

SBMA7100 Financial Management

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Module 1

Introduction of Corporate Finance

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Learning Outcome

- Research, apply and critically evaluate/discuss
 - Financial assessment techniques used to report upon **a business's financial performance**, identifying potential **areas** for further investigation which may **improve** its financial positions
 - Various techniques used in the management and control of **financial resources**

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Key Concepts and Skills

- Understand the basic types of financial management decisions and **the role of the Financial Manager**
- Know the financial implications of the various **forms of business organization**
- Know the **goal** of financial management
- Identify the **conflicts of interest** that can arise between owners and managers
- Recognize the various **regulations** that firms face

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Module Outline

1. What is Corporate Finance?
- 2 The Corporate Firm
- 3 The Importance of Cash Flows
- 4 The Goal of Financial Management
- 5 Agency Problem & Control of the Corporation Regulation

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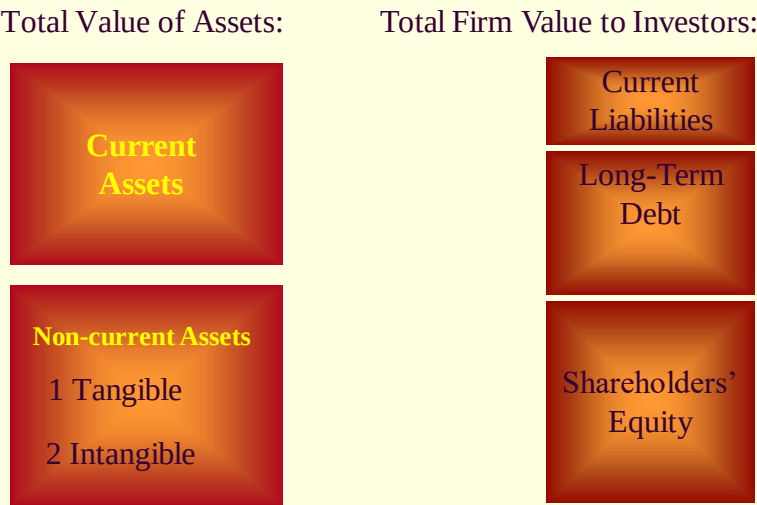
1. What Is Corporate Finance?

Corporate Finance addresses the following three questions:

1. What **long-term investments** should the firm choose?
2. How should the firm **raise funds** for the selected investments?
3. How should **short-term assets** be managed and financed?

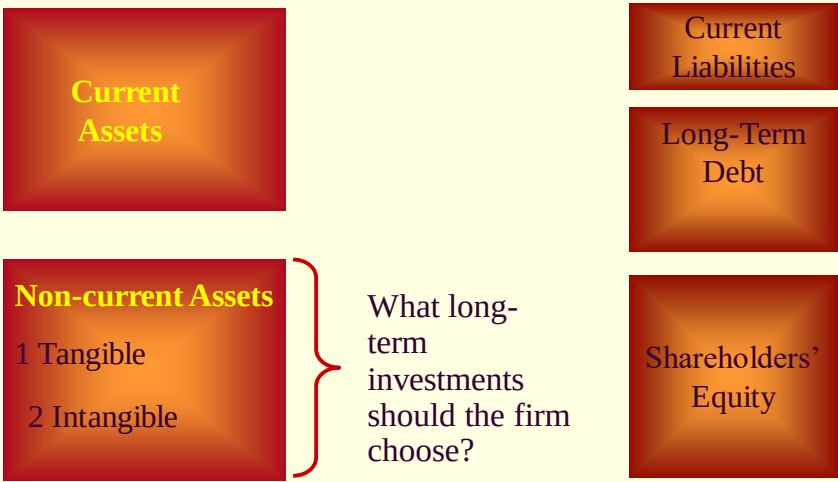
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Balance Sheet Model of the Firm



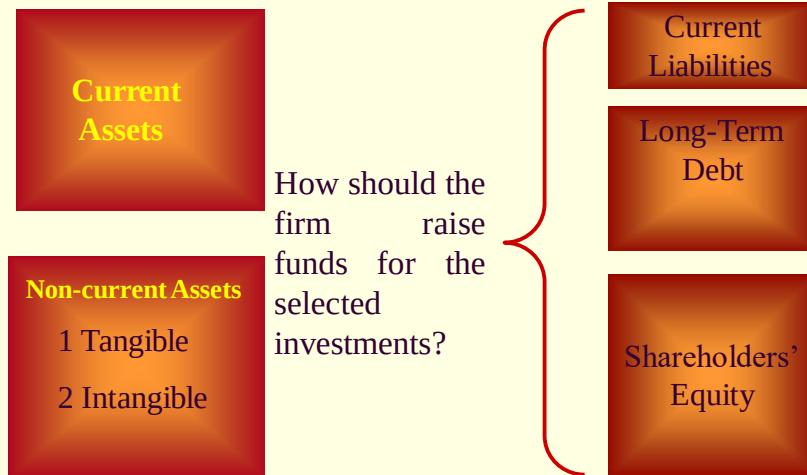
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The Capital Budgeting Decision



