

FN 201 Business Finance

Lecture Note 1

Introduction to corporate finance
and financial statements

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Bachelor of Economics, International Program

Thammasat University

Introduction to course

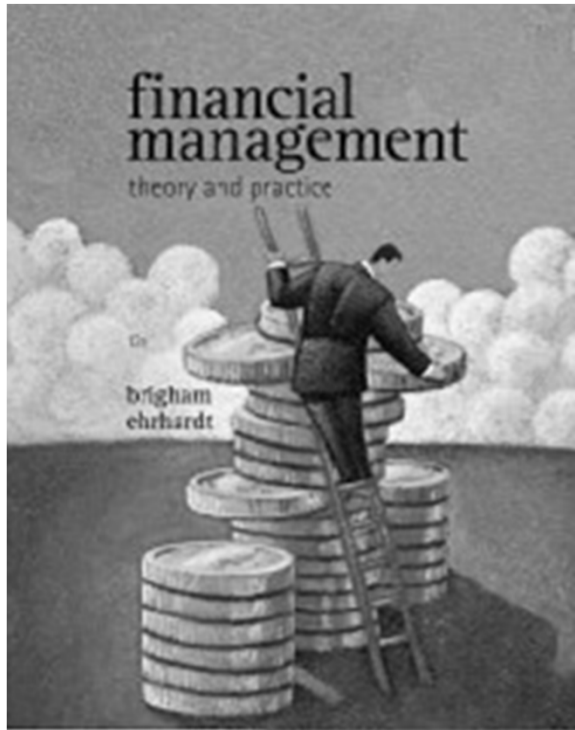
Introduction to course

COURSE REQUIREMENTS AND MATERIALS

The following books and lecture notes will be used as a class material:

1. ***BE:** Brigham and Ehrhardt, Financial Management, 12th Edition
2. **BMA:** Brealey, Myers, and Allen, Principles of Corporate Finance, 10th Edition
3. Gitman, L.J., Zutter, C.J., Principles of Managerial Finance, 13th Edition
4. Ross, S.A., Westerfield, R.W., Jordan, B.D., (2012). Fundamentals of Corporate Finance. 10th Edition. New York: McGraw-Hill/Irwin.
5. Class handouts and other materials

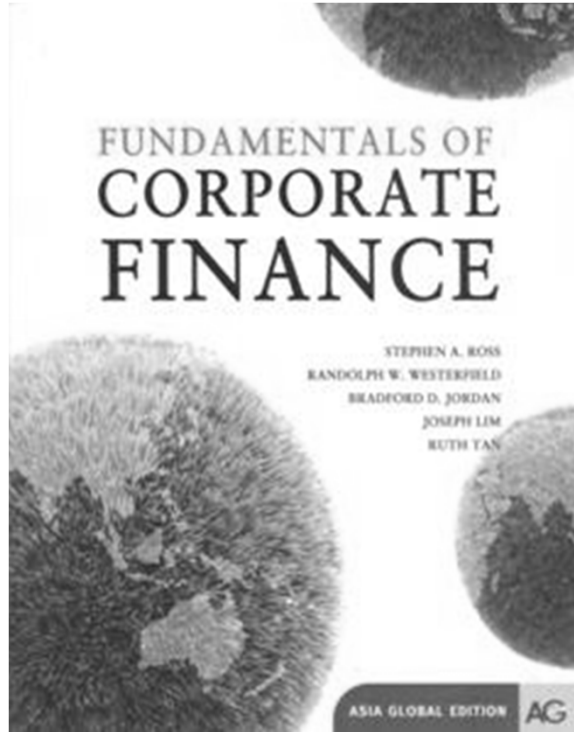
Note: * refer to main textbook to be used for this course.



