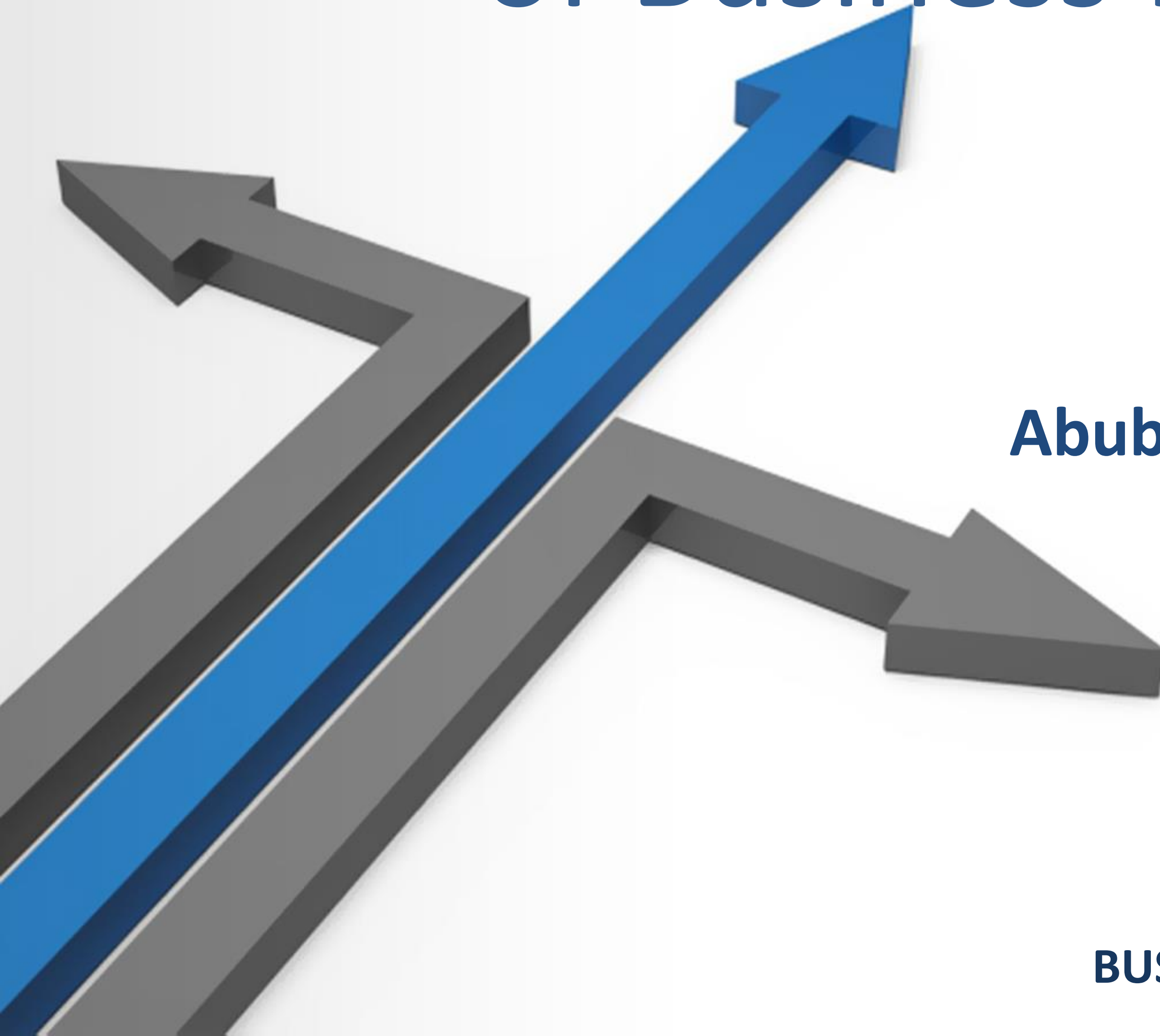
Basic Concepts and Principles of Business Finance



BY
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BUS333 Business Finance

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The Reasons for Studying Business Finance

There are several reasons for studying finance. Knowledge of the basics of finance help a person in making informed economic decisions, personal and business investment decisions, and career decisions.

- **To make informed economic decisions:** Since elected officials have the power to alter the financial system of a country by creating laws, and since their decisions can influence economic activity, it is important that individuals be informed when making political and economic choices. Do you want a balanced budget, lower taxes, free international trade, low inflation, and full employment? Therefore, every individual should attain a basic understanding of finance as it applies to the financial system.