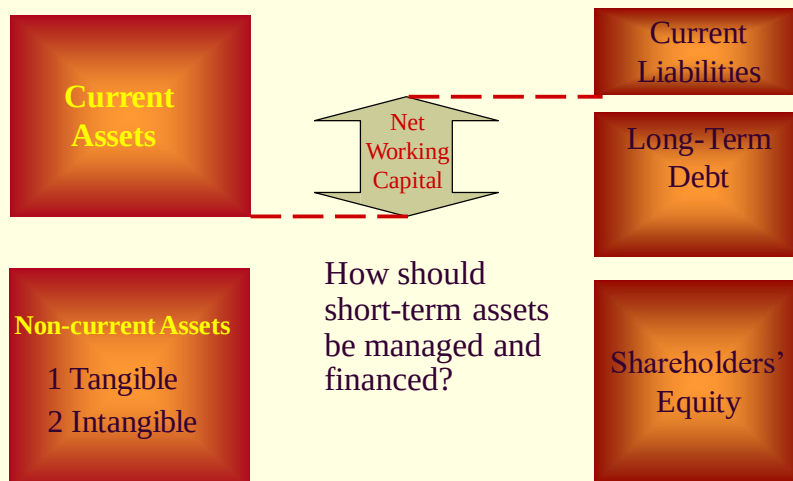
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The Capital Structure Decision



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Short-Term Asset Management



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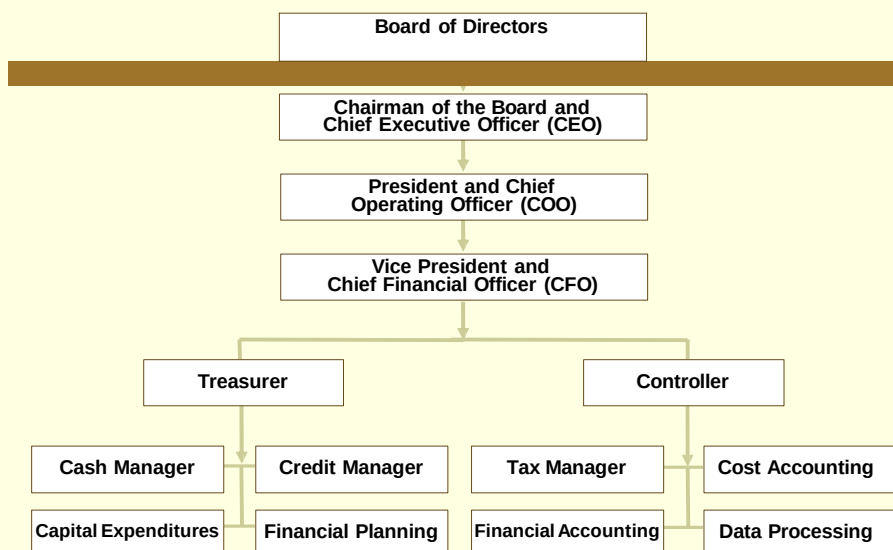
The Financial Manager

The Financial Manager's primary goal is to **increase the value of the firm** by:

1. Selecting **value** creating projects
2. Making **smart** financing decisions

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Hypothetical Organization Chart



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2 The Corporate Firm

- The corporate form of business is the standard method for solving the problems encountered in raising large amounts of cash.
- However, businesses can take other forms.

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Forms of Business Organization

Sole Proprietorship

Partnership

Corporation



- General (Unlimited)
- Limited



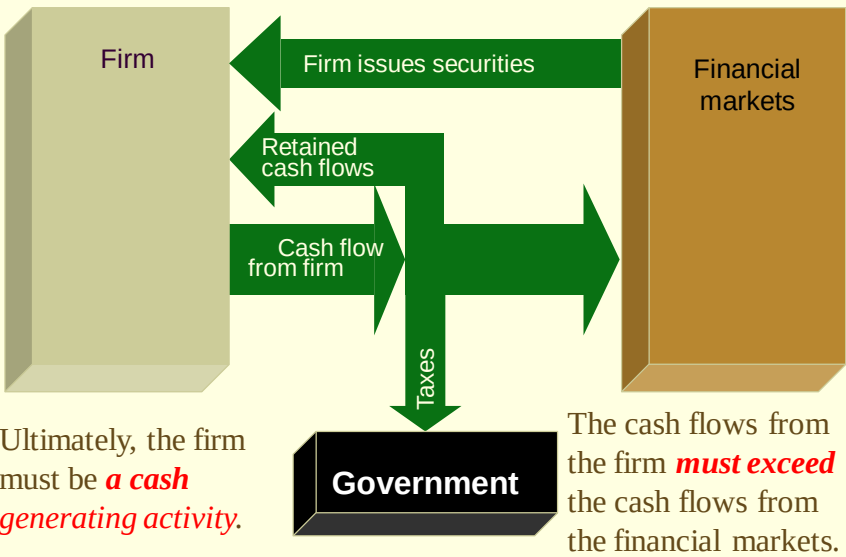
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A Comparison

	Corporation	Partnership
Liquidity	Shares can be easily <u>exchanged</u>	Subject to substantial <u>restrictions</u>
Voting Rights	Usually each share gets one vote	General Partner is in charge; limited partners may have some voting rights
Taxation	Double	Partners pay taxes on distributions
Reinvestment and dividend payout	Broad	All net cash flow is distributed to <u>partners</u>
Liability	Limited liability	General partners may have unlimited liability; limited partners enjoy limited liability
Continuity	Perpetual life	Limited life

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3 The Importance of Cash Flow



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4 The Goal of Financial Management

- What is the correct goal?
 - Maximize profit?
 - Minimize costs?
 - Maximize market share?
 - **Maximize shareholder wealth?**

What are other non-finance goals ?

