1. Introduction

Finance is the application of economic principles and concepts to business decision making and problem solving. In other words, finance is simply applied economics. We will be applying much of what you learned in microeconomics and macroeconomics in the study of the principles of finance.

The topic of finance can generally be broken into three general, yet related areas:

1. Financial management deals with the management of finances of a business enterprise,
2. Investments deals with financial markets and security pricing, and
3. Financial institutions deals with financial firms (such as banks).

Financial management requires using knowledge of economics, accounting, law, and other business disciplines. In addition, financial management requires proficiency in financial mathematics and statistics.

Finance ...
- is analytical.
- is based on economic principles.
- uses accounting information as input to decision-making.
- is global in perspective.
- is constantly changing.
- is the study of how to invest and raise money productively.

Don't remember much of the accounting?
- Walk through the Accounting Review
- Check out the StudyMate Activity
2. Overview of financial management and analysis

There are a number of different types of financial decisions made within the firm. Investment decisions concern the use of funds for future benefit, such as extending credit to customers or purchasing a processing plant.

Suppose you have an idea for a new service: the exam wake-up service. If you want to start up this business and sell your new service, you must address questions like these:

- How much will it cost to purchase the equipment needed to provide this service?
- Once you start up this business, how much money will be tied up in working capital such as cash on hand, accounts receivable, and inventory of parts to service the equipment?
- What cash flows do you expect from this service? That is, how much cash is expected to come in to the firm due to sales of the service, and how much cash is expected to flow out due to expenses, such as wages?
- By how much are actual future cash flows likely to vary from expected cash flows?
- Will you extend credit to purchasers of your service? If so, for how long? How will you collect on any late accounts?
- If you don't use your money to produce and market this service, what else can you do with it?

Or, as another example, suppose we are considering how much of a firm's assets to keep available as cash. This is an investment decision because we will be investing in cash -- tying up funds in cash balances that could be used elsewhere. It requires addressing at least the following questions:

- How large a cash balance is needed? Can a cash balance be too large?
- How certain are we about the amount of cash we will need in the future?
- Where should our cash balance be held? In the bank? Under a mattress? Invested in United States Treasury Bills?
- Should the cash balance be kept constant throughout the year or should it change as needs change?
- What else could we do with the money if we don't have it tied up in cash?

Financing decisions concern the acquisition of funds to finance investments and operations, such as issuing bonds to fund an expansion of a company's plant.

A company's operations and investments can be financed from outside the business by incurring debts, as through bank loans and the sale of bonds, or by selling ownership interests. Since each method of financing obligates the business in different ways, financing decisions can be very important. The major differences are:

- Debts must be repaid, with interest, within a specified amount of time. However, creditors (those lending the money) generally do not share in the control or profits of the borrowing firm.
- Proceeds from the sale of ownership interests do not need to be repaid. However, such sale dilutes the control of (and profits accruing to) the current owners.

The choice of financing method then involves considering, at the least,

- the length of time the funds will be needed;
- the ability of the firm to make payments to a creditor on a fixed schedule; and
the willingness of current owners to have their ownership interest (and hence control) of the firm diluted.

Some decisions, such as leasing, require both investment and financing decisions simultaneously. No matter the type of decision, however, the financial manager must focus on expected return and risk.

3. Financial management and financial analysis

In general, financial management is the management of cash flows to make a profit for the firm's owners. Financial management requires the coordination of all areas of a business to effectively benefit the owners. Within a company, financial decision-making is usually managed by the controller, treasurer, or vice-president of finance.

The organization may be a business enterprise, such as a manufacturing company, an accounting firm, an oil producer, or a credit union, or it may be a charitable organization. The day-to-day purpose of financial management is to meet current and future operating needs. Its tasks include the development, application, and monitoring of policies and decisions regarding such business activities as:

- collection of customer receipts;
- investment in marketable securities;
- investment in long-term assets, such as a factory building;
- payment of obligations; and
- raising long-term funds.

Departments that typically perform financial management tasks include Accounts Payable (payments to suppliers), Capital Budgeting (investment in long-term assets), Accounts Receivable (collection of customer credit accounts), and Financial Planning (planning for cash inflows and outflows). In many organizations, some of the functions of financial management are integrated with accounting and economics functions. These finance-oriented departments usually work in concert with other departments within the firm. For example, the development of a new product takes the joint efforts of Production Management, Marketing, and Finance personnel to identify the new product, plan its production and distribution, and assess the future benefits of the new product for the business enterprise.

Financial analysis is a tool that involves evaluating the financial condition and operating performance of a business enterprise. Financial analysis requires an evaluation of the firm, the firm's industry, and the economy.

Firms and investors can obtain data useful for analysis from various financial service sources (such as Standard & Poor's, Moody's, and Dun & Bradstreet). Within the firm, financial analysis may be used not only to evaluate the performance of the firm, but also of its divisions or departments and its product lines. Analyses may be performed both periodically and as-needed, not only to ensure informed investment and financing decisions, but also as an aid in implementing personnel policies and rewards systems.

Outside the firm, financial analysis may be used to determine the credit-worthiness of a new customer, to evaluate the ability of a supplier to hold to the conditions of a long-term contract, and to evaluate the market performance of competitors.
4. Current issues

Current issues that are the focus of financial managers, investors, and regulators include:

- Earnings management and financial disclosures. The recent scandals involving Enron, Worldcom, Sunbeam and many other companies, has raised concerns over the financial information that companies have disclosed.

- Executive compensation and company performance. Many of the cases of earnings management have arisen in an effort of either boost earnings performance to meet or beat analysts’ expectations, or to boost compensation based on earnings or share price.

- Corporate governance. The failures of the monitoring function of boards of directors are apparent in the recent scandals.

The Sarbanes-Oxley Act, passed in 2002, addresses these and other issues pertaining to disclosures and governance in public corporations. This Act addresses audits by independent public accountants, financial reporting and disclosures, conflicts of interest, and corporate governance at public companies. Each of the provisions of this Act can be traced to one or more scandals that occurred in the few years leading up to the passage of the Act. In addition, this Act establishes the Public Company Accounting Oversight Board (PCAOB).

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1 Public Law 107-204.