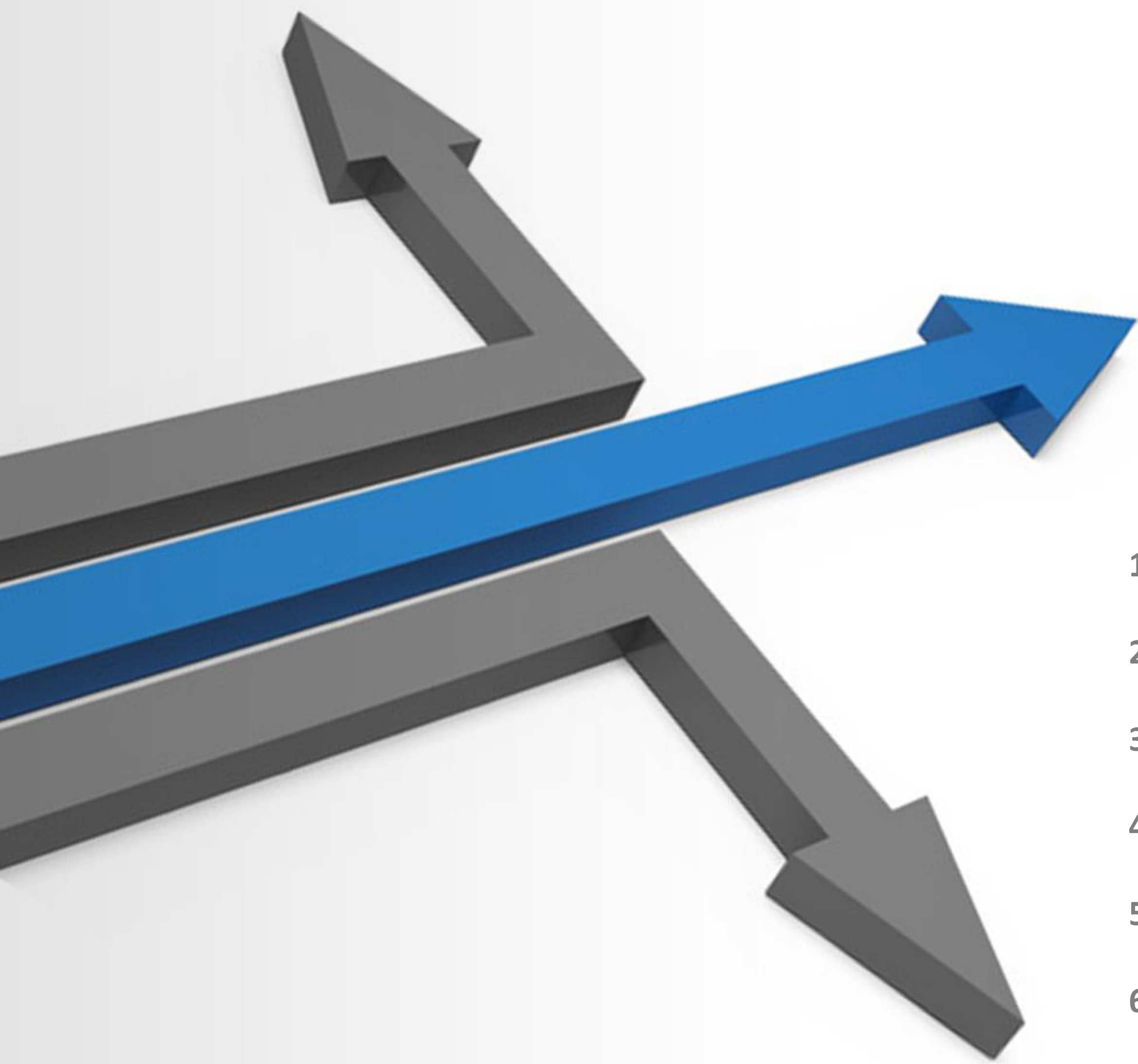
- **To make informed personal and business investment decisions:** An understanding of finance should help you better understand how the institution, government unit, or business finances its operations. At a personal level, the understanding of investments will enable you to better manage your financial resources and provide the basis for making sound decisions for accumulating wealth over time.

The Reasons for Studying Business Finance

- **To make informed career decisions based on a basic understanding of business finance**: Even if your business interest is in a nonfinancial career or professional activity, you likely will need to interact with finance professionals both within and outside your firm or organization. Doing so will require at least a basic knowledge of the concepts, and applications of financial management.

You may want to own your own business, for that business to be successful, you need to know at least the basic knowledge of finance or hire some body who does.

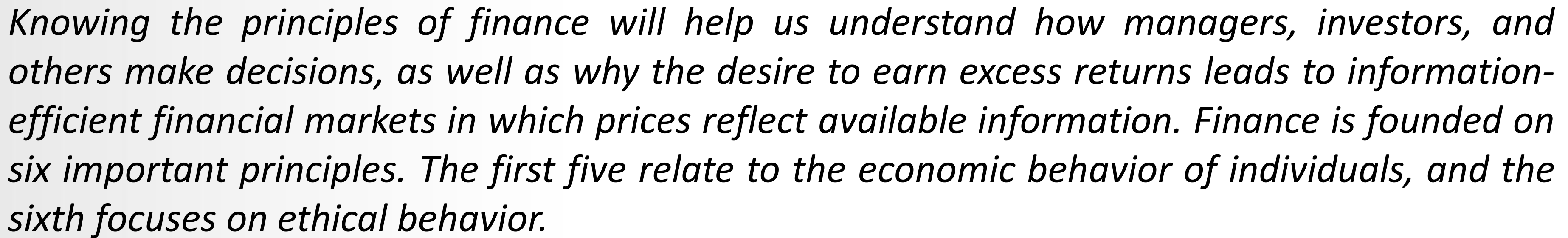
You may also aspire to work a non financial job in a non financial organization. Yet one day you may become the chief executive officer (CEO) of the organization, and to successfully manage the organization you need at least the basic knowledge of finance.