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5 The Agency Problem

- Agency relationship
 - Principal **hires** an agent to represent his/her interest
 - **Stockholders** (principals) hire **managers** (agents) to run the company
- Agency problem
 - **Conflict of interest** between principal and agent

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Managerial Goals

- Managerial goals may be **different** from shareholder goals
 - Expensive bonus
 - Survival
 - Independence
- Increased **growth and size** are not necessarily equivalent to increase **shareholder wealth**



Management vs Shareholders

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Managing Managers

- Managerial compensation
 - **Incentives** can be used to align management and stockholder interests
 - The incentives need to be structured carefully to make sure that they **achieve** their intended goal
- Corporate control
 - The threat of a **takeover** may result in better management
- Other stakeholders

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5. Corporation Regulations

Generally Accepted Accounting Principles (GAAP)

Financial accounting practice is governed by concepts and rules known as generally accepted accounting principles (GAAP).

Relevant Information

Affects the decision of its users.

Reliable Information

Is trusted by users.

Comparable
Information

Is helpful in contrasting organizations.

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Setting Accounting Principles

Financial Accounting Standards Board is the private group that sets both broad and specific principles.



The Securities and Exchange Commission is the government group that establishes reporting requirements for companies that issue stock to the public.

The International Accounting Standards Board (IASB) issues International Financial Reporting Standards that identify preferred accounting practices to create harmony among accounting practices of different countries.

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International Standards



The International Accounting Standards Board (IASB), an **independent group** (consisting of 16 individuals from many countries), issues International Financial Reporting Standards (IFRS) that identify preferred accounting



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Module 2

Financial Statements and Cash Flow

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Key Concepts and Skills

- Understand the information provided by financial statements
- Differentiate between book and market values
- Know the difference between accounting income and cash flow
- Calculate a firm's cash flow

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Chapter Outline

- 1 The Balance Sheet/Statement of Financial Position
- 2 The Income Statement /
Statement of Comprehensive Income
- 3 Net Working Capital
- 4 Financial Cash Flow
- 5 The Accounting Statement of Cash Flows
- 6 Cash Flow Management

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1 The Balance Sheet

- An accountant's snapshot of the firm's accounting value at a specific point in time
- The Balance Sheet Identity is:

$$\text{Assets} \equiv \text{Liabilities} + \text{Stockholder's Equity}$$

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1 The Balance Sheet (Content)

The Balance Sheet Identity is:

Assets	$\equiv$	Liabilities	+	Stockholder's Equity
--------	----------	-------------	---	----------------------

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Balance Sheet Analysis

- When analyzing a balance sheet, the Finance Manager should be aware of three concerns:
 1. Liquidity
 2. Debt versus Equity
 3. Value versus Cost

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Liquidity

- Refers to the ease and quickness with which assets can be **converted to cash**—without a significant loss in value
- Current assets are **the most liquid**.
- Some fixed assets are **intangible**.
- The **more liquid** a firm's assets, the less likely the firm is to experience **problems** meeting short-term obligations.
- Liquid assets frequently have lower rates of return than fixed assets.

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Debt versus Equity

- **Creditors** generally receive the first claim on the firm's cash flow.
- Shareholder's equity is the residual difference between assets and liabilities.
- $\text{Assets} - \text{Liabilities} \equiv \text{Stockholder's Equity}$

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Value versus Cost

- Under Generally Accepted Accounting Principles (GAAP), **audited financial statements of firms** carry assets at cost.
- Market value is the price at which the assets, liabilities, and equity could actually be bought or sold, which is a completely different concept from **historical cost**.

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$$\text{Assets} \equiv \text{Liabilities} + \text{Stockholder's Equity}$$



Assets: The business owner or the control of valuable resources

Eg: Cash, office buildings, plant, equipment, the sale of inventory items, raw materials

Liabilities: for others' money in arrears

Eg: Bank Loan, Bank Overdraft, the supply of the goods, due to the Government's tax