financial
management

theory and practice

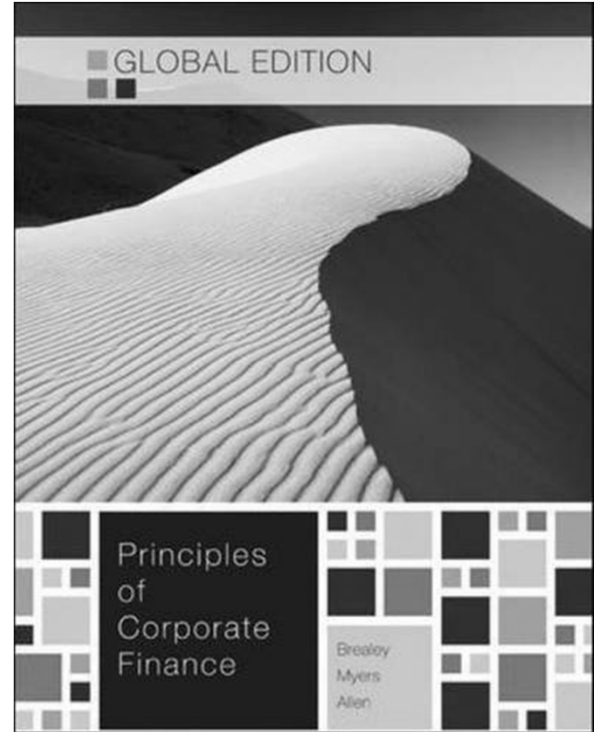
by
brigham
ehrhart



FUNDAMENTALS OF
CORPORATE
FINANCE

STEPHEN A. ROSS
RANDOLPH W. WESTERFIELD
BRADFORD D. JORDAN
JOSEPH LIM
RUTH TAN

ASIA GLOBAL EDITION AG



GLOBAL EDITION

Principles
of
Corporate
Finance

Brealey
Myers
Allen

Course Assessment

- Class participation 10%
- Assignment and/or quiz 20%
- Midterm exam 30%
- Final exam 40%

Midterm Exam

March 7, 2015 (12.30 – 2.00 PM)

Final Exam

May 16, 2015 (09.00 AM - noon)

Lecture Note 1 Outline

Part 1: Basic concepts of corporate

Financial decision and opportunity cost concept

- Legal Forms of Business Organization
- Goals of firm and agency problem
- Role of Financial Manager

Part 2: Basic concepts of financial statements

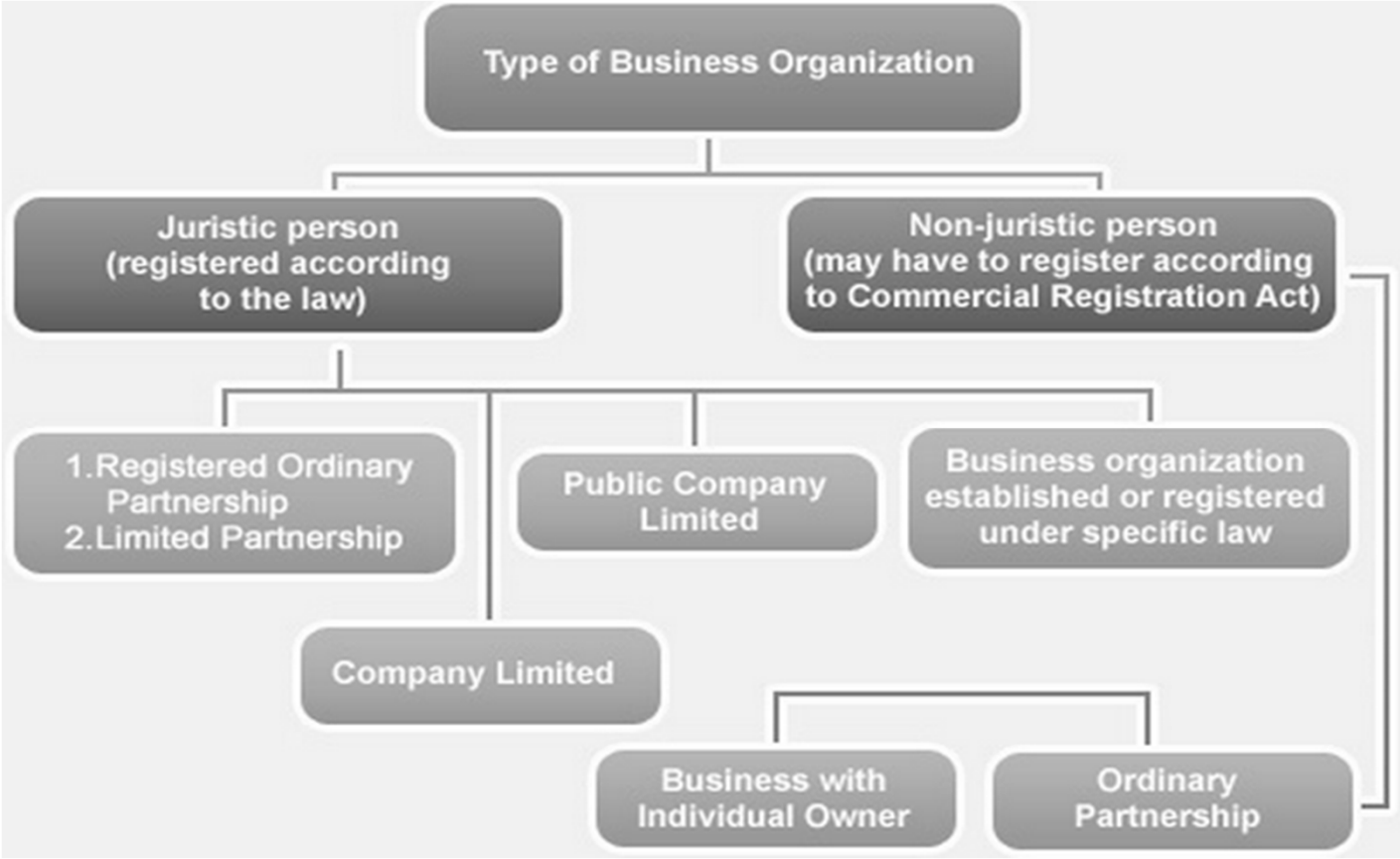
- Accounting cycle
- Financial statements and its components