02 Principles of Finance

1. Time Value of Money
2. Risk Versus Return
3. Diversification of Risk
4. Financial Markets Are Efficient
5. Management Versus Owner Objectives
6. Reputation Matters

Principles of Finance



Knowing the principles of finance will help us understand how managers, investors, and others make decisions, as well as why the desire to earn excess returns leads to information-efficient financial markets in which prices reflect available information. Finance is founded on six important principles. The first five relate to the economic behavior of individuals, and the sixth focuses on ethical behavior.

Time Value of Money: The time-value-of-money principle helps us to understand the economic behavior of individuals and the economic decisions of the institutions and businesses that they run. This finance principle pillar is apparent in many of our day-to-day activities. Money in hand today is worth more than the promise of receiving the same amount in the future.

Example: Assume that you have $1,000 today and that it could earn $60 (6%) interest over the next year. Thus, $1,000 today would be worth $1,060 at the end of one year. As a result, a dollar today is worth more than a dollar received a year from now.

Principles of Finance

Risk Versus Return: A trade-off must exists between risk and expected return in all types of investments both real assets and financial assets.

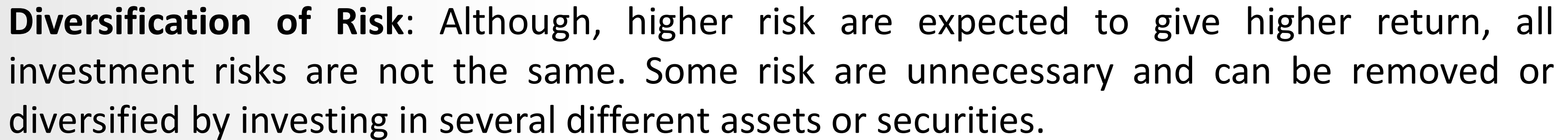
- Risk is the uncertainty about the outcome or payoff of an investment in the future.

  Example: Assume that you invest $1,000 in a business venture today. After one year, the firm might collapse and you may lose your total investment. On the other hand, the company may prosper and after one year your investment might be worth $2,400

Therefore, This variability in possible outcomes is what is known as risk. Rational investors would prefer the business investment that is riskier and would choose this investment only if they feel the expected return is high enough to justify the greater risk.

Investors make these trade-off decisions every day. Business managers make similar trade-off decisions when they choose between different projects in which they could invest.

Principles of Finance



Diversification of Risk: Although, higher risk are expected to give higher return, all investment risks are not the same. Some risk are unnecessary and can be removed or diversified by investing in several different assets or securities.

Example:

Now let's assume that there also is an opportunity to invest $1,000 in a second, unrelated business venture in which the outcomes would be zero dollars or $2,400. Let's further assume that we will put one-half of the $1,000 investment funds in each investment opportunity such that the individual outcomes for each $500 investment would be zero dollars or $1,200.

While it is possible that both investments could lose everything (i.e., return zero dollars) or return $1,200 each (a total of $2,400), it is also possible that one investment would go broke and the other would return $1,200.

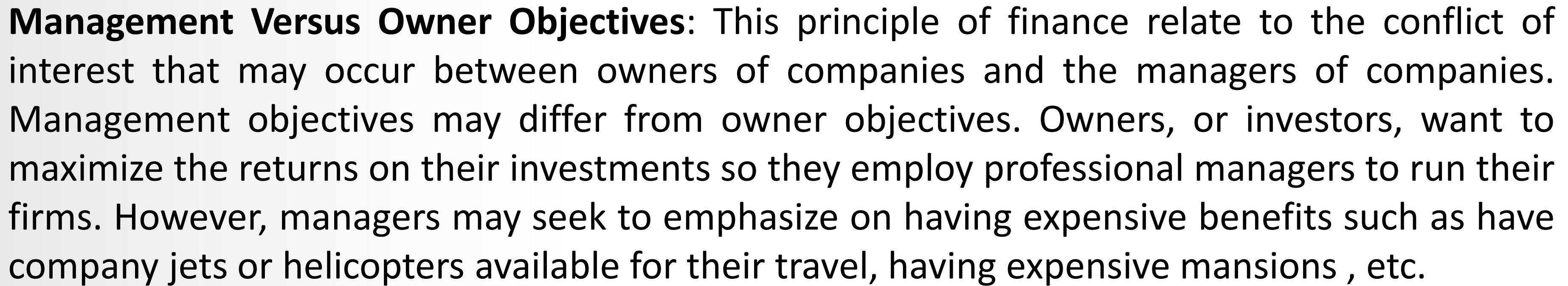
Therefore, this diversification result in four outcomes:

Principles of Finance

Possible Outcomes	Combined Investment	Possible Returns		Combined Return
Outcome 1:	$500 + $500	$0 + $0	=	$0
Outcome 2:	$500 + $500	$0 + $1,200	=	$1,200
Outcome 3:	$500 + $500	$1,200 + $0	=	$1,200
Outcome 4:	$500 + $500	$1,200 + $1,200	=	$2,400

Financial Markets Are Efficient: A financial market is said to be information efficient if at any point the prices of securities reflect all information available to the public. When new information becomes available, prices quickly change to reflect that information. This informational efficiency of financial markets exists because a large number of professionals are continually searching for mispriced securities. Of course, as soon as new information is discovered, it is immediately reflected in the price of the associated security. Information-efficient financial markets play an important role in the marketing and transferring of financial assets between investors by providing liquidity and fair prices.