Equities: Owner of the shares

Eg: Common Stock, Retained Earnings

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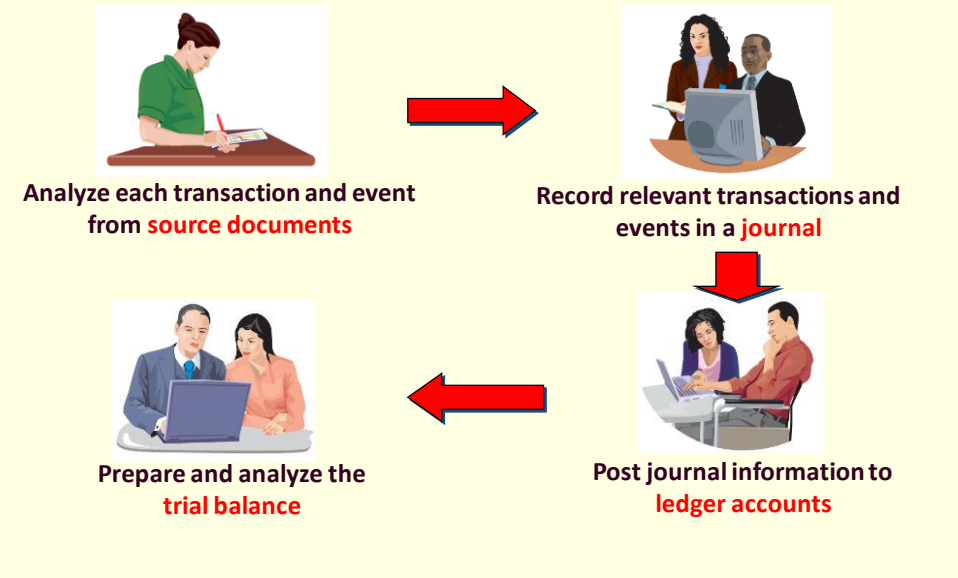
Accounting – Transactions

- Sources of transactions
- **Recognize** the transactions and **post** into the account

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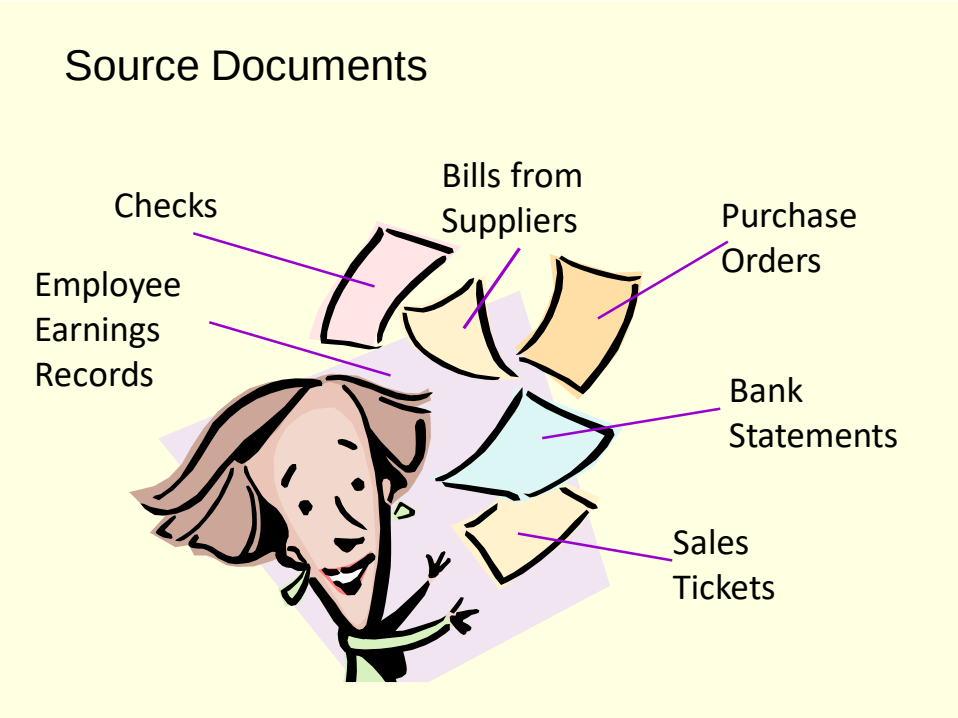
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Analyzing and Recording Process



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Source Documents



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Summary – Double Entry

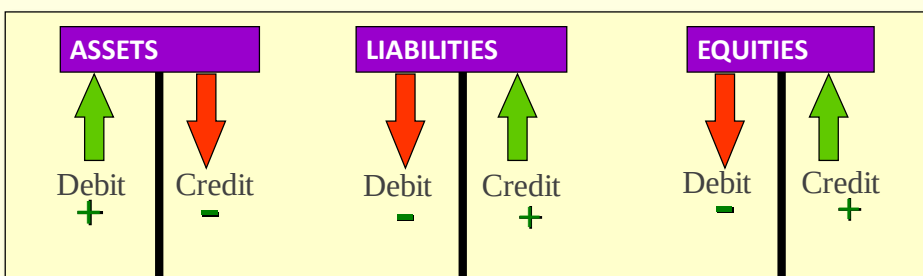
- Balance Sheet: Asset = Liabilities + Equity.
- Every transactions will required **2 and more entries** to full balance the account. Moreover, it reflects the total value of the transaction and flow of the transaction

