

# Financial Policy Introduction

## CERAM Business School

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and

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# Organization

- 10-week 3h lectures
- The same course is given:
  - ◆ In Sophia Antipolis by Prof. B. Gros Lambert
  - ◆ In Paris by Prof H. Hajj Chehade
- Grading System
  - ◆ Quizz 1 15%
  - ◆ Mid-Term Exam 30%
  - ◆ Quizz 2 15%
  - ◆ Final Exam 40%
- Reading
  - ◆ **Mandatory Textbook:** Brealey, Myers & Allen, Corporate Finance, McGraw-Hill

# Organization

- **Contact**
  - You can contact the professors through **WEBINTEC** (forum + direct access)
  - <http://webintec.ceram.fr>
- **Information and data available on webintec**
  - Syllabus
  - Slides
  - Exercises + correction
  - Forum FAQ
- **Make sure you are registered** in the course Financial Policy on webintec **with your regular email address**

# Organization

- **Key success factors for this course**
  - ◆ You don't need to be intelligent
  - ◆ You don't need to be good in maths
  - ◆ You only need to **work hard** and more important **regularly** (every week)
    - Do the homeworks
    - Read the slides and Brealey&Myers chapters

# Course Outline

- **Introduction**
  - ◆ **Lecture 1: Financial Management and the Business Environment**
    - Readings: Brealey & Myers (B&M) Chap1, Chap2.
  - ◆ Lecture 2: Time Value of Money
    - Readings: B&M Chap3
- **Investment Decisions**
  - ◆ Lecture 3: Investment Appraisal Methods (+ **Quiz 1**)
    - Readings: B&M Ch5
  - ◆ Lecture 4: Net Working Capital and Cash Flow Management
    - Readings: B&M Ch30, 31.
  - ◆ Lecture 5: Financial Forecasting and Budgeting
    - Readings: B&M Ch6, 19.2, 29.
  - ◆ **Week 6 Midterm Exam (1h30)**
- **Financing Decisions**
  - ◆ Lecture 6: The Value of Bonds and Common Stocks
    - Readings: B&M Ch4.
  - ◆ Lecture 7: Internal Funds, Equity Financing and Dividend Policy
    - Readings: B&M Ch14, 15, 16.
  - ◆ Lecture 8 and 9: Capital Structure and the Cost of Financing (+ **Quiz 2**)
    - Readings: B&M Ch9, 10.1, 19.
  - ◆ Lecture 10: Overall Recap
  - ◆ **Week 11 Final Exam (3h)**

# Financial Management and Control of a Firm

- Different forms of business organisation
  - ◆ SOLE PROPRIETORSHIP
  - ◆ PARTNERSHIP
  - ◆ CORPORATION

## Financial Management and Control of a Firm

- Sole Proprietorship
  - ◆ Business owned by one person
  - ◆ Taxed as **personal** income
    - No distinction between **business** income and **personal** income
  - ◆ Advantage
    - easy to start
  - ◆ Disadvantage
    - **Unlimited** liability
    - Creditors can look beyond **business** assets to **personal** asset
    - Limited transferability

## Financial Management and Control of a Firm

- General partnership
  - ◆ Similar to a sole proprietorship but with multiple owners
  - ◆ Disadvantage
    - **Unlimited** liability including for the business dealings of other partners

## Financial Management and Control of a Firm

- Limited Liability partnership
  - ◆ Similar to a general partnership but with a separate classification of partners
  - ◆ Advantage
    - Liability can be limited for the "limited partners" as opposed to the "general partners"
  - ◆ Disadvantage
    - More complex administrative requirements
    - Limited partners are passive investors and have no control

## Financial Management and Control of a Firm

- Corporation
  - ◆ Corporation = legal 'person'
    - Separate and distinct from owners
    - Can borrow money
    - Enter into contracts
    - Own property
    - Sue and be sued
    - Can own stock in another corporation

## Financial Management and Control of a Firm

- Corporation
  - ◆ **Stockholders** elect Board of Directors
  - ◆ Only **Board of Directors** has legal power
    - To declare a dividend
    - To issue securities
    - To commit large investment outlays
  - ◆ Directors elect senior management (**CEO, President**)
    - To run the corporation **in interest of stockholders**

## Financial Management and Control of a Firm

- What's a firm?
  - ◆ A pool of **resources**  
  
In order to finance and run
  - ◆ Assets and **investment** projects

Example

## Financial Statements (recap)

### ● Balance sheet

#### ASSETS (investments)

- Current Assets
    - ◆ Cash and securities
    - ◆ Accounts receivable
    - ◆ Inventories
  - Fixed Assets
    - ◆ Machinery
    - ◆ Land, etc, etc
  - Other Assets
    - ◆ Patents
    - ◆ Goodwill
- = TOTAL ASSETS**

#### LIABILITIES (resources)

- Equity (shareholders)
    - ◆ Preferred and Common stock
    - ◆ Retained earnings
  - Debt
    - ◆ Long-Term Debt
      - Long-term notes
      - Mortgages
    - ◆ Current Debt
      - Accounts payable
      - Accrued expenses
      - Short-term notes
- = TOTAL LIABILITIES**