Part 1:
Basic concepts of corporate

Overview of Financial Management

- Contributions of financial management
 - Firm's operating performance and growth
 - Consumers
 - Staffs and creditors
 - Community and society
- Financial management in other sector
 - Individual person – personal finance
 - Government sector – public finance
 - Private sector – corporate finance
 - International – international finance
 - Financial institution

Legal Forms of Business Organization



Source: Department of Business Development, Ministry of Commerce

Legal Forms of Business Organization

Sole Proprietorships

Partnerships

Corporations

Legal Forms of Business Organization

TABLE 1.1 Strengths and Weaknesses of the Common Legal Forms of Business Organization			
	Sole proprietorship	Partnership	Corporation
Strengths	<ul style="list-style-type: none"> • Owner receives all profits (and sustains all losses) • Low organizational costs • Income included and taxed on proprietor's personal tax return • Independence • Secrecy • Ease of dissolution 	<ul style="list-style-type: none"> • Can raise more funds than sole proprietorships • Borrowing power enhanced by more owners • More available brain power and managerial skill • Income included and taxed on partner's tax return 	<ul style="list-style-type: none"> • Owners have <i>limited liability</i>, which guarantees that they cannot lose more than they invested • Can achieve large size via sale of stock • Ownership (stock) is readily transferable • Long life of firm • Can hire professional managers • Has better access to financing • Receives certain tax advantages
Weaknesses	<ul style="list-style-type: none"> • Owner has <i>unlimited liability</i>—total wealth can be taken to satisfy debts • Limited fund-raising power tends to inhibit growth • Proprietor must be jack-of-all-trades • Difficult to give employees long-run career opportunities • Lacks continuity when proprietor dies 	<ul style="list-style-type: none"> • Owners have <i>unlimited liability</i> and may have to cover debts of other partners • Partnership is dissolved when a partner dies • Difficult to liquidate or transfer partnership 	<ul style="list-style-type: none"> • Taxes generally higher, because corporate income is taxed, and dividends paid to owners are also taxed • More expensive to organize than other business forms • Subject to greater government regulation • Lacks secrecy, because stockholders must receive financial reports

Source: Gitman and Zutter (2011)

Goals of Firm

1. Shareholder wealth maximization
 - maximizing the price of firm's common stocks
2. Profit maximization
3. Managerial reward maximization
4. Behavioral goals – i.e. social responsibility
 - consumers
 - community
 - firm's staff
 - creditor
 - government and social

Goals of Firm

Shareholder wealth vs. Profit maximization

Goal	Objective	Advantage	Disadvantage
Profit maximization	Large amount of profits	<ol style="list-style-type: none">1. Easy to calculate profits2. Easy to determine the link between financial decisions and profits	<ol style="list-style-type: none">1. Emphasizes the short term2. Ignores risk or uncertainty3. Ignores the timing of returns4. Requires immediate resources
Shareholder wealth maximization	Highest market value of common stock	<ol style="list-style-type: none">1. Emphasizes the long term2. Recognizes risk or uncertainty3. Recognizes the timing of returns4. Considers stockholders' return	<ol style="list-style-type: none">1. Offers no clear relationship between financial decisions and stock price2. Can lead to management anxiety and frustration3. Can promote aggressive and creative accounting practices

Source: Shim and Siegel (2007)