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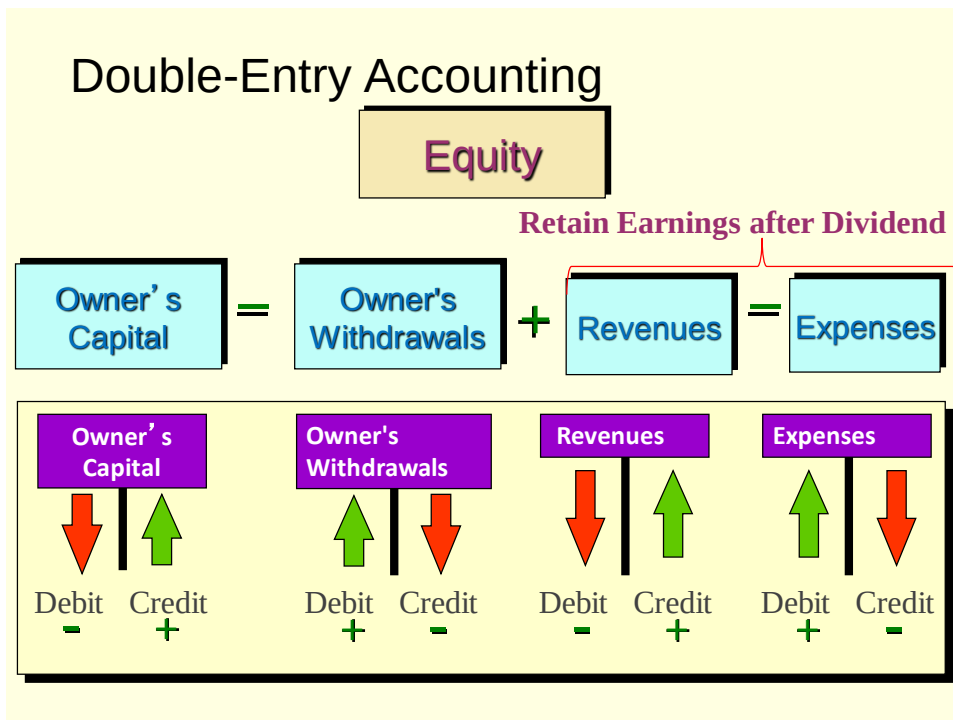
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Double-Entry Accounting

$$\boxed{\text{Assets}} = \boxed{\text{Liabilities}} + \boxed{\text{Equity}}$$



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Introduction – by Example

SMART – Construction Consultant Co. Ltd

Balance Account (Dual “double” entry)
– for all the transactions

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Original Investment

SMART invests \$50,000 to SMART Ltd - common share

Account books :

(1) Cash (Asset)

(2) Equity (Equity)



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Original Investment

SMART - \$50,000 invest as common share

Asset			=	Liability		+	Equity
CASH	Off Use	Equipt		A P	Long Debt		Equity
(1) \$ 50,000							\$ 50,000
\$ 50,000	\$ -	\$ -		\$ -	\$ -		\$ 50,000
\$ 50,000			=	\$ 50,000			



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Purchase

Buy “goods” and pay \$4,800 cash

Account :

(1) Cash (asset) 

(2) Inventory (asset) 

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Purchase

Buy “goods” and pay \$4,800 cash

Asset				=	Liability		+	Equity
	cash	off use	equipt		AR	L. Debt		Equity
(1)	\$ 50,000							\$ 50,000
(2)	(4,800)	\$ 4,800						
								
	\$ 45,200	\$ 4,800	\$ -		\$ -	\$ -		\$ 50,000
	\$ 50,000			=	\$ 50,000			

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Purchase equipment

Buy equipment for \$30,000 in cash

Account :

(1)cash (asset)



(2)equipment(asset)



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Buy equipment for \$30,000 in cash

Asset			=	Liabilities		+	Equity
	cash	off use	equipt	AP	L. Debt		Equity
(1)	\$ 50,000						\$ 50,000
(2)	(4,800)	\$ 4,800					
(3)	(30,000)		\$ 30,000				
	\$ 15,200	\$ 4,800	\$ 30,000	\$ -	\$ -		\$ 50,000
	\$ 50,000			=	\$ 50,000		

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Account Payable

Buy office use items \$9,400, and settle 100% in 2 weeks ◦

Account:

- (1) Inventory (Asset) 
- (2) Account Payable (Liabilities) 

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Account Payable

Buy office use items \$9,400, and settle 100% in 2 weeks ◦

Asset				=	Liabilities		+	Equity
	cash	Off Use	equipt		Account Payable	Long debt		Equity
(1)	\$ 50,000							\$ 50,000
(2)	(4,800)	\$ 4,800						
(3)	(30,000)		\$ 30,000					
(4)		9,400			\$ 9,400			
	\$ 15,200	\$ 14,200	\$ 30,000		\$ 9,400	\$ -		\$ 50,000
	\$ 59,400			=	\$ 59,400			

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Accounting update

Update all the previous transactions

Asset			=	Liabilities		+	Equity
	cash	off use	equipt	Acct payable	Long Debt		Equity
Bal	\$ 15,200	14,200	30,000	9,400			\$50,000
	\$ 15,200	\$ 14,200	\$ 30,000	\$ 9,400	\$ -		\$50,000
	\$ 59,400			=	\$59,400		

