardless of how they are organized. Still, a firm's legal structure affects its operations and thus should be recognized.



FORMS OF BUSINESS ORGANIZATION

There are three main forms of business organizations:

- (1) Proprietorships.
 - (2) Partnerships.
 - (3) Corporations.
- limited liability companies (LLCs)
 - limited liability partnerships (LLPs)



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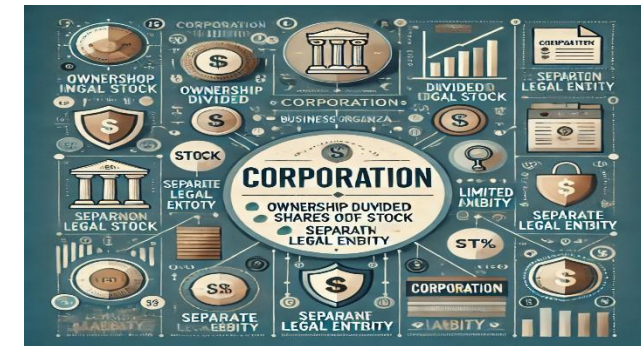
FORMS OF BUSINESS ORGANIZATION



- ◆ Owned by one person
- ◆ Owner is often manager/operator
- ◆ Owner receives any profits, suffers any losses, and is personally liable for all debts



- ◆ Owned by two or more persons
- ◆ Often retail and service-type businesses
- ◆ Generally unlimited personal liability
- ◆ Partnership agreement



- ◆ Ownership divided into shares of stock
- ◆ Separate legal entity organized under state corporation law
- ◆ Limited liability

FORMS OF BUSINESS ORGANIZATION

A proprietorship is an unincorporated business owned by one individual. Going into business as a sole proprietor is easy—a person begins business operations.

Proprietorships have three important advantages:

- (1) They are easy to form.
- (2) They are subject to few government regulations.
- (3) They are subject to lower income taxes than are corporations.



FORMS OF BUSINESS ORGANIZATION

A partnership is a legal arrangement between **two or more people** who decide to do business together. Partnerships are **similar to** proprietorships in that they can be established relatively easily and inexpensively.

Moreover, the firm's income is allocated on a pro rata basis to the partners and is taxed on an individual basis.

This allows the firm to avoid the corporate income tax.



FORMS OF BUSINESS ORGANIZATION

Limited Liability Company (LLC)

- **Hybrid Structure:** Combines elements of corporations and partnerships/sole proprietorships.
- **Limited Liability:** Owners (called members) are protected from personal liability for business debts.
- **Flexible Management:** Can be managed by members or designated managers.
- **Pass-Through Taxation:** Profits are passed to owners without corporate taxes, similar to a partnership or sole proprietorship.
- **Ownership:** Can be owned by one or more members (individuals, corporations, or even other LLCs).



FORMS OF BUSINESS ORGANIZATION

Limited Liability Partnership (LLP)

- **Partnership with Limited Liability:** Primarily used by professionals like lawyers, doctors, accountants.
- **Limited Liability:** Partners are not personally liable for the actions or debts of other partners, though they might be liable for their own misconduct.
- **Pass-Through Taxation:** Profits pass through to partners who report them on their personal tax returns.
- **Flexible Structure:** Partners share in management but enjoy personal liability protection.



FORMS OF BUSINESS ORGANIZATION

A corporation is a **legal entity** created by a state, and it is separate and distinct from its owners and managers.

It is this **separation** that limits stockholders' losses to the amount they invested in the firm.

the corporation can lose all of its money, but its owners can lose only the funds that they invested in the company.



FORMS OF BUSINESS ORGANIZATION

Corporations also have unlimited lives, and it is easier to transfer shares of stock in a corporation than one's interest in an unincorporated business.

These factors make it much easier for corporations to raise the capital necessary to operate large businesses. Thus, companies such as Hewlett-Packard and Microsoft generally begin as proprietorships or partnerships, but at some point, they find it advantageous to become a corporation.



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The Main Financial Goal: Creating Value for Investors

In public corporations, managers and employees work on behalf of the shareholders, who own the business, and therefore they have an obligation to pursue policies that promote stockholder value.

While many companies focus on maximizing a broad range of financial objectives, such as growth, earnings per share, and market share, these goals should not take precedence over the main financial goal, which is to create value for investors.

