Introducing Finance

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the discipline of finance and its purpose. Specifically, this lesson will cover:

1. Defining Finance

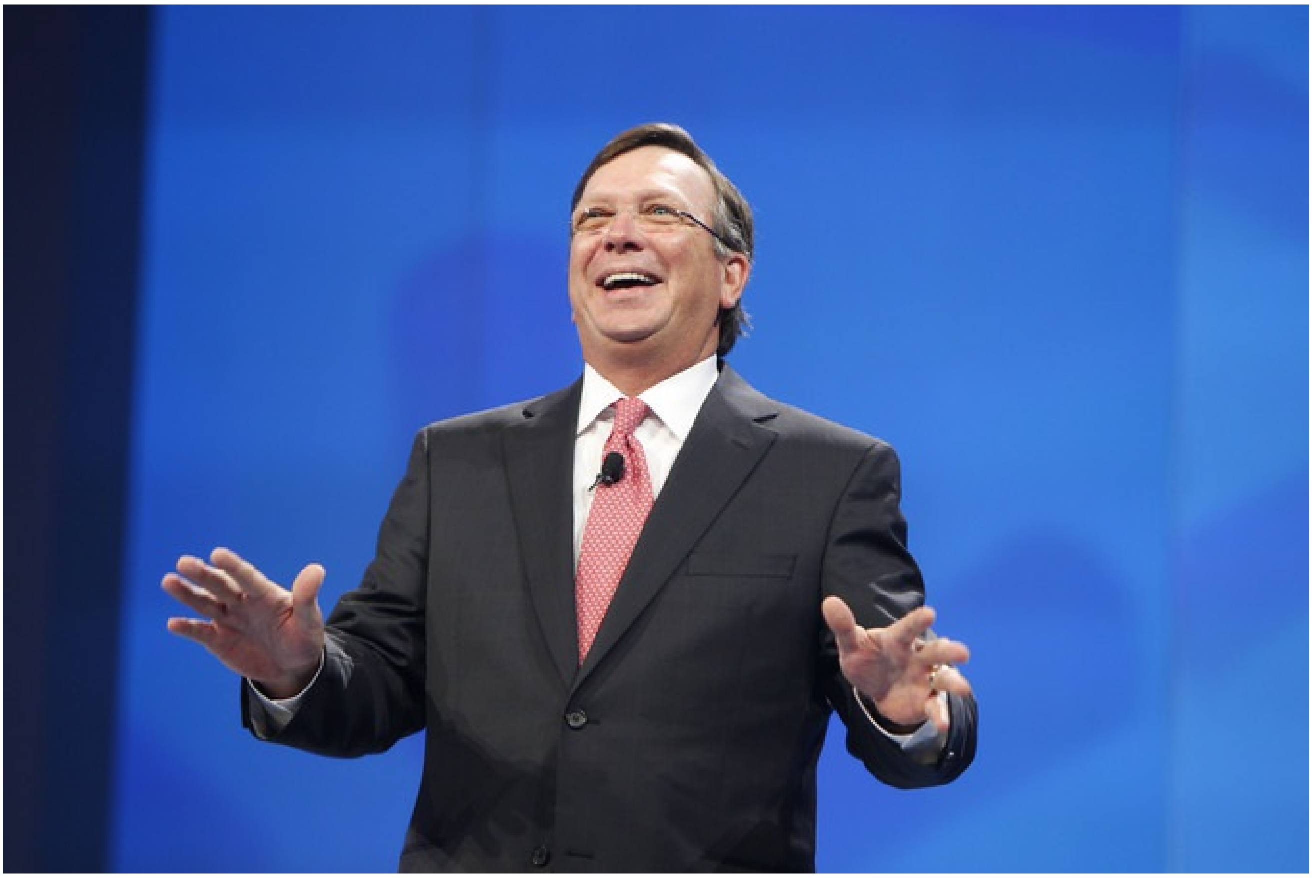
Finance is the study of funds management and asset allocation over time. Funds consist of money and other **assets**. There are many different types of finance, but all are fundamentally concerned with studying how best to allocate assets in different conditions over time.