Proceed to other transactions



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Revenue

Consultant income\$9,800 in cash

Account :

(1)Cash (Asset)

(2)revenue(Equity)



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Revenue 收入

Consultant income\$9,800 in cash

Asset			=	Liabilities		+	Equity
	cash	off use	equipt	Acct Payable	Long Debt		Equity
Bal	\$ 15,200	14,200	30,000	9,400			\$ 50,000
(5)	9,800						9,800
	\$ 25,000	\$ 14,200	\$ 30,000	\$ 9,400	\$ -		\$ 59,800
	\$ 69,200			=	\$ 69,200		

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Payment Rent

Paid \$2,800 as rental to rental company

Account:

- (1) cash (asset) 
- (2) rental (equity) 

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Paid \$2,800 as rental to rental company

	Asset			=	Liabilities		+	Equity
	Cash	Off use	Equipt		Acct Payable	Long Debt		Equity
Bal	\$ 15,200	14,200	30,000		9,400			\$ 50,000
(5)	9,800							9,800
(6)	(2,800)							(2,800)
	<u>\$ 22,200</u>	<u>\$ 14,200</u>	<u>\$ 30,000</u>		<u>\$ 9,400</u>	<u>\$ -</u>		<u>\$ 57,000</u>
	\$ 66,400			=	\$ 66,400			

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Pay worker salary

Salary payment \$2,300.

Account :

(1) Cash (Asset)



(2) Salary pay (equity)



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Salary payment \$2,300.

	Asset			=	Liabilities		+	Equity
	Cash	Off use	Equipt		Acct Payable	Long Debt		Equity
Bal	\$ 15,200	14,200	30,000		9,400			\$ 50,000
(5)	9,800							9,800
(6)	(2,800)							(2,800)
(7)	(2,300)							(2,300)
	\$ 19,900	\$ 14,200	\$ 30,000		\$ 9,400	\$ -		\$ 54,700
	\$ 64,100			=	\$ 64,100			

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Account Receivable 应收账款

Overstock of office supplies, sold 10 unit to ABC for \$3,400 , ABC agrees to pay in 30 days

Account:

(1) AR (Asset)



(2) Off Use (Asset)



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AR 应收账款

Overstock of office supplies, sold 10 unit to ABC for \$3,400 , ABC agrees to pay in 30 days

Asset				=	Liabilities +	Equity
	Cash	AR	Off Use Equipt		Acct Payable	Equity
Bal (8)	\$ 19,900		14,200 30,000		9,400	\$ 54,700
		3,400	(3,400)			
	\$ 19,900	3,400	\$ 10,800 \$ 30,000		\$ 9,400	\$ 54,700
	\$ 64,100			=	\$ 64,100	

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AR 应收账款

ABC Settled in 10 days

Account:

(1) Cash (Asset)



(2) AR (Asset)



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AR 应收账款

ABC Settled in 10 days

Asset					=	Liabilities	+	Equity
	Cash	AR	Off Use	Equipt		Acct Payable		Equity
Bal	\$ 19,900	3,400	10,800	30,000		9,400		\$ 54,700
(8)	3,400	(3,400)						
	\$ 23,300	-	\$ 10,800	\$ 30,000		\$ 9,400		\$ 54,700
	\$ 64,100				=	\$ 64,100		

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SMART - Construction Consultant Co. Ltd		
Trial Balance		
MMM DD, YYYY		
	Dr (HK\$)	Cr (HK\$)
Cash	23,300	
Office Use	10,800	
Equipment	30,000	
Account Payable		9,400
Capital Stock		50,000
Revenue		9,800
Rental Expense	2,800	
Salary Expense	2,300	
Total	\$ 69,200	\$ 69,200

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SMART – Construction Consultant Co. Ltd

Income Statement

for the year end MMM DD, YYYY

		HK\$
Revenue		9,800
Expenses		
Rental Expense	2,800	
Salary Expense	2,300	
Total Expenses		5,100
Net Income		\$ 4,700

SMART – Construction Consultant Co. Ltd			
Balance Sheet			
as at MMM DD, YYYY			
Fixed Assets		Current Liabilities	
Equipment	\$ 30,000	Account Payable	\$ 9,400
		Total Current Liabilities	\$ 9,400
Total Fixed Asset	\$ 30,000		
Current Assets		Total Liabilities	
Cash	\$ 23,300		\$ 9,400
Office Use	\$ 10,800		
Total Current Asset	\$ 34,100	Owner Equities	
		Capital Stock	\$ 50,000
		Retained Earnings	\$ 4,700
		Total Owner Equities	\$ 54,700
Total Assets	\$ 64,100	Total Liabilities and Owner Equities	\$ 64,100

2 The Income Statement

- Measures financial performance over a specific period of time
- The accounting definition of income is:
 $\text{Revenue} - \text{Expenses} \equiv \text{Income}$

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Income Statement Analysis

- There are three things to keep in mind when analyzing an income statement:
 1. Generally Accepted Accounting Principles (GAAP)
 2. Non-Cash Items
 3. Time and Costs

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GAAP

- The matching principle of GAAP dictates that **revenues** be matched with **expenses**.
- Thus, income is reported when it is **earned**, even though no cash flow may have occurred.