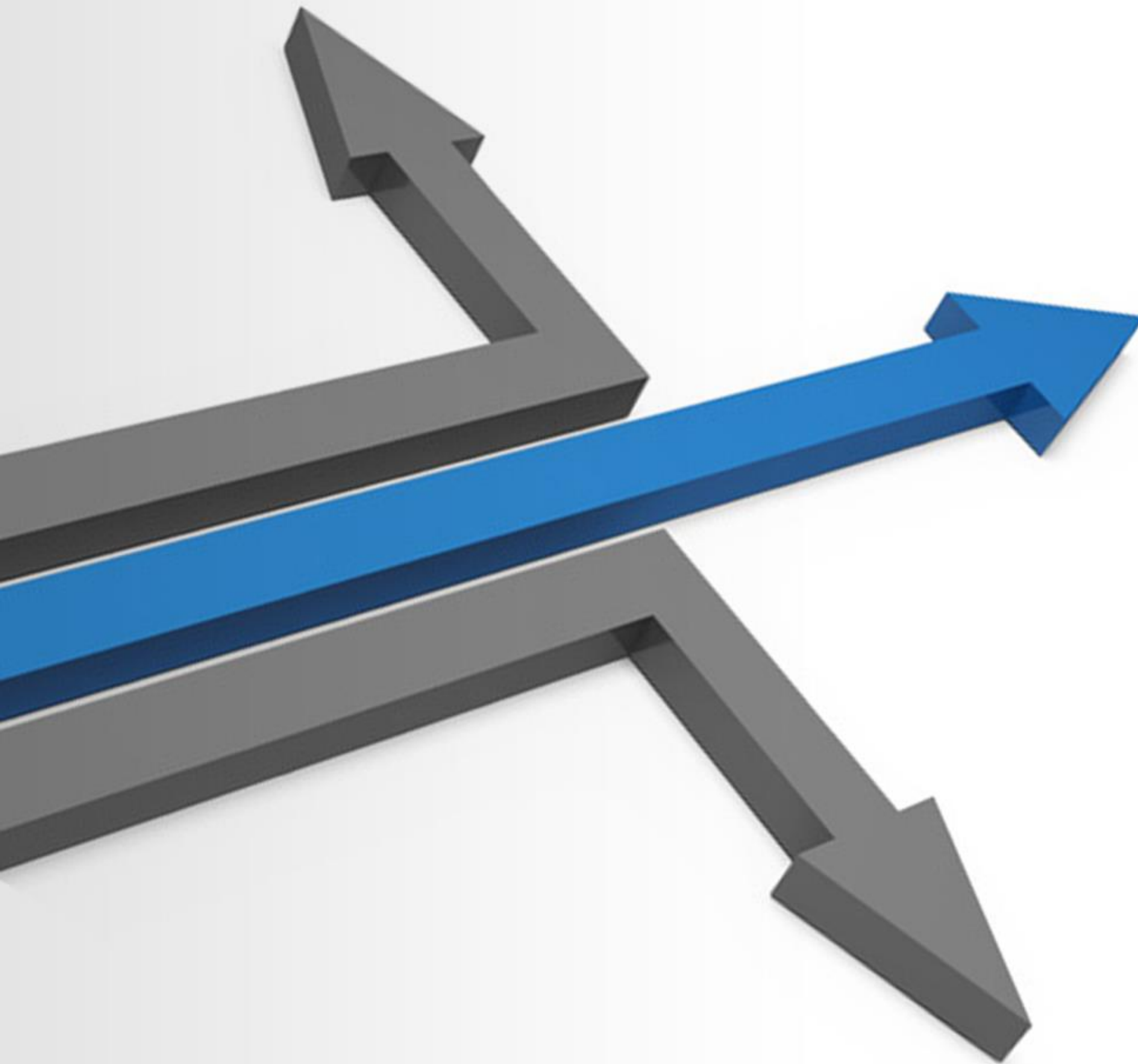
Principles of Finance



Management Versus Owner Objectives: This principle of finance relate to the conflict of interest that may occur between owners of companies and the managers of companies. Management objectives may differ from owner objectives. Owners, or investors, want to maximize the returns on their investments so they employ professional managers to run their firms. However, managers may seek to emphasize on having expensive benefits such as have company jets or helicopters available for their travel, having expensive mansions , etc.

To bring manager objectives in line with owner objectives, it often is necessary to tie manager compensation to measures of performance beneficial to owners. Managers are often given a portion of the company shares and bonuses tied to stock price performance in publicly traded firms.

Reputation Matters: This principle deals with the ethical aspect of economic entity. An individual's reputation reflects his or her ethical standards or behavior. Ethical behavior is how an individual or organization treats others legally, fairly, and honestly. The ethical behavior of firms reflects the ethical behaviors of their directors, officers, and managers.