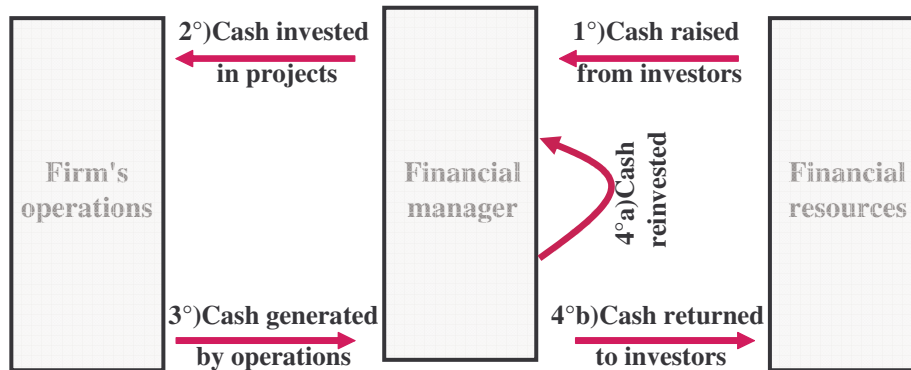
## Financial Statements (recap)

### ● Income Statement

- |                      |   |   |
|----------------------|---|---|
| Operating Activities | { | Sales   |
|                      |   | - Cost of producing or acquiring product/services |
|                      |   | <b>= Gross Profit</b>                             |
|                      |   | - Operating Expenses                              |
|                      |   | marketing and selling expenses                    |
|                      |   | general and administrative expenses               |
|                      |   | <i>depreciation expenses</i>                      |
|                      |   | <b>= Operating Income</b>                         |
| Financing Activities | { | - Interest expense                                |
|                      |   | <b>= Earnings before taxes</b>                    |
|                      |   | - Corporate taxes                                 |
|                      |   | <b>= Net Income</b>                               |

# Cash Flows

- What are the different kinds of cash flows circulating in or around a firm?



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15

# The Role of the Financial Manager

- The CFO (Chief Financial Officer) stands between
  - ◆ Cash flows invested in the real assets of the firm
  - ◆ Cash flows generated by the real assets of the firm
  - ◆ Cash flows invested in the firm by the investors
  - ◆ Cash flows generated by the firm and returned to the investors or retained into the firm

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16

# The Role of the Financial Manager

CFO is in charge of

- Treasurer
  - ◆ Capital budgeting
  - ◆ Financing
  - ◆ Cash management
  - ◆ Recommending dividend policy
  - ◆ Insurance
  - ◆ Pension plans
- Controller
  - ◆ Accounting
  - ◆ Preparation of financial statements
  - ◆ Preparing budgets
  - ◆ Internal auditing

# The Role of the Financial Manager

- The CFO tries to maximize the value of the firm through
  - ◆ Investment decision
  - ◆ Financing decision
  - ◆ Dividend decision
- This course will investigate these 3 decisions

## Time Value of Money

- What do you prefer
  - ◆ €10,000 now or €10,000 in a year ?
  - ◆ €10,000 now or €10,050 in a year ?
  - ◆ €10,000 now or €10,500 in a year ?
  - ◆ €10,000 now or €15,000 in a year ?
  - ◆ €10,000 now or €20,000 in a year ?
  - ◆ If you have not yet answered it is €10,000 now

## Time Value of Money

- Time is money !
- Why ?
- Choosing between
  - ◆ Consumption (spending) today
  - ◆ Consumption tomorrow, next year, or later on...

## Time Value of Money

- Where does the time value of money come from?
- To compensate for
  - ◆ Delayed consumption
  - ◆ Risk
    - Inflation Risk
    - Risk Premium

## Time Value of Money

- What determines trade-off between
  - ◆ Current dollars (or Euros)
  - and
  - ◆ Future dollars (or Euros)

### **INTEREST RATE**

## Time Value of Money

- The **lender** renounces to consume now
  - ◆ => the interest rate is the **price/reward** required by the lender for accepting not to dispose immediately of his/her cash
- The **borrower** is offered the opportunity to consume now
  - ◆ => the interest is the **cost** paid by the borrower over a period  $t$  at a rate  $r$

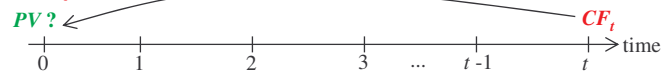
## Time Value of Money

- The basic problem faced by financial manager is
  - ◆ I have to spend money today (for example to build a plant) that will generate **cash flows in the future**
    - **Today**, how to value these **future** cash flows ?
    - Does it make sense to commit money **today** for revenue **tomorrow** ?

**ANSWER: PRESENT VALUE**

## Present Value

- **Present Value ( $PV$ )** is the value today of a future cash flow ( $CF_t$ )



$$PV = \frac{CF_t}{(1+r)^t}$$

- $r$  is the discount rate: **opportunity cost of capital**

## Present Value

### Example: Valuing an Office Building

#### **Step 1: Forecast cash flows**

Cost of building =  $C_0 = 350$

Sale price in Year 1 =  $C_1 = 400$

#### **Step 2: Estimate opportunity cost of capital**

If equally risky investments in the capital market offer a return of 7%, then

Cost of capital =  $r = 7\%$



## Present Value

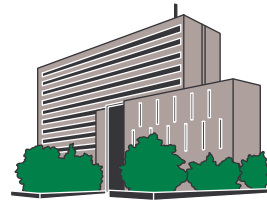
### Example: Valuing an Office Building

**Step 3: Discount future cash flows**

$$PV = \frac{C_1}{(1+r)} = \frac{400}{(1+0.07)} = 374$$

**Step 4: Go ahead if PV of payoff exceeds investment**

$$NPV = -350 + 374 = 24$$



## Net Present Value

$NPV = PV - \text{required investment}$

$$NPV = \frac{C_1}{1+r} - C_0$$

# Homework

- Exercise B&M chap2, n°2, p31
  - ◆ A parcel of land costs €500,000. For an additional €800,000 you can build a motel on the property. The land and motel should be worth €1,500,000 next year. Suppose that common stocks with the same risk as this investment offer a 10 percent expected return. Would you construct the motel? Why or why not?