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INTRODUCTION TO FINANCE AND INVESTMENT STUDY TEXT

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PAPER NO. 6 INTRODUCTION TO FINANCE AND INVESTMENT

UNIT DESCRIPTION

This paper is intended to equip the candidate with knowledge, skills and attitudes that willenable him/her to apply the principles of finance in investment decision making under non- complex scenarios.

LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Select and apply the techniques and concepts of the time value of money, compounding,discounting, and annualising
- Analyse the risks and returns offered by short-term, liquid instruments
- Calculate non-complex risk and return measures
- Calculate the cost of capital of a firm
- Apply the basic valuation models to determine value of financial securities
- Evaluate the viability of capital investments using appropriate appraisal

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CHAPTER ONE
NATURE AND PURPOSE OF FINANCE

INTRODUCTION

Finance is called “The science of money”. It studies the principles and the methods of obtaining control of money from those who have saved it, and of administering it by those into whose control it passes.

Involves the task of raising funds required by the firm at the most favorable terms.

It’s the study of how best to raise funds needed by the business and allocation of the utilized and the distribution of returns generated.

The above definition will therefore cover the four financial management functions namely;

1. Financing function
2. Investing function
3. Dividend function
4. Liquidity function

Financing function

The finance management is responsible for making projections of the firms’ future financial needs. He has to determine the companies fixed capital needs in the short, medium and long-term as well as the working capital needs.

He has to ensure that the finance is provided in the most appropriate form and for the purpose for which it is required at the lowest possible cost to the company.

He needs to be well equipped with the requirement of financial markets.

Investing function

The finance manager has to ensure that the funds raised are allocated to the most efficient and most productive uses so as to fulfill the company’s objective of maximizing shareholders wealth.

Liquidity function

The finance manager has additional responsibility of advising on the quantity and timing of funds since cash receipts and distribution don’t always consider.

He should ensure that the firms’ financial resources are well managed by;

1. Ensure that there is proper management of working capital.
2. Maintain optimal level of investments in each of the working capital items investments (stocks), debtors, opportunity costs in order to efficiently with deal cash shortage or surplus.

Dividend function

Involves allocation of profits available for distribution

Appropriate of earnings attributable to shareholders i.e. profit after interest and tax and preference dividend is paid out as cash dividend and the other proportion is to be retained for re-investment.

FINANCIAL DECISION-MAKING PROCESS

Managers and business owners must weigh financial considerations with every major decision they make for their firm. Whether the decision involves capital expansion, hedging assets or acquiring major equipment or merging with another firm, solid financial analysis will provide the assurance that the decision is made with the best information available. There are six factors to consider.

The Opportunity

Financial analysis begins with a thorough description of the project being undertaken. This narrative includes background of the project, the current status and how you intend to complete the project. If, for example, you are planning to expand your business by building a new facility, you should explain why you have outgrown your current location, why the proposed addition will solve your problem and how long it will take to become operational.

Accounting Considerations

Your analysis will include pro forma balance sheets, income statements and projected cash flow -- with and without the expansion. This will be necessary to convince investors that you have thought through details and can justify the expense of the project being undertaken.

Financial Considerations

Financial considerations include the details regarding the cost of the project, what working capital is required and the sources of any funds that you do not already control. If you plan to borrow funds, then weigh the cost and terms of each potential lender -- venture capitalist, bank or private investor. Determine what collateral is required and if there are any special terms and conditions.

Risk Factors

Assessing risk factors is essential. Many risks cannot be avoided. Fire, accidents on the job, business interruptions and non-performance by a contractor are just a few of the risks you may encounter. Some require insurance; others you may self-insure. In any case, you must assess probabilities and present alternatives. Market risks and some risks of operations are uninsurable. If there is an environmental impact, then that too must be factored into your risk analysis.

ROI Forecast

While the forecast is implied in your pro forma financial statements, you need to address the return on investment, presenting best-case, likely case and worst-case scenarios. Since it is impossible to project business conditions with absolute certainty, offering a range of forecasts will provide assurance to investors that even with the worst case the project will have an acceptable return.

Legal Issues

Whatever project you are contemplating, there will be legal considerations. A physical expansion will raise environmental issues. The purchase of major equipment will require contractual agreements. There are federal, state and local ordinances and regulations that must be followed, and tax considerations that must be met at all levels.

RELATIONSHIP BETWEEN ACCOUNTING AND FINANCE

Finance can be defined as the art and science of managing money. Virtually all individuals and organization earn or raise money and spend or invest money. Finance is concerned with the process, institutions, markets and instruments involved in the transfer of money among and between individuals, business and governments. Finance, in another word, can be defined as the management of the flows of money through an organization, whether it be a corporation, school, bank, or government agency. Finance concerns itself with the actual flows of money as well as any claims against money. Finance is regarded as the life-blood of the business unit. This function involves planning, procurement and effective utilization of the funds of the business.

Accounting is the methodical or precise recording, reporting, and assessment of financial deals and transactions of a business. Accounting also involves the preparation of statements or declarations concerning assets, liabilities, and outcomes of operations of a business.

Relationship Between Finance and Accounting

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Relationship Between The Two

Finance concerns with accounting because financial accounting is one branch of accounting. Accounting relates to booking of the historical transaction of an organization and it leads to preparation of financial status of the company stating that asset and what liabilities are held by the entity as on the day when relevant period like a year ends i.e. Balance Sheet. Financial status is concluded from the accounting records (i.e. balance sheet, profit and loss account). Account keeps the record of the organization's income, expenditure, asset liabilities and by evaluating those transactions finance makes the decision for investment like where to invest? How much funds to invest? Etc. In a short form we can say that where account ends of keeping records, finance starts the work by evaluating them.
Finance is connected with accounting. The accounting process produces one of the essential raw materials needed to make financial decisions, financial data. Accounting is a tool for handling only the financial aspects of business operations. It is geared to the financial ends of business only because these are measurable on the scale of money values. The distinction between financial management and management accounting is semantic one, but the gap between the two is rapidly closing. Financial management, however, has the broader meaning of planning and control of all activities by financial means, while management accounting originally meant the internal management of finance. The accountant devotes his attention to the collection and presentation of financial data. The financial officer evaluates the accountant statements, develops additional data and arrives at decisions based on his analysis. As a matter of fact, sound financial management is a matter of good accounting. Accounting and Finance is a very important function of any business either for profit making or for non-profit making institutions. It provides an avenue where a business analyses its operations in terms of what they own, what comes and what goes out.

Goals of a firm

This can be divided into 2:

1. Financial goals
2. Non-financial goals