03 Financial Decisions

1. Debt versus Equity
2. Value versus Cost
3. Liquidity

Financial Decisions

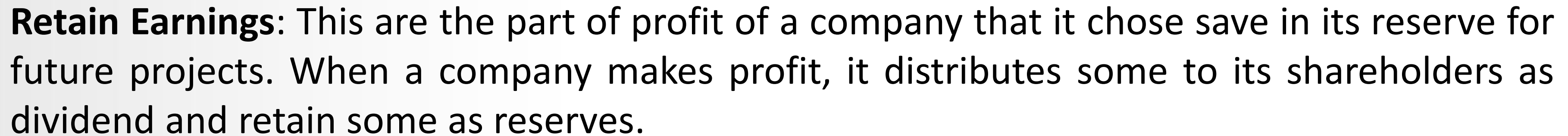
The most common sources of finance of private and public companies are 3:

- *Equity*
- *Debt*
- *Retain Earnings*

- **Equity**: Equity is the ordinary shares of a company. Equity is also known as "**Common stocks**", it represent ownership shares in a firm. Each share of common stock entitles its owners to one vote on any matters of corporate governance put to a vote at the firm's annual meeting and to a share in the financial benefits of ownership, such as, the right to any dividends that the firm may choose to distribute.

- **Debt**: Debt are the money that a company borrow to finance it projects or activities. Debt are liabilities and obligations of the firm that require a payout of cash within a stipulated period. Example include loan from bank, issuance of bond and debentures, etc.

Financial Decisions



Retain Earnings: This are the part of profit of a company that it chose save in its reserve for future projects. When a company makes profit, it distributes some to its shareholders as dividend and retain some as reserves.

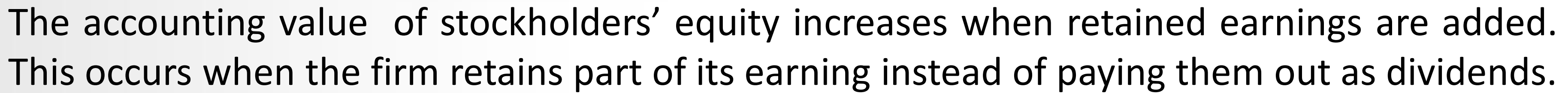
- **Debt versus Equity**: This is the decision whether to finance a growth project with debt or equity of the firm. This is one of the important decision that every firm goes through. Both debt and equity financing have their advantages and disadvantages.

  While debts are liabilities and are frequently associated with fixed cash burdens, called debt service, that put the firm in default of a contract if they are not paid. Stockholders' equity is a claim against the firm's assets that is residual and not fixed.

Generally, when the firm borrows, it gives the debt giver first claim on the firm's cash flow. The debt owner can sue the firm if the firm defaults on its debt contracts. This may lead the firm to declare itself bankrupt.

On the other hand, Stockholders' equity is the difference between a company's assets and its liabilities: Equity = assets – Lliabilities.