The underlying driver behind all of finance is time. There are two reasons why time is so important to finance:

- *Time value of money:* For a number of reasons, money today is worth more than the same amount of money in the future. For example, you would rather have $100 today than $100 in 10 years – the money is worth more to you now than it would be in the distant future. We will explore this concept in greater depth later on.
- *Risk:* Making an investment does not guarantee a return. When a bank makes a loan, they're not sure the **debtor** will pay it back. There is a risk that the person will just take the money and run, the debtor will file for bankruptcy, or, for dozens of other reasons, the bank will not get the money they lent back.

The field of finance embraces time. Finance asks, "Since I know assets change value over time, how do I use that to cause my assets to change value in the direction I want? How do I manage assets so that they're worth more in the future than they are today? "

Figuring out what to do with assets is sometimes easy: all of the variables are known, and there is clearly an option that is better than all the others. However, most of the time this is not the case. Finance generally operates with a lot of uncertainty. As a result, companies hire entire departments of people to help them figure out which option is best.



Walmart CFO: Charles Holley, the Chief Financial Officer (CFO) of Wal-Mart, is in charge of making sure all of Wal-Mart's assets are allocated as optimally as possible.

TERMS TO KNOW

Assets
Something or someone of any value; economic resources that represent value of ownership that can be converted into cash.

Debtor
A person or firm that owes money, one in debt, or one who owes a debt.

Finance
To provide or obtain funding for a transaction or undertaking; to back; to support.

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2. Comparing the Fields of Finance, Economics, and Accounting

Finance, economics, and accounting are business subjects with many similarities and differences. While they influence each other, each is a distinct field of study.

Fields	Description
	Finance is the study of how to optimally allocate assets—how individuals and organizations

Finance	should invest assets in order to get the highest possible return given changing conditions over time. Finance is fundamentally a forward looking field, concerned with what an asset will be worth in the future.
Economics	Economics is a social science that analyzes the production, distribution, and consumption of goods and services. It focuses on how economic agents (people, businesses, and government) interact and make decisions. Economics is fundamentally the study of cause and effect. It tries to figure out how one variable affects economic agents or the economy as a whole.
Accounting	Accounting focuses on communicating a business's financial information. Accounting is fundamentally a backward-looking field, concerned with what has already happened financially and what position that leaves the company in today.

HINT

Think of the relationship of these subjects this way: Business is the application of finance on the framework of economics. Accounting is the recordkeeping.

Finance, economics, and accounting overlap in a lot of areas.

> EXAMPLE An investor will use accounting to see whether a company has shown past financial success and to predict what the company will look like in the future. Part of that prediction incorporates economics. The investor wants to know what the overall economy will look like in the future and wants to know how the company will interact with its competitors. The investor can use finance to figure out what his or her investment will be worth in the future.

BIG IDEA

There are few strong delineators between finance, economics and accounting. All three fields intermingle and influence one another. It is almost impossible to have a strong grasp of one without at least a basic understanding of the other two.

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3. Role of Finance in an Organization

Corporate finance is the area of finance dealing with monetary decisions that business enterprises make. Technically, corporate finance deals only with corporations, while managerial finance deals with all types of companies; however, we will use the terms interchangeably.

There are other branches of finance such as personal finance (individuals taking care of their money) and public finance (the finances of the government).