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Non-Cash Items

- **Depreciation** is the most apparent. No firm ever writes a check for “depreciation.”
- Another non-cash item is **deferred taxes**, which does not represent a cash flow.
- Thus, **net income is not cash**.

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Time and Costs

- In the short-run, certain equipment, resources, and commitments of the firm are **fixed**, but the firm can vary such inputs as labor and raw materials.
- In the long-run, all inputs of production (and hence costs) are **variable**.
- Financial accountants do not distinguish between variable costs and fixed costs. Instead, accounting costs usually fit into a classification that distinguishes product costs from period costs.

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Financial
accountants will
concern

Managerial
accountants will
concern

Product Cost	Net Sales	\$600,000	Net Sales	\$600,000
	Cost of Goods Sold			
	variable costs	\$120,000	Variable costs 可變成本	
	fixed costs	<u>\$200,000</u>	Cost of Goods Sold	\$120,000
	Gross Profit 毛利	\$280,000	Selling and Adm. Exp.	<u>\$40,000</u>
			Contribution Margin 貢獻	\$440,000
	Operational Expenses:			
	selling and administrative expenses		Fixed costs 固定成本	
	銷售及行政開支		Cost of Goods Sold	\$200,000
Period Cost	variable expenses	\$40,000	Selling and Adm. Exp.	<u>\$150,000</u>
	fixed expenses	<u>\$150,000</u>	Total fixed Costs	<u>\$350,000</u>
	Total Operational Expenses:	<u>\$190,000</u>		
	Net Profit	\$90,000	Net Profit	\$90,000

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3 Net Working Capital

- Net Working Capital (NWC) $\equiv$
Current Assets – Current Liabilities
- NWC usually **grows with the firm**

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4 Financial Cash Flow

- In finance, the **most important item** that can be extracted from financial statements is the **actual** cash flow of the firm.
- Since there is no magic in finance, it must be the case that the cash flow received from the firm's assets must equal the cash flows to the firm's creditors and stockholders.

$$CF(A) \equiv CF(L) + CF(E)$$

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5 The Statement of Cash Flows

- There is an official accounting statement called the **statement of cash flows**.

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Purpose of the Statement of Cash Flows

How does a company obtain its cash?

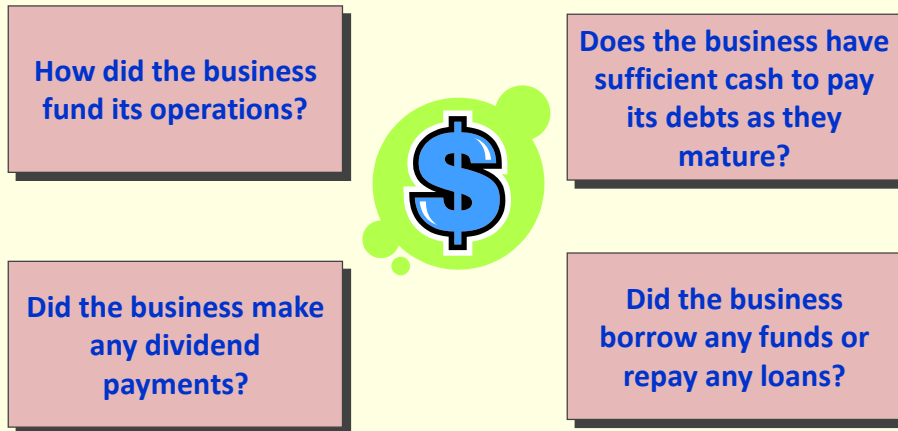
Where does a company spend its cash?



What explains the change in the cash balance?

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Importance of Cash Flows



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Classification of Cash Flows

The Statement of Cash Flows includes the following three sections:

- **Operating Activities**
- **Investing Activities**
- **Financing Activities**



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Format of the Statement
of Cash Flows

Company Name Statement of Cash Flows For Period Ended Date	
Cash flows from operating activities:	
[List of individual inflows and outflows]	
Net cash provided (used) by operating activities	\$ #####
Cash flows from investing activities:	
[List of individual inflows and outflows]	
Net cash provided (used) by investing activities	#####
Cash flows from financing activities:	
[List of individual inflows and outflows]	
Net cash provided (used) by financing activities	#####
Net increase (decrease) in cash	\$ #####
Cash (and equivalents) balance at beginning of period	#####
Cash (and equivalents) balance at end of period	\$ #####

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6 Cash Flow Management

- **Earnings** can be manipulated using subjective decisions required under GAAP
- Total cash flow is more objective, but the underlying components may also be “managed”
 - Moving cash flow from the investing section to the operating section may make the firm’s business appear more stable

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Importance of Cash Flow Statements

- Balance sheet, profit & loss account and cash flow statement
- Creative accounting and manipulation of profits
- Non-manipulation of cash

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RooHa Firm	
A) <u>Reducing balance depreciation at 40% p.a.</u>	
	£
Sales revenue	<u>640,000</u>
Depreciation (500,000x 40%)	200,000
All other expenses	<u>390,000</u>
Total expenses	<u>590,000</u>
Net profit	<u>50,000</u>