Financial Decisions

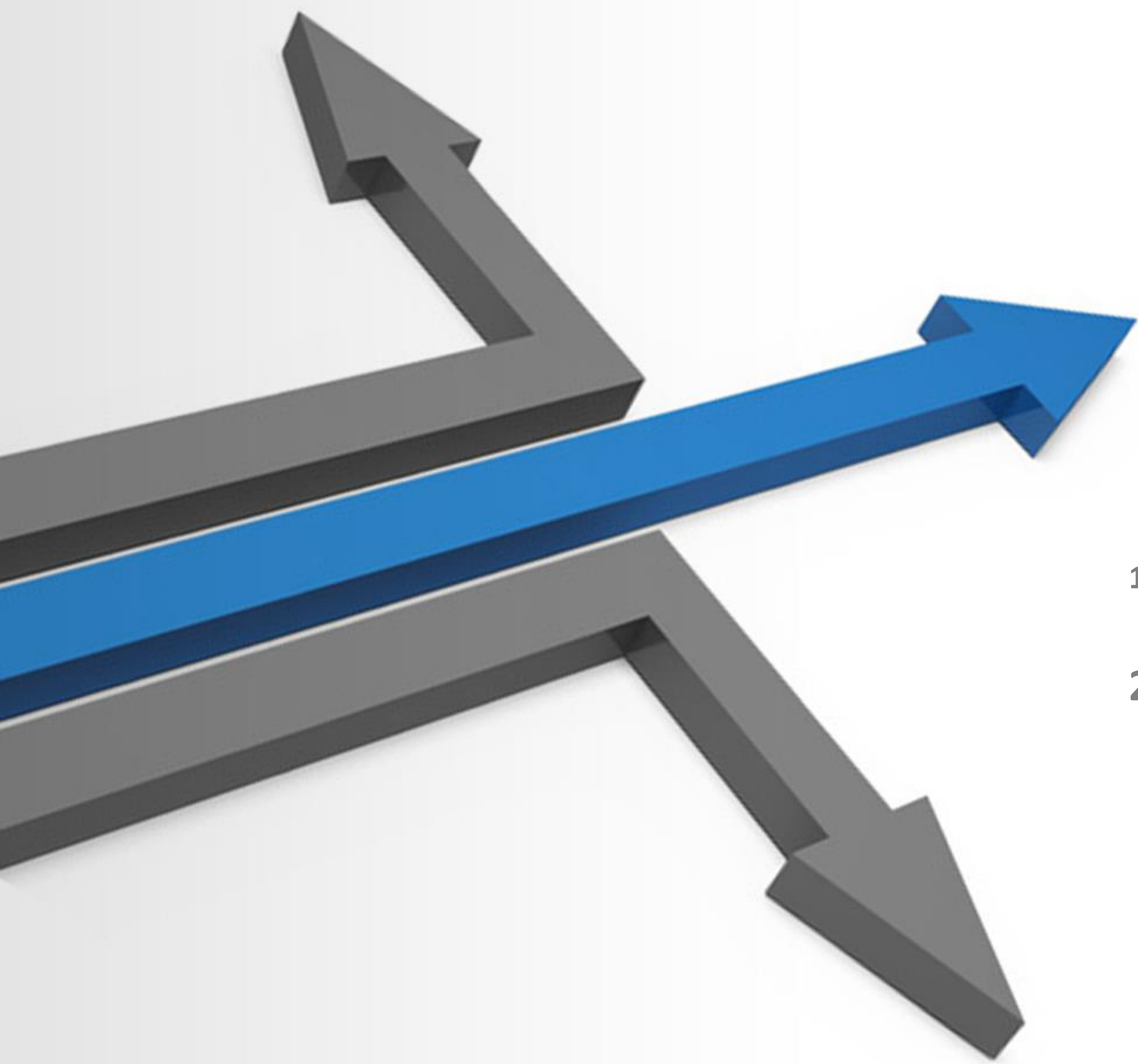


The accounting value of stockholders' equity increases when retained earnings are added. This occurs when the firm retains part of its earning instead of paying them out as dividends.

Value Versus Cost: The accounting value of a firm's assets is frequently referred to as "***the carrying value***" or "***the book value***" which is a fancy name for cost of the assets. The cost of firm's asset is the original historical price that the asset was purchase. ***Market value*** on the other hand, is the price at which willing buyers and sellers would trade the assets. Accounting principles and standards dictates that real assets should be recorded and carried at its cost, while Financial assets are normally recorded at its market value.

Liquidity: Liquidity refers to the ease and quickness with which assets can be converted to cash without significant loss in value. Current assets are the most liquid assets, they include cash and other assets that will be turned into cash within a year from the balance sheet date .

A company is said to be liquid if it has enough assets that can be quickly converted into cash for the working capital of the firm. Working capital is the blood of any firm. Thus a firm must decide the means of financing its liquidity.



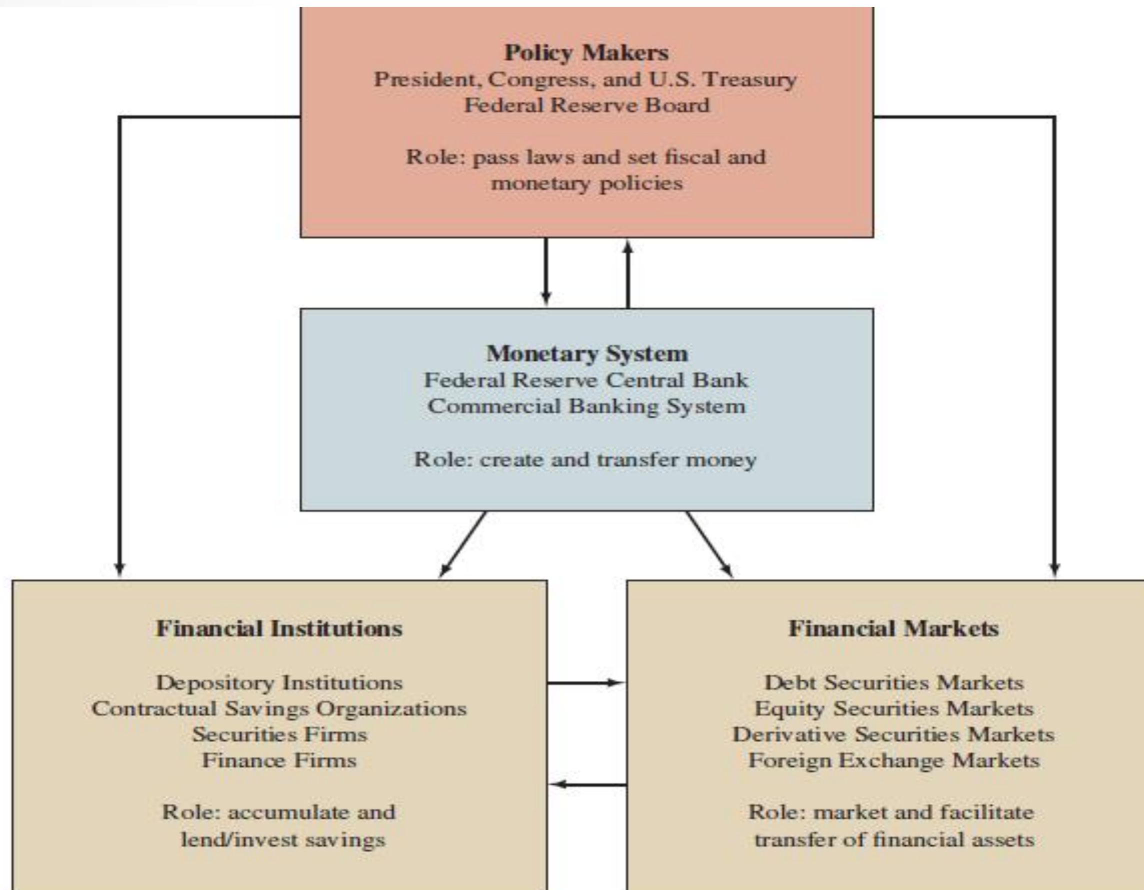
04 Overview of the Financial System

1. Features and Requirements

2. Components and Function

Overview of the Financial System

The financial system is a complex mix of financial intermediaries, markets, instruments, policy makers, and regulations that interact to expedite the flow of financial capital from savings into investment.