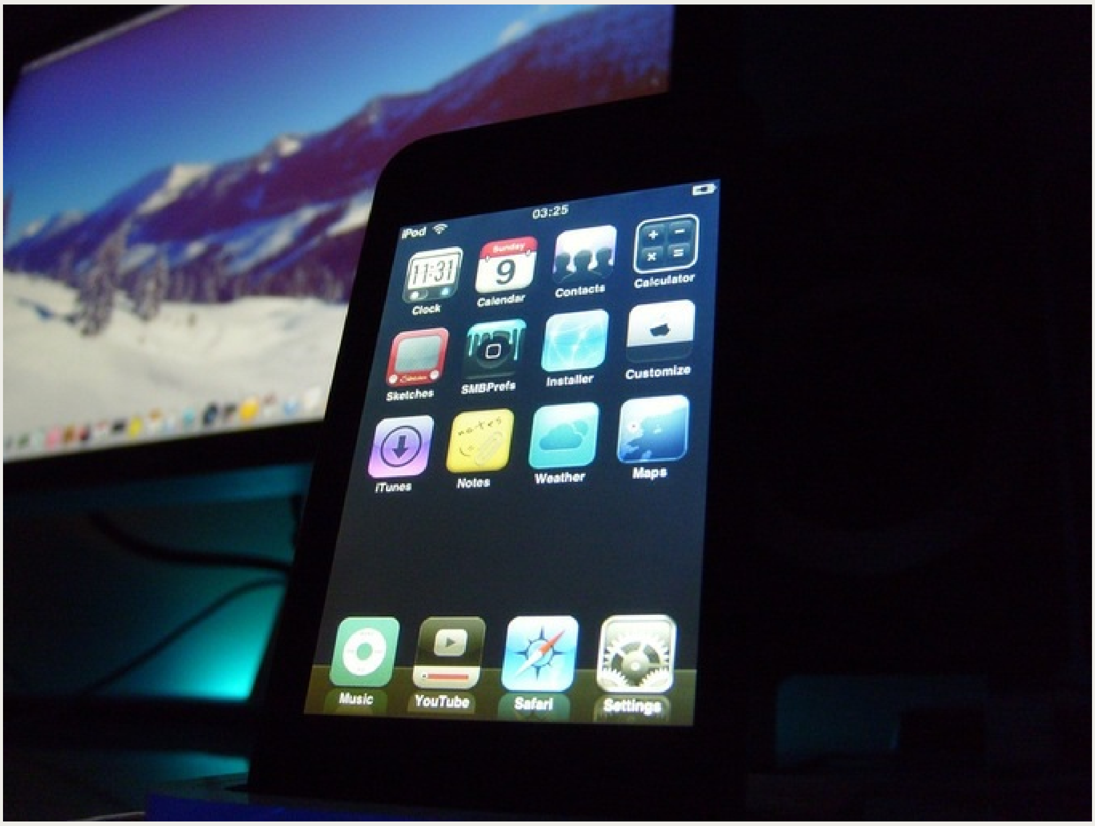
The primary goal of corporate finance is to maximize **shareholder** value. Maximizing shareholder value can be done over the long term or the short term, so the job of the finance department is to determine how best to do both. Sometimes, the goals may appear to be in competition with one another.

> EXAMPLE A company can choose to pay dividends (a small payment to each person who owns a stock of a company), which increases short-term shareholder wealth. However, paying dividends means that the money is not being invested in long-term investments, which may cause the stock price to increase more in the future, thereby increasing long-term shareholder wealth.

The technique behind maximizing shareholder value is the management of assets. This means that the finance department figures out how to best invest its money.

IN CONTEXT

A company could have two proposals from the R&D department to develop different products, but only enough money to fund one. The finance department will project out the future revenues and costs of each product and figure out which one, if either, is worth the money.



Apple used financial analysis to decide to fund the development of the iPod. The money allocated to development could have been used for another project, but the finance department determined the iPod was the best option.

Also, the finance department will determine when a company should take on a **liability**.

↪ EXAMPLE Suppose both projects are absolute home runs, but the company still only has enough money to fund one. The finance department will figure out if the company should borrow money so that it can fund both.

The role of finance in an organization is to make sure that money is at the right place at the right time. A company wants to have enough money to pay its bills, but also wants to invest so that it can grow in the future. The finance department is devoted to the task of figuring out how to allocate assets to do so, for the overarching goal of maximizing shareholder value.

TERM TO KNOW

Liability
An obligation, debt or responsibility owed to someone.

Shareholder

One who owns shares of stock.

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4. Types of Financial Decisions

There are two fundamental types of financial decisions that the finance team needs to make in a business:

- Investment
- Financing

The two decisions boil down to how to spend money and how to borrow money. Recall that the overall goal of financial decisions is to maximize shareholder value, so every decision must be put in that context.

4a. Investment

An **investment** decision revolves around spending **capital** on assets that will yield the highest return for the company over a desired time period. In other words, the decision is about what to buy so that the company will gain the most value.