Investment: Equity vs. Debt

Debt financing advantage

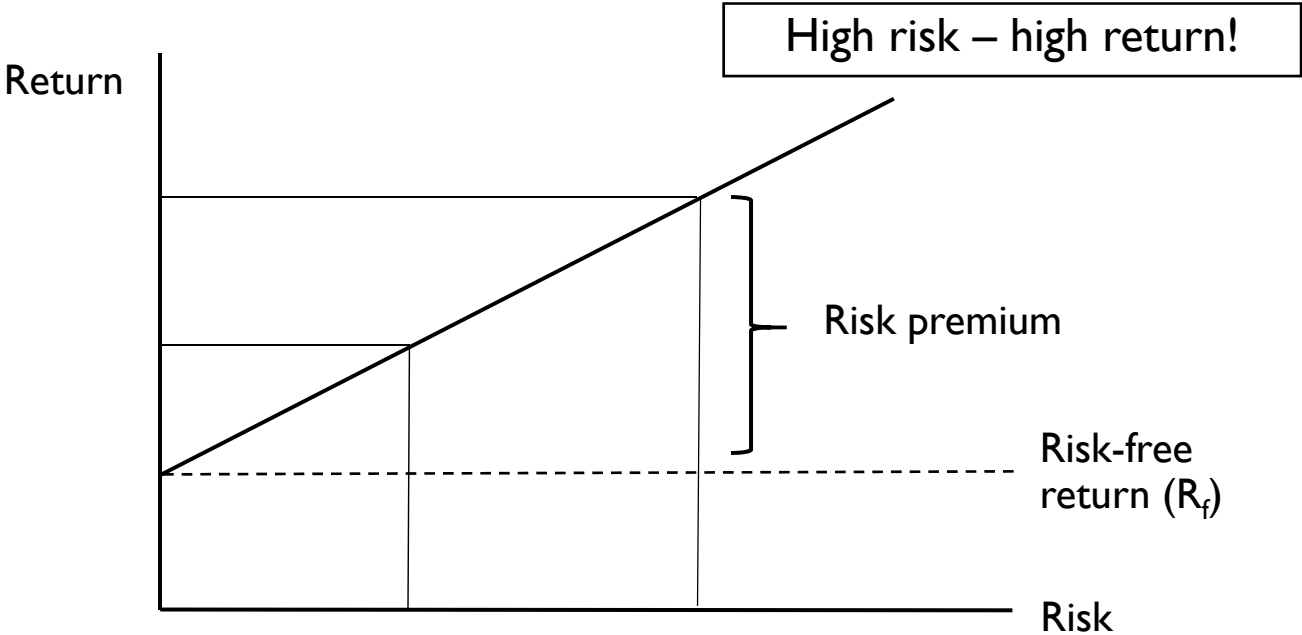
Investment: Debt Advantage

Rationale

Items	Case 1	Case 2	Case 3	Case 4
(1) Project return	150	150	150	150
(2) Debt	0	40	60	90
(3) Equity	100	60	40	10
(4) Cost of debt: 10%	0	4	6	9
(5) Net project return: NPR = (1) - (2) - (4)				
(6) Return to Equity: ROE = (5) / (3)				

Risk-Return Tradeoff

The relationship between risk and return



$$\begin{aligned} \text{Required rate of return} &= \text{Risk-free return} + \text{Risk premium} \\ &= R_f + \text{Risk premium} \end{aligned}$$

Managerial measures of shareholder's wealth

1. Market value of equity or common stock (MV)
2. Market value added (MVA)
3. Economic value added (EVA)

Note: Capital with costs! Cost of all financing includes (+) Note payable, long-term debt, and equity but not marketable security.

Managerial measures of shareholder's wealth

Note for Economic Value Added (EVA)

$$\begin{aligned} \text{EVA} &= \text{EBIT} (1 - \text{Tax Rate}) - \text{Cost of all financing} \\ &= \text{Net Income} + \text{Interest} (1 - \text{Tax Rate}) - (\text{Cost of Capital} \times \text{Capital}) \end{aligned}$$

What are the roles of financial manager?

Role of Financial Manager

Investment Decision

Financing Decision

Current Assets

- Cash
- Short-term investments
- Account receivable
- Inventory

Fixed Assets

- Plant and office equipment
- Machine
- Land

Current Liabilities

- Account payable
- Accrued expense
- Short-term debt

Long-term debt

- Long-term loan
- Long-term bond

Equity

- Capital stock
- Retained earning

Balance Sheet

Role of Financial Manager

Liquidity Management

Current Assets

- Cash
- Short-term investments
- Account receivable
- Inventory

Fixed Assets

- Plant and office equipment
- Machine
- Land

Current Liabilities

- Account payable
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Long-term debt