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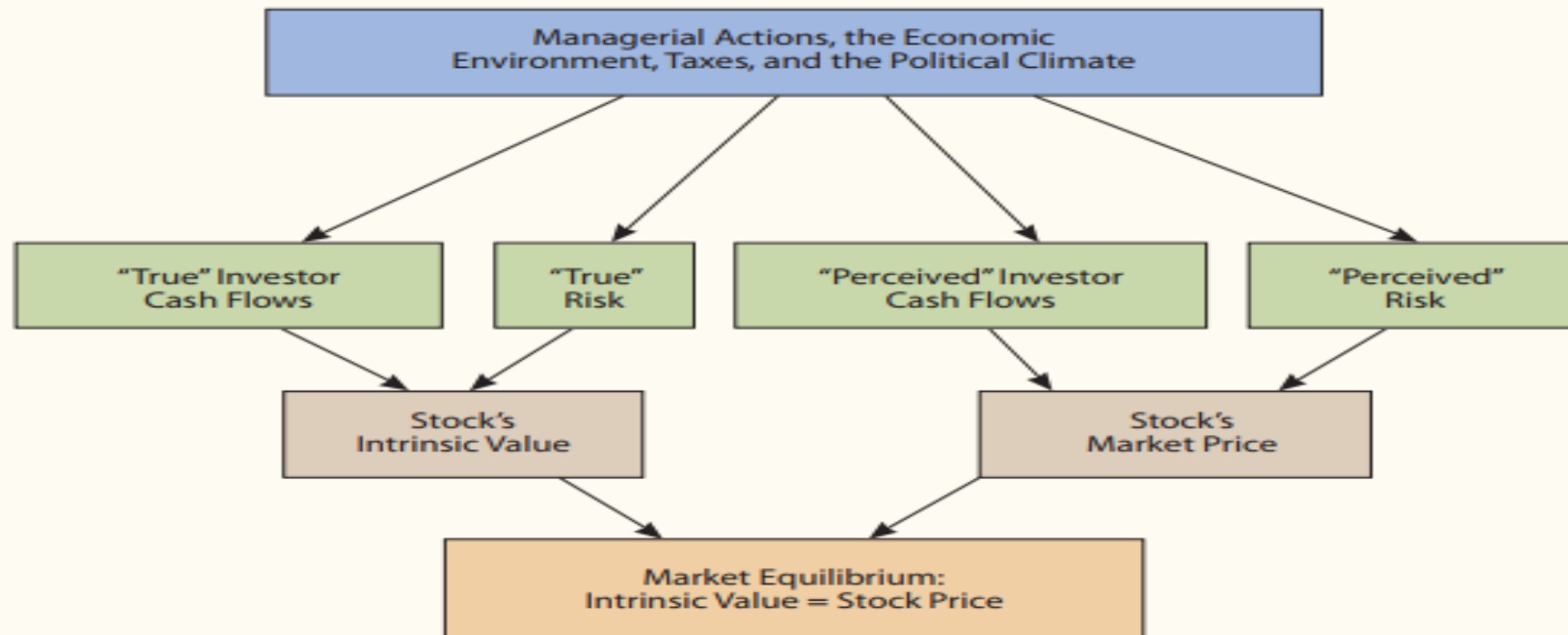
The Main Financial Goal: Creating Value for Investors

If a manager is to maximize stockholder wealth, he or she must know how that wealth is determined.

we shall see that the value of any asset is the present value of the stream of cash flows that the asset provides to its owners over time.

stock prices are based on cash flows expected in future years, not just in the current year. Thus, stock price maximization requires us to take a long-run view of operations. At the same time, managerial actions that affect a company's value may not immediately be reflected in the company's stock price.

The Main Financial Goal: Creating Value for Investors

FIGURE 1.2**Determinants of Intrinsic Values and Stock Prices**

The Main Financial Goal: Creating Value for Investors

1. Managerial Actions, the Economic Environment, Taxes, and the Political Climate

- This top section represents the external factors and actions that influence investor behavior and the stock's value. These factors can change investor expectations, risks, and cash flows, ultimately affecting both the intrinsic and perceived value of the stock.



The Main Financial Goal: Creating Value for Investors

2. "True" Investor Cash Flows and "True" Risk

- These are fundamental factors related to the intrinsic value of the stock.
- **"True" Investor Cash Flows:** The actual or fundamental cash flows expected by investors.
- **"True" Risk:** The real risks associated with the stock that investors consider.



The Main Financial Goal: Creating Value for Investors

3. Stock's Intrinsic Value

- Based on true cash flows and risks, this represents the actual or fundamental value of the stock. This is what the stock is theoretically worth based on all available information.



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4. "Perceived" Investor Cash Flows and "Perceived" Risk

- These represent the investors' perceptions of the stock's future cash flows and risks, which may differ from the actual or "true" values.
- **"Perceived" Investor Cash Flows:** What investors believe will be the future cash flows.
- **"Perceived" Risk:** The risks that investors think the stock carries.



The Main Financial Goal: Creating Value for Investors

5. Stock's Market Price

- Based on perceived investor cash flows and risks, this is the price at which the stock is currently trading in the market. It reflects the collective perceptions of all market participants.



The Main Financial Goal: Creating Value for Investors

6. Market Equilibrium

- The diagram indicates that market equilibrium is achieved when the stock's intrinsic value equals its market price. This means that investor perceptions align with the stock's actual value, resulting in no pressure for the price to change.



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The Main Financial Goal: Creating Value for Investors

The top box indicates that **managerial actions**, combined with **the economy**, **taxes**, and **political conditions**, influence the level and riskiness of the company's future cash flows, which ultimately determine the company's stock price.

