Introduction to financial management

Finance

ASSIGN BUSTER

Define the termsfinanceand financial management, and identify the major sub-areas of finance. Finance is the study of applying specific value to things individuals own to include services used and decisions determined [Finance by Cornett, M. M., Adair, T. A., & Nofsinger J. (2014). M: Finance (2nd ed.)]. In simple words, finance is how much value is attributable to goods and services and the basis of such attribution. Financial management may be defined as the management of the finances of a business or an organization in order to achieve the financial objectives. It includes creation, effective utilization of funds to ensure the smooth functioning of the business. It encompasses planning, administration and controlling. The various sub areas of finance are:

1. Investments – deals with deciding on what kinds of securities/bonds the company can buy. 2. Financial management – management of finances to ensure that the financial objectives are reached 3. Financial institutions and markets – these two sub areas facilitate the raising of capital funds by the company.

“ What are the three basic forms of business ownership? What are the advantages and disadvantages to each” (Cornett, Adair, &Nofsinger, 2014, p. 21)? The three basic forms of business ownership are sole proprietorship, partnership and corporation. A sole proprietorship is where the business is run by a single person. The advantages of this form of ownership are as follows:

•This is the easiest form of business to start
•This is affected least by regulations
•There is no question of share of profits. The owner gets to retain the full

share

•The profits are taxed only once as business income.

The disadvantages of this form of ownership is as follows:

•The life of the company is limited to the life of the owner. There will be no continuity once the owner dies.

•The capital invested in the business is limited to the resources available with the owner. The scope of raising external finance is limited

•The owner undertakes the entire risk of the business

•The liability of the owner is unlimited and may extend to his personal assets also A partnership is that form of business ownership where more than one person work together based on an agreement to share the profits and losses.

The advantages are as follows:

•More than one owner is there in business and hence the risk is shared

•Each partner will contribute capital and hence more capital will be available

•This is also relatively easier to start compared to a corporation

•The income from this type of ownership is taxed once as personal income

The disadvantages of a partnership is as follows:

•The profits are shared between the partners. Hence, when compared to a sole proprietorship there is lesser profits

•Generally, the liability of the partners is unlimited (except in the case of a limited liability)

• It is difficult to transfer ownership

A corporation is a separate legal entity whose transactions and conduct of the business is separate from its owners. Corporations can borrowmoney,

sue and be sued in its own name. The advantages of a corporation are as follows: •The liability is limited to the amount paid on stock by the investor •The corporation has an unlimited life

•There is separation of ownership and management as the corporation is a separate legal entity •Transfer of ownership is easy •As a corporation, it is easier to raise capital from equity and debt market The disadvantages are: •The agency problem arises as there is separation of management and ownership •There is double taxation – the business income is taxed in the hands of the corporate and the dividends is taxed in the hands of the shareholders as dividend income

Define the terms agency relationship and agency problem, and list the three approaches to minimize the conflict of interest resulting from the agency problem. An agency relationship is where a principal hires another person (called an agent) to carry out the work of the principal in a fiduciary capacity.

In case of a corporation, the board of directors who constitute the top management are the agents elected by the principals (stockholders) to carry on the business. An agency problem is where there is a conflict between the agent and principal in terms of functioning and in terms of interest. There are many ways to minimize the conflict of interest. However the three most important are as follows: 1. Ignore the challenge on hand:

This is the least preferred way of resolving the problem. The stakeholders may resolve to ignore the problem on hand. The disadvantage is that the

problem continues to remain a problem and is never solved. In this case, the problem may go out of control. 2. Monitor manager’s action:

The shareholders may monitor the management’s action closely to ensure that the situation is not going out of control. 3. Make manager’s take ownership

By giving the managers a portion in the capital of the company in the form of say ESOP, the manager will also have a moralresponsibilityimposed on him to make decisions and act in the best interests of the company.

" Why is ethical behavior so important in the field of finance" (Cornett, Adair, &Nofsinger, 2014, p. 21)? A corporation is a type of ownership where the management is separated from the ownership. The shareholders are the owners who have invested their money in the form of equity capital. It is the management’s responsibility to spend the money judiciously. Since the management is handling other people’s money, ethical behavior plays a very important role in the field of finance. Some of the many famous financial scandals are: (accounting-degree, 2013) •Waste management scandal:

This is a Houston based company which reported $1. 7 billion fake earnings. •Enron: This was a Houston based commodities, energy and service corporation where the shareholders lost $74 billion dollars. •Worldcom scandal: A telecommunications company inflated the assets by as much as $11 billion. •Tyco: New Jersey based swiss security company where the CEO and CFO stole $150 million and inflated company income by $500 million •Satyam scandal: Indian IT services company falsely boosted revenue by $1. 5 billion " Does the goal of shareholder wealth maximization conflict with

behaving ethically? Explain" (Cornett, Adair, &Nofsinger, 2014, p. 21). The most important goal of management is to ensure that there is maximization of shareholder's wealth.

This means that over a long period of time, the value of the stock has to increase steadily so as to ensure maximum profits to the shareholders. However, there is always a question on whether the maximization goal conflicts with ethics. While the goal of wealth maximization is very important, it should not be done in an unethical way. The affairs of the company has to be conducted in such a way that it adheres to all government regulations, accounting principles and ethical standards. Examples of unethical ways to increase the wealth is window dressing, violating regulations, etc. All these cannot be cited as an excuse to ensure that the goal of maximization is reached.