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Equity

- Capital stock
- Retained earning

Role of Financial Manager

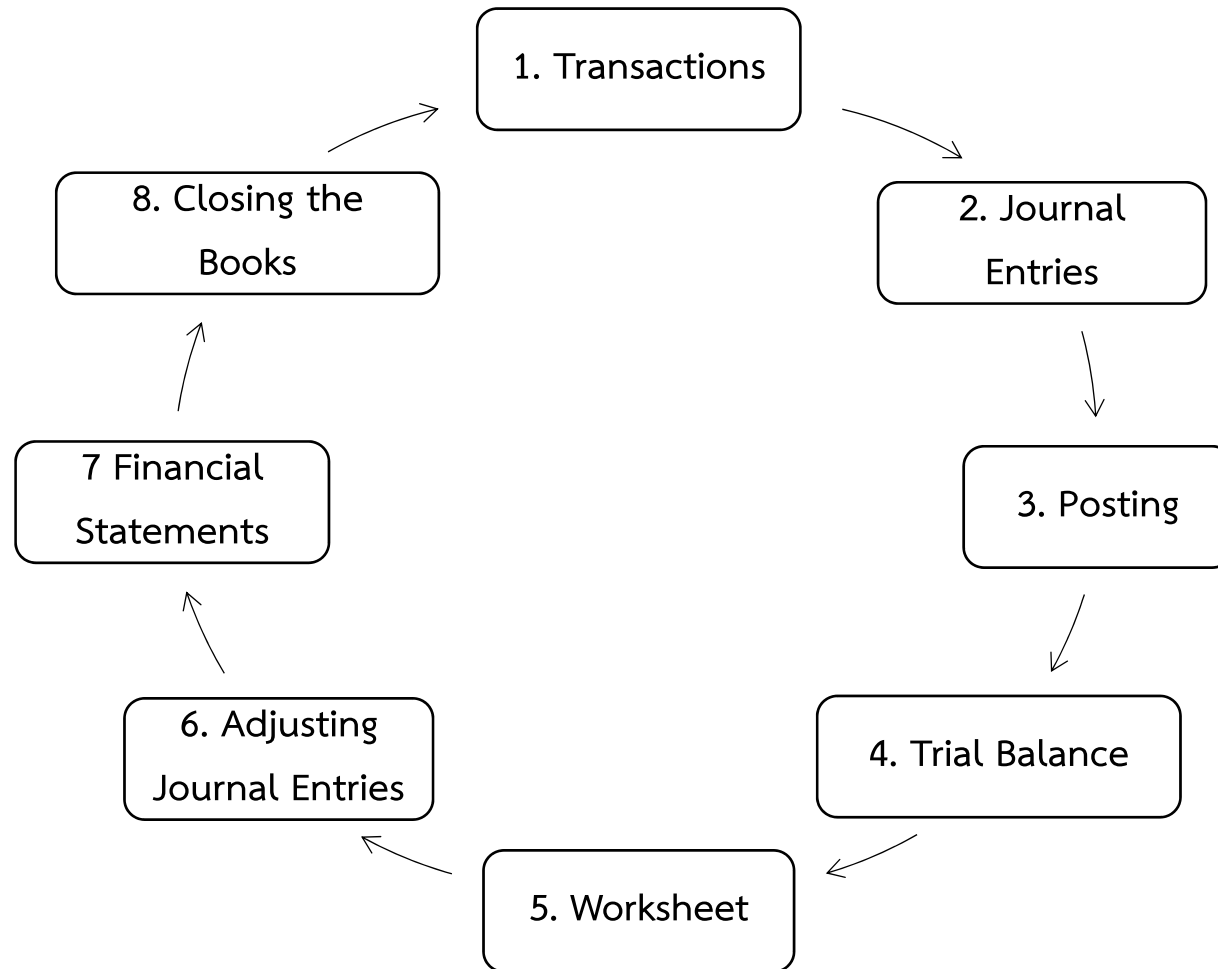
Current Assets <ul style="list-style-type: none">- Cash- Short-term investments- Account receivable- Inventory	Current Liabilities <ul style="list-style-type: none">- Account payable- Accrued expense- Short-term debt
Fixed Assets <ul style="list-style-type: none">- Plant and office equipment- Machine- Land	Long-term debt <ul style="list-style-type: none">- Long-term loan- Long-term bond Equity <ul style="list-style-type: none">- Capital stock- Retained earning

Growth Management

Part 2:

Basic concepts of financial statements

Accounting Cycle



Primary Financial Statements

Records that outline the financial activities of a business, an individual or any other entity.

Primary financial statements answer basic questions including:

- What is the company's current financial status?
- What was the company's operating results for the period?
- How did the company obtain and use cash during the period?