To do so, the company needs to find a balance between its short-term and long-term goals. In the very short term, a company needs money to pay its bills, but keeping all of its cash means that it isn't investing in things that will help it grow in the future. On the other end of the spectrum is a purely long-term view. A company that invests all of its money will maximize its long-term growth prospects, but if it doesn't hold enough cash, it can't pay its bills and will go out of business soon. Companies thus need to find the right mix between long-term and short-term investment.

The investment decision also concerns what specific investments to make. Since there is no guarantee of a return for most investments, the finance department must determine an **expected return**. This return is not guaranteed, but is the average return on an investment if it were to be made many times.

An investment must meet three main criteria:

1. It must maximize the value of the firm, after considering the amount of risk the company is comfortable with (risk aversion).
2. It must be financed appropriately (we will talk more about this shortly).
3. If there is no investment opportunity that fills (1) and (2), the cash must be returned to shareholders in order to maximize shareholder value.

TERMS TO KNOW

Capital
Money and wealth; the means to acquire goods and services, especially in a non-barter system.

Expected Return
Considering the magnitude and likelihood of exogenous events, the yield that an investor predicts they will earn on average.

Investment
A placement of capital in expectation of deriving income or profit from its use.

4b. Financing

All functions of a company need to be paid for one way or another. It is up to the finance department to figure out how to pay for them through the process of **financing**.

There are two ways to finance an investment: using a company's own money or by raising money from external funders. Each has its advantages and disadvantages.

There are two ways to raise money from external funders:

- *Taking on debt:* This is the same as taking on a loan. The loan has to be paid back with interest, which is the cost of borrowing.
- *Selling equity:* This is essentially selling part of your company. When a company goes public, for instance, they decide to sell their company to the public instead of to private investors. Going public entails selling stocks which represent owning a small part of the company. The company is selling itself to the public in return for money.

> EXAMPLE If a company chooses to finance an investment by selling**equity**, they may issue stocks on an exchange like the New York Stock Exchange

BIG IDEA

Every investment can be financed through company money or from external funders. It is the financing decision process that determines the optimal way to finance the investment.

TERMS TO KNOW

Financing
A transaction that provides funds for a business.

Equity
The residual claim or interest to investors in assets after all liabilities are paid.

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5. Functions of Corporate Finance

Corporate finance deals with monetary decisions that business enterprises make and the tools and analysis utilized to make the decisions. Corporate finance is concerned primarily with making investment and financing decisions – that is, making sure that money is being used in the best way.

The corporate finance department of a company is in charge of budgeting. Management must allocate limited resources between competing opportunities; since a dollar cannot be used for more than one project at once, it is a challenge to determine how much money should be allocated to each part of the business.

In determining how to allocate money, the finance group must also figure out where the money will be best utilized. This requires valuing projects and business functions. A large element of finance is deciding how exactly to value a project. There are a number of variables – inflation, expected revenues, expected costs, length of time required – that are all incorporated into the valuation process. Finding the true value of a project is often wrought with uncertainty, but without an accurate valuation, a company may allocate its resources sub-optimally.

The corporate finance department must also determine how to finance projects. A company can finance a project by using either internal funds (money the company already has), borrowing, or selling equity. Each option carries a certain cost that can be quantified. It is the job of the finance department to make sure that the overall cost isn't too high and that the company has an optimal mix of all three strategies.

One public job function of corporate finance is determining whether or not the company pays a dividend, and if so, how much. The company has a responsibility to maximize shareholder value, but that can be achieved in multiple ways. Paying a dividend puts cash directly in the hands of shareholders, increasing shareholder value. However, paying a dividend means that money is not being reinvested in the company. If a company doesn't pay a dividend and instead chooses to reinvest the money, the value of the company will presumably increase, in turn increasing shareholder value. The finance department determines which option maximizes shareholder value.

Lastly, the finance department must also ensure that there is a good balance between long- and short-term goals. The company must have enough assets to cover short-term costs, referred to as working capital management, and enough invested to ensure the company has long-term growth.

6. The Role of Financial Manager

The financial manager is responsible for budgeting, projecting cash flows, and determining how to invest and finance projects. This role is a complex one, requiring both an understanding of how the business functions as a whole and specialized financial knowledge. The head of the financial operations is called the chief financial officer (CFO).