Overview of the Financial System

Financial System Components and Financial Functions: The role of monetary system, financial institutions, and financial markets components are the financial functions that are necessary in an effective financial system.

COMPONENTS

ROLES EXPRESSED AS FINANCIAL FUNCTIONS

Monetary System → Creating money

Monetary System → Transferring money

Financial Institutions → Accumulating savings

Financial Institutions → Lending/investing savings

Financial Markets → Marketing financial assets

Financial Markets → Transferring financial assets

Overview of the Financial System

- **Creating Money**: Since money is something that is accepted as payment for goods, services, and debts, its value lies in its purchasing power. Money is the most generalized claim to wealth, because it can be exchanged for almost anything. Therefore, One of the most significant functions of the monetary system within the financial system is creating money, which serves as a medium of exchange. A sufficient amount of money is essential if economic activity is to take place at an efficient rate. Having too little money constrains economic growth. Having too much money often results in increase in the prices of goods and services.

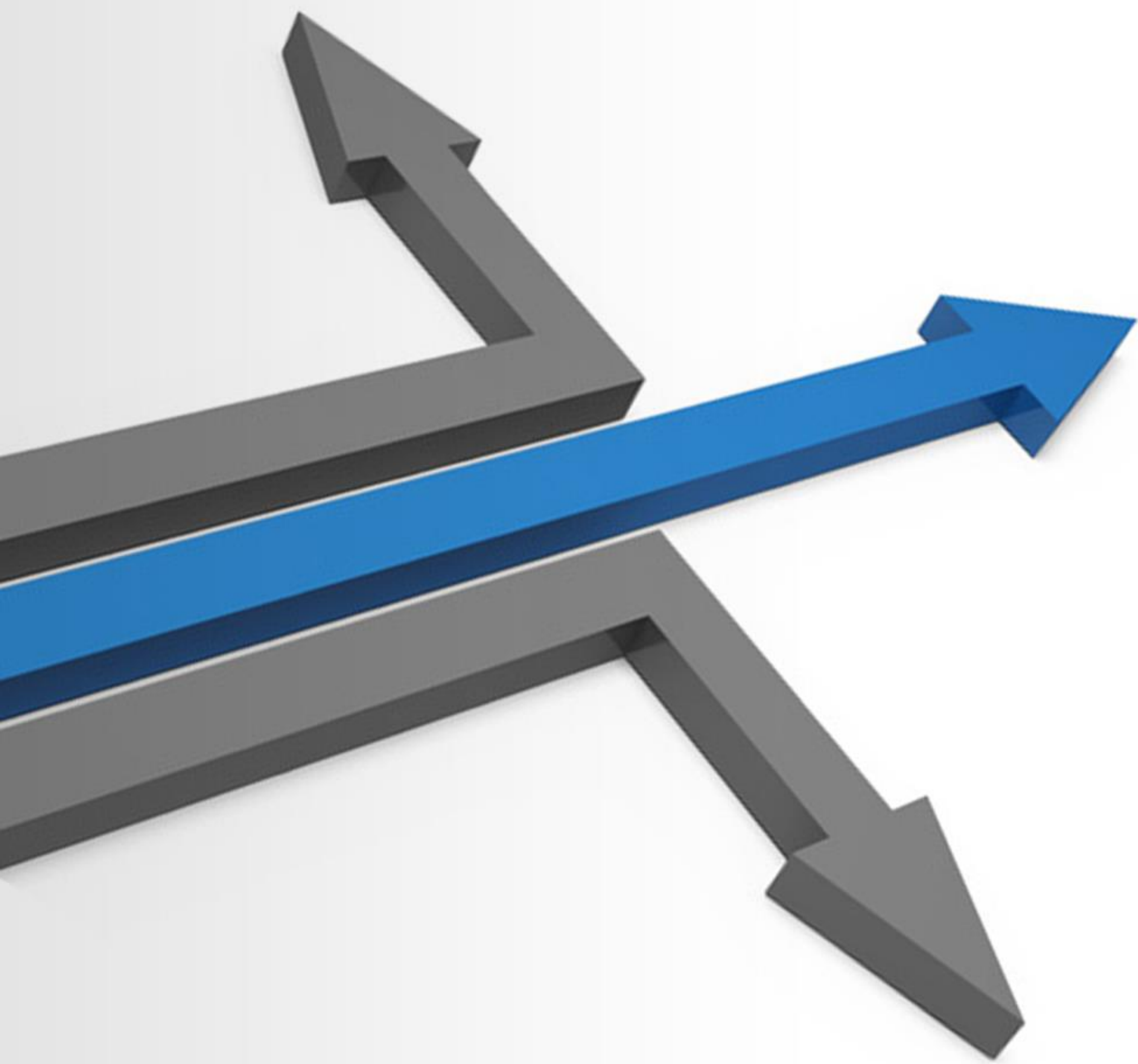
- **Transferring Money**: Individuals and institutions can transfer funds between accounts by means of cheque, or electronically, making payments easier and faster. Funds transfers can be made by telephone, at automated teller machines (ATMs) connected to a bank’s computer, and via the Internet.