As you might expect, investors like higher expected cash flows, but they dislike risk; so, the larger the expected cash flows and the lower the perceived risk, the higher the stock's price.



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The second row of boxes differentiates what we call “true” expected cash flows and “true” risk from “perceived” cash flows and “perceived” risk.

By “true,” we mean the cash flows and risk that investors would expect if they had all of the information that existed about a company. “Perceived” means what investors expect, given the limited information they have.

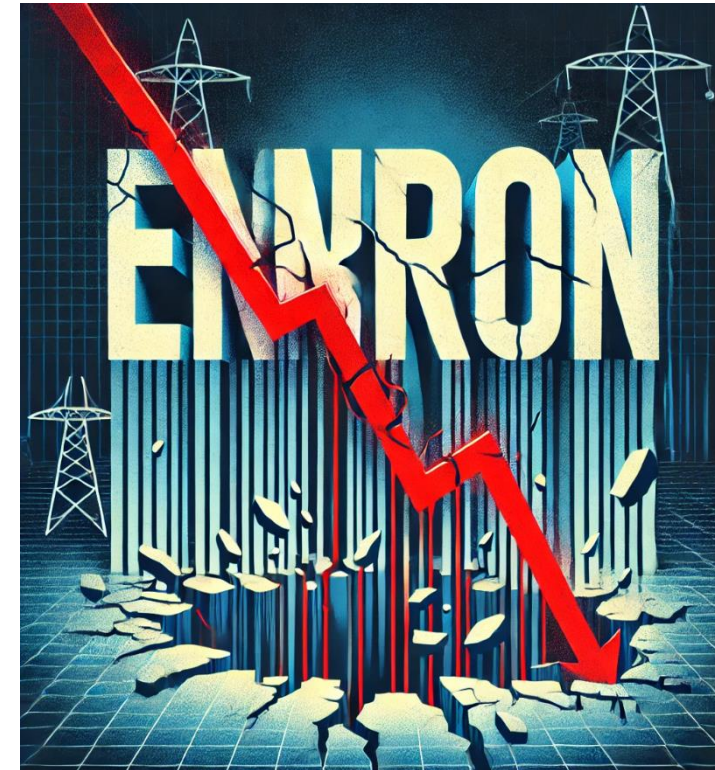


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To illustrate, in early 2001, investors had information that caused them to think Enron was highly profitable and would enjoy high and rising future profits. They also thought that actual results would be close to the expected levels and hence that Enron's risk was low. However, true estimates of Enron's profits, which were known by its executives, but not the investing public, were much lower; Enron's true situation was extremely risky



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Consequences OF Having a Short- run Focus

Ideally, managers adhere to this long-run focus, but there are numerous examples in recent years where the focus for many companies shifted to the short run.

Perhaps most notably, prior to the recent financial crisis, many Wall Street executives received huge bonuses for engaging in risky transactions that generated short-term profits. Subsequently, the value of these transactions collapsed, causing many of these Wall Street firms to seek a massive government bailout.



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Consequences OF Having a Short- run Focus

A **bailout** is when the government gives financial support to rescue a company that is in financial trouble and possibly at risk for bankruptcy.



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Consequences OF Having a Short- run Focus

there have been other examples where managers have focused on short-run profits to the detriment of long-term value.

For example, Wells Fargo implemented incentives to reward employees for signing up customers to new accounts.

Unfortunately, to obtain bonuses some employees created fake accounts or signed up customers for unauthorized credit cards.



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Consequences OF Having a Short- run Focus

This led to the firing of thousands of employees, as well as its CEO and other senior managers, and millions of dollars in fines for Wells Fargo.

With these types of concerns in mind, many academics and practitioners stress the need for boards and directors to establish effective procedures for corporate governance. Component of strong governance.



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Consequences OF Having a Short- run Focus

This involves putting in place a set of rules and practices to ensure that managers act in shareholders' interests while also balancing the needs of other key constituencies such as customers, employees, and affected citizens.

Having a strong, independent board of directors is viewed as an important component of strong governance.



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Effective governance requires holding managers accountable for poor performance and understanding the important role that executive compensation plays in encouraging managers to focus on the proper objectives.



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Stockholder–Manager Conflicts

It has long been recognized that managers' personal goals may compete with shareholder wealth maximization.

Managers might be more interested in maximizing their own wealth than their stockholders' wealth; therefore, managers might pay themselves excessive salaries. Effective executive compensation plans motivate managers to act in their stockholders' best interests.

Agency problem: the likelihood that managers may place personal goals ahead of corporate goals

Stockholder–Manager Conflicts

Useful motivational tools include

- (1) reasonable compensation packages,
- (2) firing of managers who don't perform well
- (3) The threat of hostile takeovers

Compensation packages should be sufficient to attract and retain able managers, but they should not go beyond what is needed.

Compensation policies need to be consistent over time.

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Stockholder–Debtholder Conflicts

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.

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Thank You