The structure of the company varies, but a financial manager is responsible for the same general things across the board. The manager is responsible for:

- *Managing the budget:* This involves allocating money to different projects and segments so that the business can continue operating, but the best projects get the necessary funding.
- *Figuring out the financial projections for the business:*The development of a new product, for example, requires an investment of capital over time. The finance manager is responsible for knowing how much the product is expected to cost and how much revenue it is expected to earn so that they can invest the appropriate amount in the product. This is a lot tougher than it sounds because there is no accurate financial data for the future. The finance manager will use data analysis and estimates to approximate the value, but it's extremely rare that s/he can be 100% sure of the future cash flows.
- *Determining the cost of financing:* Figuring out the value of an operation is one thing, but it is another thing to figure out if it's worth financing. There is a cost to investing money, either the opportunity cost of not investing it elsewhere, the cost of borrowing money, or the cost of selling equity. The finance manager uses a number of tools, such as setting the cost of capital (the cost of money over time, which will be explored in further depth later on) to determine the cost of financing.
- *Ensuring that the business has enough cash:*Businesses need to have enough cash to pay upcoming financial obligations without hoarding assets that could otherwise be invested. This is a delicate dance between short-term and long-term responsibilities.
- *Collaborating:* The finance manager must collaborate across business functions in order to determine how to best allocate and manage assets.

The CFO is the head of the financial department and is responsible for all of the same things as their subordinates, but is also the person who has to sign off that all of the company's financial statements are accurate. They are also responsible for financial planning and record-keeping, as well as financial reporting to higher management.

The financial manager is not just an expert at financial projections. They must also have a grasp of the accounting systems in place and the strategy of the business over the coming years.

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7. Reasons to Study Finance

The study of finance often feels a lot narrower than it really is. There is a lot of talk of issuing bonds or pricing projects which belies how relevant finance is to everyday life, regardless of whether or not you have any desire to work in finance. Finance is relevant to all business functions, the macroeconomy, and personal finances.

Area	Description
Economic Environment	Finance plays an involved role in the health of the overall economy, which impacts everyone, regardless of whether or not they have studied finance. The field of finance explains why the 2008 recession occurred; it is the reason why people care about how the stock market is doing each day; and it articulates why businesses and governments make some of the decisions they do. Finance plays a role in many of the stories in the news every day, which means that those who understand finance have a better grasp on how the events of the world affect them.
Personal Finances	Each person will also have to manage his or her own personal finances. Like corporations, individuals are faced with investment and financing decisions. In order to invest, individuals must be able to do the same projections and valuations as companies in order to determine the best investment for their needs. Individuals cannot sell equity like corporations, but they can choose to either dip into their savings or take out loans. Many take on debt in the form of student loans, mortgages, or through their credit cards; being able to properly compare options to leverage is just as important for individuals as it is for companies.
Business Applications	Of course, finance is an important field of study for those who have a desire to work in finance or accounting. Finance is heavily used in jobs ranging from investment banker to CFO to venture capitalist. However, finance is not segmented from the other functions in business. Every job from marketing to engineering has to be able to manage a budget and make a business case that it should get funding for a project. This is especially true higher up in the organizational hierarchy: managers, directors, and vice presidents need to be able to articulate why their departments should get financial support from the company.

BIG IDEA

Finance is a field of both hard analytical skill and personal judgment. There are set processes and theories for determining which financial option is best, but in the real world, it is rare to have all of the information needed to be absolutely certain about what to do. Finance develops strong analytical skills, but also the degree of finesse required to operate in an environment of uncertainty.

SUMMARY

In this lesson, you **defined finance** as the study of determining value. It is concerned with allocating assets over time in a way that optimizes value. **The fields of finance, economics, and accounting** are business subjects with many similarities and differences; each is a distinct field of study.

The **role of finance in an organization** is to determine how best to maximize shareholder value. **Investment and financing decisions** boil down to how to spend money and how to borrow money. **Functions of corporate finance** include utilizing tools and analysis to make sound financial business decisions. The **role of financial manager** involves being responsible for budgeting, projecting cash flows, and determining how to invest and finance projects.

There are many **reasons to study finance** as it is relevant to all business functions, the macroeconomy, and personal finances.

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