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(Continued)	
B) <u>Straight line depreciation over 5 years</u>	
	£
Sales revenue	<u>640,000</u>
Depreciation (500,000/5)	100,000
All other expenses	<u>390,000</u>
Total expenses	<u>490,000</u>
Net profit	<u>150,000</u>
<i>NB: No physical change but profits tripled!!!</i>	

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Analyzing Cash Sources and Uses

Cash Flows of Competing Companies			
<i>all numbers in thousands</i>	BMX	ATX	CAX
Cash provided (used) by operating activities	\$ 90,000	\$ 40,000	\$ (24,000)
Cash provided (used) by investing activities:			
Proceeds from sale of operating assets			26,000
Purchase of operating assets	(48,000)	(25,000)	
Cash provided (used) by financing activities:			
Proceeds from issuance of debt			13,000
Repayment of debt	(27,000)		
Net increase (decrease) in cash	<u>\$ 15,000</u>	<u>\$ 15,000</u>	<u>\$ 15,000</u>

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Module 3

An Introduction – Accounting
Balancing Account - Assets, Liability,
Expenses, Profits

McGraw-Hill/Irwin

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Chapter Outline

- Transaction - impacts to Assets, Liability and Equity, and profitability
- Accounting / Operation - balance
- Relationship between Income statement and Balance sheet

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Accounting – Transactions

- Sources of transactions
- **Recognize** the transactions and **post** into the account

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Exercise : 20 mins

Company JJ - recognize the transactions and post onto :

- Balance Sheet
- Income statement

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May1, 20X4 - Wang families invested \$8000 and register JJ Co as 800 common share @\$10			
JJ co			
Balance Sheet			
May 2, 20X4			
Cash	Asset	Equity	
	\$ 8,000	Equity	\$ 8,000
Total	\$ 8,000	Total	\$ 8,000
Asset = Liabilities + Equity			
\$8,000 = 0 + \$8,000			1-88

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May 2, JJ purchased a cutting tool sets \$2,500 cash .			
JJ Co			
Balance Sheet			
May 2, 20X4			
Cash	Asset	Equity	
Tools and Equip	\$	Equity	\$
Total	\$	Total	\$
Asset = Liabilities + Equity			
			1-89

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May 8, JJ bought a lorry \$15,000 ° JJ paid \$2,000 cash, and a 30 day cheque \$13,000

JJ Co			
Balance Sheet			
May 8, 20X4			
Asset		Liabilities and Equity	
Cash	\$	Liabilities	\$
Tools and Equipt		Acct Payable	
Lorry		Total Equit	
		Equity	
Total	\$	Total	\$
Net Asset = Total Asset - Total Laibilities			

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May 11, purchase Tools' components\$300, on loan

JJ Co			
Balance Sheet			
May 11, 20X4			
Asset		Liabilities and Equity	
Cash	\$	Liabilities	\$
Tools/Equipt		Accout Payable	
Lorry		AccountPayable1	
		Total Liabilities	
		Total Equity	
		Equity	
Total	\$	Total	\$

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May 18, JJ sold \$150 tools' components to ABC in 30 days credit °

JJ Co			
Balance Sheet			
May 18, 20X4			
Asset		LBY + Equity	
Cash	\$	Liabilities	\$
Acct Receivable		Acct Payable	
Tools - Equipt		Acct Payable 1	
Lorry		Total Liabilities	\$
		Total Equity	
		Equity	
Total	\$	Total	\$

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May 25, ABC paid JJ \$75 for Tools' components

JJ Co			
Balance Sheet			
May 25, 20X4			
Asset		LBY + Equity	
Cash	\$	Liabilities	\$
AR		Acct Payables	
Tools and Equipt		Acct Payables	
Lorry		Total Liabilities	\$
		Total Equity	
		Equity	
Total	\$	Total	\$

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May 28, JJ paid the Tools' component bill for \$150 ◦

JJ Co			
Balance Sheet			
May 28, 20X4			
Asset		LiBY + Equity	
Cash	\$	Liabilities	\$
AR		Acct Payable	
Tools and Equipt		Acct Payable 1	
Lorry		Total Liabilities	
		Total Equity	
		Equity	
Total	\$	Total	\$

91

May 29, JJ collect service revenue contract of \$750 in cash.

JJ Co			
Balance Sheet			
May 29, 20X4			
Asset		LiBY + Equity	
Cash	\$	Liabilities	\$
AR		Acct Payable	
Tools and Equipt		Acct Payable 1	
Lorry		Total Liabilities	
		Total Equity	
		Equity	
		Retain Earning	
Total	\$	Total	\$

Asset = Liabilities + Equity + Earning

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May 29, JJ in May

Revenue **\$750**, paid in cash.

May 31, JJ purchase the fuel
\$50 for cutting tool and
 lorry, paid in cash.

93

93

JJ's Consulting Company

Income Statement

20X4 May 31

Revenue	\$750
Operating expenses -Fuel	<u>50</u>
Net Income	<u>\$700</u>

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Thanks

End