Financial Statements

1. Balance sheet
2. Income statement
3. Statement of retained earnings /
Statement of changes in owner equity
4. Statement of cash flow

* Notes to the Financial Statements

1. Balance Sheet

Summary of the financial position of a company at a particular date

- What are the resources of the company?
- What are the company's existing obligations?
- What are the company's net assets?

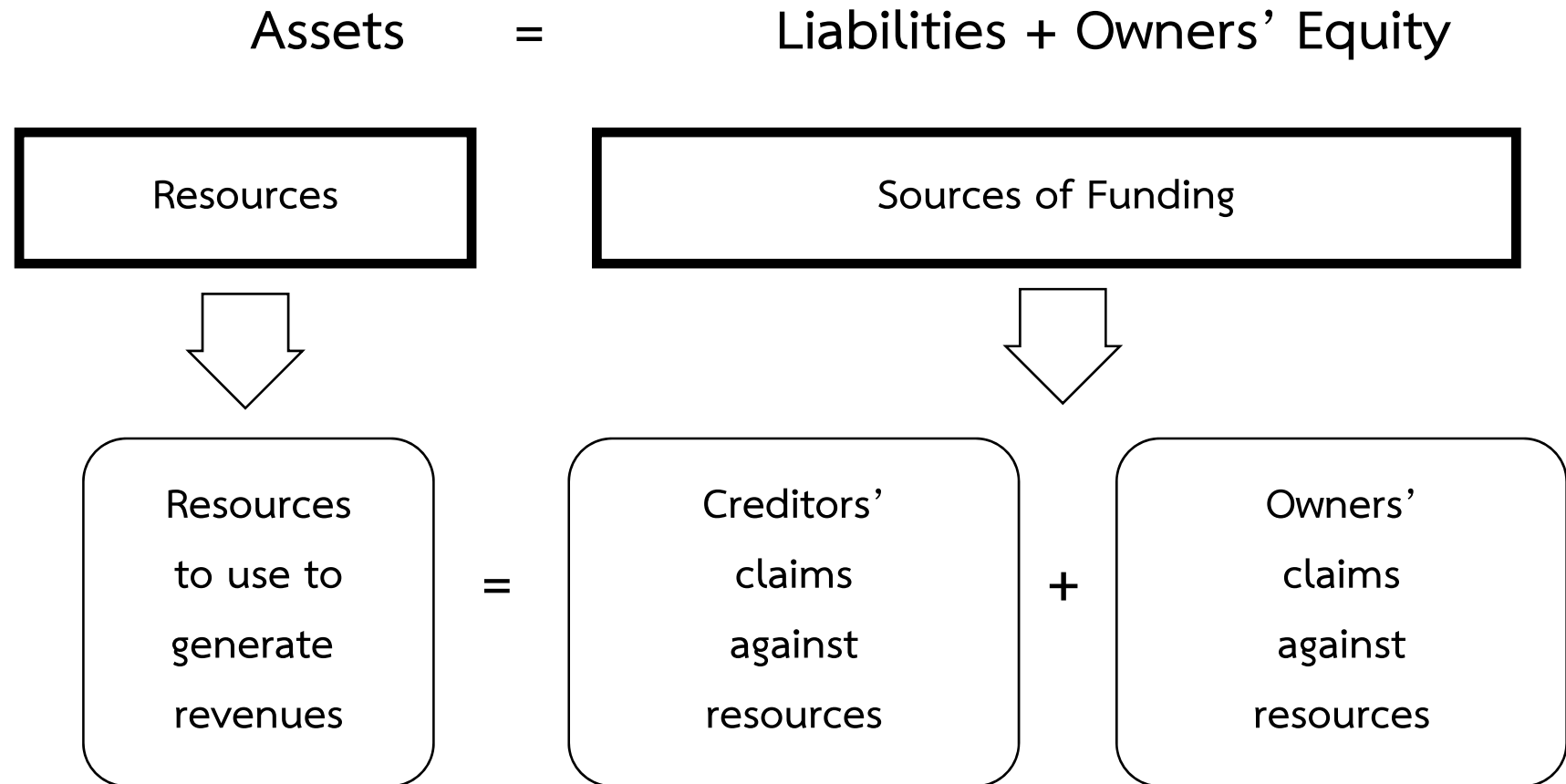
Balance Sheet and Its Components

- Assets: cash, accounts receivable, inventory, land, buildings, equipment and intangible items
- Liabilities: accounts payable, notes payable and mortgages payable
- Owners' Equity: net assets after all obligations have been satisfied

