Chapter 1: Business Finance

WHAT IS FINANCE?

Finance is a part of economics. Economics pertains to making decisions on how to best allocate scarce resources (land, labor, capital) to meet the needs and wants of society.

The goal of individuals is to maximize their utility (satisfaction).

Satisfaction can come from many sources - time with family, eating, getting an education, owning a new car, etc. Some sources of satisfaction cost money (buying a new car), while other sources take time (a trip with the family) that prevent you from acquiring (earning) money.

Why do so many sources of satisfaction cost money? Because they are only possible if others (e.g. automobile workers) are willing to spend their valuable time building the car - but they do so only because the reward they earn from what you pay for the car will allow them to acquire many of the things that bring them satisfaction.

We can't have or do all we want to, so we have to make choices - for example, spend more time at work and make more money to buy things we want and need versus spending more time with.

FINANCE pertains to making decisions on how to best allocate our financial resources (money).
GOAL OF INDIVIDUALS - Maximize our utility (satisfaction). Allocate (spend vs. invest) financial resources to maximize satisfaction.

Only we can decide how to best maximize our satisfaction in life. If you choose to spend most of your time cloistered in prayer, that is your choice - you do what best "fulfills" you.

If the things that bring you satisfaction cost money - and for most of us that is most things, than you must decide how to spend, or, whether to not spend and invest (put your money to work) to earn a return so you will have even more later on and can acquire even more satisfaction later.

When running a business - especially a large one where the managers are not the owners - the people making the decisions must keep in mind that they are working for the owners and must do what is best for them.

OBJECTIVE OF FINANCE (Business Finance)

Maximize wealth of owners - you do this by maximizing the value of the firm, which you in turn do by maximizing the price of the company's stock

You are maximizing the wealth of owners who can then maximize their personal satisfaction

Managers cannot decide for individual owners how to best maximize their personal satisfaction.
AGENCY PROBLEM

Agent (Manager) vs. Principal (Owner) - managers of large business are rarely the owners, so the managers (agent) are acting on behalf of the owners (principal). The owners must take care to assure the managers are acting in the owners' best interest and not in the manager's interest.

AREAS OF FINANCE

Business Finance - Decision making within a business

Investments - Allocating money to earn future return

Markets and Institutions - How financial resources (money) are allocated throughout the economy - borrowing and lending

IMPORTANCE OF CASH FLOWS

When can "less" be worth more than "more"

Less can be worth more than more when "less" is received before the "more" and it can be put to work and grow so it is worth more than the "more" when the more is received.

Consider receiving $1,000 now versus receiving $1,050 one year from now.

Which is better? Assuming you aren't starving and need to spend the money immediately to stay alive, which is better depends on what you could earn if you put the $1,000 to work, say in a bank that pays 4% interest.
At 4% you would have $1,040 a year from now, but that wouldn't be as good as the $1,050.

So which is better depends on what you could earn.

Time is not the only factor that needs to be considered.

For example, you want to invest $1,000 for two years - you can invest it for one year and renew it or invest it for the whole two years. The one year rate is 5% and the two year rate is 6% per year. Which is better?

Which is better depends on what the one-year rate will be one year from now. If it is 8%, you would be better off investing for one year and then renewing: \( \frac{5\%+8\%}{2} = 6.5\% \) per year. If the rate would be 6% one year from now, you would be better off investing for the whole two years now: \( \frac{5\%+6\%}{2} = 5.5\% \) per year. Since you don't know for sure what the one-year rate will be one year from now, your choice involves risk - the chance the one-year rate one year from now will be different from what you expect, possibly leading to your having made the wrong choice.

**WHAT DEFINES FINANCE?**

* Time Value of Money
* Risk

As in the examples, what is best for you when making a financial decision depends on what you can earn by putting your money to work elsewhere (time value of money) and whether the future might change and cause your choice to turn our to be a bad one - because what you thought would happen, didn't.
TO ACHIEVE FINANCE OBJECTIVE

FINANCE FUNCTIONS (DECISIONS)

Investment Decision - determining what assets the firm should own?
Financing Decision - deciding how firm should pay for assets (debt or equity)?
Dividend Decision - deciding whether to distribute income to owners or reinvest in firm?

HOW TO MAKE DECISIONS

1) Determine how decision will change cash flows of the firm
2) Adjust change in cash flows for the time value of money
3) Evaluate the change in cash flows for risk

FORMS OF BUSINESS

Proprietorship - Individual
Partnership
Corporation - Limited liability, ability to raise money