Overview of the Financial System

- **Accumulating Savings**: One of the functions performed by financial institutions is the accumulation or gathering of individual savings. When deposits are accumulated in one place, they can be used for loans and investments in amounts much larger than any individual depositor could supply. Depository institutions regularly conduct advertising campaigns and other promotional activities to attract deposits.

- **Lending and Investing Savings**: Another basic function of financial institutions is lending and investing. The money that has been put into these intermediaries may be lent to businesses, farmers, consumers, institutions, and governmental units. It may be lent for varying periods and for different purposes, such as to buy equipment or to pay current bills.

- **Marketing and Transferring Financial Assets**: New financial instruments and securities are created and sold in the primary securities market. An investment bank as a financial intermediary handle the sale of shares. Brokerage firms also markets and facilitate the transferring of market securities.



05 Financial Markets: Types and Features

1. Money and Capital Markets
2. Primary and Secondary Markets
3. Major Types of Financial Markets

Financial Markets: Types and Features

Money Market: Money markets are where debt securities with maturities of one year or less are issued and traded. These markets are generally characterized by high liquidity. Securities in these markets can be easily sold or traded with little loss of value. These short-lived securities generally have low returns and low risk. The securities traded in these markets include; Treasury Bills, Certificates of Deposit, Commercial Paper, etc.

Capital markets: Capital markets are where debt instruments or securities with maturities longer than one year and corporate stocks or equity securities are issued and traded. Capital market securities are generally issued to finance the purchase of homes by individuals, buildings and equipment by businesses, and for provision of infrastructure (roads, bridges, buildings, etc.) by governments.

Business firms and governments issue long-term debt securities, called bonds, to finance their assets and operations. Mortgages are issued to finance homes and buildings. Corporations also issue stocks to meet their financing needs.

Financial Markets: Types and Features

Primary Market: primary market is the market where the Initial Public Offering (IPO) or origination of debt and equity securities takes place. The primary market is the only market where the security issuer directly benefits (receives funds) from the sale of its securities.

Secondary Market: Secondary are markets where the transfer of existing debt (bonds and mortgages) and equity securities between investors occurs. This is a physical located or electronic forums where debt (bonds and mortgages) and equity securities are traded.

Over-the-counter Markets: An over-the-counter (OTC) market is a decentralized market in which market participants trade stocks, commodities, or other securities directly between two parties and without a central exchange or broker.

Commodity Markets: A commodity market is a market that trades in the primary economic commodities rather than manufactured products. This commodities include gold, silver, cocoa, cotton, petrol, gas, dollar, euro, etc. Commodity markets can include physical trading and derivatives trading using spot prices, forwards, futures, and options prices.

Financial Markets: Types and Features

There are four main types of financial markets, namely; debt securities markets, equity securities markets, derivative securities markets, and foreign exchange markets.

Debt Securities Markets: Debt securities are obligations to repay borrowed funds. Debt securities markets are markets where money market securities, bonds (corporate, financial institution, and government), and mortgages are originated and traded.

- ✓ ***Bond Markets***: Bond markets are form of debt securities market, they are where debt securities with longer-term maturities are originated and traded. Government entities (federal, state, and local), financial institutions, and business firms can issue bonds.

- ✓ ***Mortgage Markets***: Mortgage markets are where loans to purchase real estate (buildings and houses) are originated and traded.

Financial Markets: Types and Features

Equity Securities Markets: are markets where ownership shares in corporations are initially sold and traded. Corporations can raise funds either through a private placement, which involves issuing new common stocks directly to specific investors, or through a public offering, which involves selling new common stocks to the general public.

Derivative Securities Markets: These are markets for financial contracts or instruments that derive their values from underlying debt and equity securities. A familiar form of derivative security is the opportunity to buy or sell a corporation's equity securities for a specified price and within a certain amount of time. Derivatives securities include futures, forward, options and, etc. Derivative securities may be used to speculate on the future price direction of the underlying financial assets or to reduce price risk associated with holding the underlying financial assets.

Foreign Exchange Markets: This is also known as *FOREX Markets* they are electronic markets in which banks and institutional traders buy and sell various currencies on behalf of business es and other clients.

Careers In Finance

Career opportunities in finance are available in:

- Business Financial Management (Example working as a Stock Broker)
- Depository financial institutions (Example, Banks, Insurance companies and, etc.),
- Contractual savings and real property organizations (Example Investment companies)
- Securities markets and investment firms (Example London Stock Exchange and etc.).

While most of you may aspire to own your own business or to be a chief executive officer (CEO) or chief financial officer (CFO) in a major company, you must begin your careers in an entry-level position.

Any Questions?

THANK YOU

Question Bank

1. Briefly explain the six principles of finance. And how is the 6th principle different from the rest.
2. What is the difference between Ordinary shares and preference shares?
3. Differentiate between Equity and Debt.
4. What is retain earnings.
5. What does liquidity means.
6. Which assets are recorded in their historical cost and which ones are recoded in their market value.
7. List and explain the financial functions that are necessary for financial system efficiency.
8. Differentiate between the following
   a. Money Markets and Capital Markets
   b. Primary Market and Secondary Market
   c. Commodities Markets and Over-the-counter Markets
9. List and explain the four main types of financial markets.