1. Balance Sheet: Its components

<p>Current Assets</p> <ul style="list-style-type: none">- Cash- Short-term investments- Account receivable- Inventory <p>Non-current / Fixed Assets</p> <ul style="list-style-type: none">- Plant and office equipment- Machine- Land	<p>Current Liabilities</p> <ul style="list-style-type: none">- Account payable- Accrued expense- Short-term debt <p>Non-current / Long-term Liabilities</p> <ul style="list-style-type: none">- Long-term loan- Long-term bond <p>Equity</p> <ul style="list-style-type: none">- Capital stock- Retained earning
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1. Balance Sheet: Accounting Equation



1. Balance Sheet: Its Components

Executive Paper Balance Sheet (millions)

	Dec 2004	Dec 2005	diff
<i>Assets</i>			
Current Assets			
Cash & Securities	75	110	35
Receivables	433.1	440	6.9
Inventory	339.9	350	10.1
Total	848	900	52
Fixed Assets			
P, P, E	929.5	1000	70.5
accum Depr	396.7	450	53.3
Net Fixed Assets	532.8	550	17.2
<i>Total Assets</i>	1,380.80	1,450.00	69.2

1. Balance Sheet: Its Components

Executive Paper Balance Sheet (millions)

	Dec 2004	Dec 2005	diff
<i>Liabilities and Equity</i>			
Current Liabilities			
Debt due in 1 year	96.6	100.0	3.4
Payable	349.9	360.0	10.1
Total current liabilities	446.5	460.0	13.5
Long term debt	425.0	450.0	25.0
Shareholders equity	509.3	540.0	30.7
<i>Total liabilities and equity</i>	<u>1,380.80</u>	<u>1,450.00</u>	<u>69.2</u>

1. Balance Sheet: Its Components

<u>Executive Paper - Other Data</u>	2004	2005
Market value of equity	598	708
Average number of shares, millions	14.16	14.16
Share price, dollars	42.25	50

1. Balance Sheet: Special Issues

Classified and Comparative Balance Sheets

- They distinguish between:
 - Current and long-term assets
 - Current and long-term liabilities
- Listed in decreasing order of liquidity

Limitations

- Assets recorded at historical value
- Only recognizes assets that can be expressed in monetary terms
- Owners' equity is usually less than the company's market value

2. Income Statement

- Shows the results of a company's operations over a period of time.
- What goods were sold or services performed that provided revenue for the company?
- What costs were incurred in normal operations to generate these revenues?
- What are the earnings or company profit?

2. Income Statement

Revenues

- Assets (cash or AR) created through business operations

Expenses

- Assets (cash or AP) consumed through business operations

Net Income or (Net Loss)

- Revenues - Expenses

2. Income Statement: Its Components

Sale Revenue

(-) Cost of goods sold

Gross profit

operating expenses

- Salary

- General expenses

- Other operating expenses

(-) Total operating expenses

Earning before interest, taxes, and depreciation (EBITDA)

(-) Depreciation and amortization

Earning before interest and taxes (EBIT) = operating income

(-) Interest expense

Earning before taxes (EBT)

(-) Income Taxes

Net income

2. Income Statement: Example

Sales	\$25,265.00
<u>Costs of Goods Sold</u>	<u>-\$19,891.00</u>
Gross Profit	\$5,374.00
<u>Cash operating expense</u>	<u>-\$2,761.00</u>
EBITDA	2,613.00
Depreciation & Amortization	-\$156.00
<u>Net other Income and Expense (+/-)</u>	<u>-\$6.00</u>
EBIT	\$2,451.00
<u>Interest</u>	<u>-\$0.00</u>
EBT	\$2,451.00
Income Taxes	-\$785.00
<u>Special Income/Charges (+/-)</u>	<u>-\$194.00</u>
<u>Net Income (EAT)</u>	<u>\$1,666.00</u>

3. Statement of Retained Earnings

= an additional financial statement that identifies changes in retained earnings from one accounting period to the next.

= to measure changes in owner's equity from the beginning of period to the end of period

Reporting:

1. As a separate statement
2. Shown in a Statement of Comprehensive Income

3. Statement of Retained Earnings

Beginning retained earnings

+ Net income

- Dividends paid

= Ending retained earnings

4. Statement of Cash Flows

- Reports the amount of cash collected and paid out by a company in operating, investing and financing activities for a period of time.
- How did the company receive cash?
- How did the company use its cash?
- Complementary to the income statement.
- Indicates ability of a company to generate income in the future.

4. Statement of Cash Flows: Background

- Accounting profit vs. Cash Flows
 - Accrual Method

Sale

- As CASH
- As CREDIT => Account Receivable

Cost of goods sold

- Paid as CASH
- Paid as CREDIT => Account Payable
- Stock => Inventory

Operating expense

- Paid as CASH
- Unpaid items => Accrual expenses
- Non-cash items => Depreciation

4. Statement of Cash Flows: Background

- Accounting profit vs. Cash Flows
 - Accrual Method

CASH INFLOW VS. CASH OUTFLOW

- **Operating activities** – Transactions and events that enter into the determination of net income.
- **Investing activities** – Transactions and events that involve the purchase and sale of securities, property, plant, equipment, and other assets not generally held for resale, and the making and collecting of loans.
- **Financing activities** – Transactions and events whereby resources are obtained from, or repaid to, owners and creditors.

4. Statement of Cash Flows: Classification of Cash Flow

	Operating activities	Investing activities	Financing activities
Cash Inflow	<ul style="list-style-type: none"> • Sale of goods or services • Sale of investments in trading securities • Interest revenue* • Dividend revenue* 	<ul style="list-style-type: none"> • Sale of plant assets • Sale of securities, other than trading securities • Collection of principal on loans* 	<ul style="list-style-type: none"> • Issuance of own stock • Borrowing
Cash Outflow	<ul style="list-style-type: none"> • Inventory payments • Interest payments* • Wages • Utilities, rent • Taxes 	<ul style="list-style-type: none"> • Purchase of plant assets • Purchase of securities, other than trading securities • Making of loans to other entities* 	<ul style="list-style-type: none"> • Dividend payments* • Repaying principal on borrowing • Treasury stock purchase*

4. Statement of Cash Flows: Calculation – (1)

Operating Cash Flow Calculation

1. Income Statement

Operating cash flow = Net Income + Depreciation and Amortization

2. Balance Sheet – changes in current assets (CA) and liabilities (CL)

Changes in CA and CL	Source of Inflow	Source of Outflow
1. Account Receivable		
2. Inventory		
3. Account Payable		
4. Accrual Expense		

Note: (1) Retained earning

(2) High value of fixed Assets

4. Statement of Cash Flows: Calculation – (2)

Note for “Changes in Fixed Assets” calculation

That is:

$$\begin{aligned} \text{Net Change in Fixed Assets or CapEx (Capital Expenditures)} \\ = (\text{EndCap} - \text{BeginCap}) + \text{Depreciation} \end{aligned}$$

Note: CapEx = (EndCap – BeginCap) + Depreciation
Gross Investment = Net Investment + Depreciation

4. Statement of Cash Flows: Calculation – (3)

2. Put the items into the activities in statement of cash flows and compute net cash flow

- Operating cash flow

- Investing cash flow

- Financing cash flow

4. Statement of Cash Flows: Analysis

Cash flows	Period A	Period B	Period C	Period D
Operating	(300)	700	2000	800
Investing	(1500)	(1000)	(800)	(200)
Financing	<u>2000</u>	<u>200</u>	<u>(700)</u>	<u>(300)</u>
Net Cash Flows	200	(100)	500	300

**Statement of
Cash Flow**

Cash--Op. Act.	\$ 973,000
Cash--Inv. Act.	(1,188,000)
Cash--Fin. Act.	<u>245,000</u>
Net increase	<u>\$ 30,000</u>
Beg. cash	<u>80,000</u>
End. cash	<u>\$ 110,000</u>

**Balance
Sheet 12/31/11**

Balance Sheet 12/31/10

Cash	\$ 80,000
Other	<u>4,550,000</u>
Total	<u>\$4,630,000</u>
Liabilities	\$2,970,000
Cap. stock	900,000
R/E	<u>760,000</u>
Total	<u>\$4,630,000</u>

Income Statement

Revenues	\$12,443,000
Expenses	<u>11,578,400</u>
Net income	\$ 864,600

Retained Earning

R/E 12/31/10	\$ 760,000
Net income	864,600
Dividends	<u>(400,000)</u>
R/E 12/31/11	\$1,224,600

Cash	\$ 110,000
Other	<u>4,975,000</u>
Total	\$5,085,000

Liabilities	\$2,860,400
Cap. stock	1,000,000
R/E	<u>1,224,600</u>
Total	\$5,085,000

5. Notes to the Financial Statements

Four general types of notes:

1. Summary of significant accounting policies: assumptions and estimates.
2. Supplementary information required by the FASB or the SEC.
3. Additional information about the summary totals.
4. Disclosure of important information that is not recognized in the financial statements.

Question?