

# **Topic one, Introduction to Finance for Procurement**

- Definition of finance
- Definition of Finance for Procurement
- Definition of financial management
- Role of financial management
- Scope or financial management decisions
- Financial manager
- Role of financial manager
- Objectives of firms
- Risk return relationship

# Finance

- To Individual, finance is having money
- To government, Finance is the allocation of financial resources over time.
- Financial resources are resources with money value.
- Finance is the art and science of managing money.
- Finance is blood stream of organizations (human resource, marketing, production, etc..).
- Therefore, businesses or individuals needs to manage their finances well for the survival and or success of the business or individual.
- It is the study of institutions, instruments and markets used to transfer money and credit for purposes of making goods and services.

# Institutions

- Establishments that conduct financial transactions such as investments, loans and deposits.
- Financial Intermediaries; these are financial institutions that channel funds from the surplus income units to the deficit income units.
- Examples;
  - 1) Commercial banks (*depository institutions*)
  - 2) Investment banks (*underwriting debt, equity offerings, making markets, facilitating mergers & takeovers, broker for institutional clients*)
  - 3) Insurance companies
  - 4) Pension funds
  - 5) Investment companies (*Corporations or Trusts; include Unit Investment Trusts UITs, Face Amount Certificate Cos, Management Investment Cos*)
  - 6) Brokerages (*Full service and Discount*)
  - 7) Non-Bank Financial Institutions (*S&L, Credit Unions, Shadow banks*)

# Financial Instruments

- These are monetary contracts between parties.
- Business dictionary definition;
- ***A document such as a check , draft, bond, share, bill of exchange, futures or options contract that has a monetary value or represents a legally enforceable (binding) agreement between two or more parties regarding a right to payment of money.***
- International Accounting Standards definition (IAS 32&39)
- ***Any contract that gives right to a financial asset of one entity and financial liability or equity instrument of another entity.***

# Financial Instruments c'tnues...

- Broadly categorized as;
  - 1) Debt instrument (***Banks acceptance, Bills of exchange, Bonds, Certificates of deposits, debentures and promissory notes***)
  - 2) Equity instruments (***stock /share certificates and any other that serve as evidence of right of ownership***)
  - 3) Financial instrument (***promissory note, shares, bonds, cash or any other used to acquire equity or debt capital***)
  - 4) Derivative instruments (***the value of these is dependent on the value and characteristics of the underlying entity***)
  - 5) Foreign exchange instruments.

# Markets

- Financial markets
  - Primary markets and secondary markets
  - Money and capital markets
- Commodity markets
- Real estate markets
- Derivatives markets
- Etc.

# Financial markets

- A financial market is where financial assets are traded/exchanged;
- Spot/cash market is where financial assets are traded for immediate delivery.

## 1) Money markets

- These deal with short-term securities, i.e. securities with maturities of  $0 \leq x \leq 1 \text{ yr}$
- E.g. commercial paper, T-bills

## 2) Capital markets

- These deal with long-term securities, i.e. with maturities  $\geq 1 \text{ yr}$ .

# Primary & Secondary Markets

## 1) Primary Market

- When securities are created and sold for the first time by a deficit income unit, that transaction takes place in the “primary market”.
- Those dealing with financial claims that are newly issued called ***Primary market***.

## 2) Secondary market

- New securities are created in the primary market and are subsequently sold in the “secondary market”.
- Those for exchanging financial claims previously issued called ***Secondary market***

# Financial Management

- Financial management is a generic subject (Real estate finance, corporate finance or business finance, managerial finance).
- Real estate finance is the acquisition of finance for the purchase and or acquisition/construction of real estate properties.
- Corporate/ business finance is concerned with financing businesses or corporations for them to succeed in their operations.
- Managerial finance is the application of financial management tools/skills in decisions making by managers.
- However, these are used interchangeably by different scholars.
- **Finance for Procurement** is sourcing funds for acquisition of raw materials in order to produce desired goods/services or to procure goods/and services.

## **Therefore, financial management is ....**

- A managerial activity that is concerned with planning and controlling of financial resources to achieve firm's objectives.
- Planning deals with how the firm source its finances by identifying the available cheaper sources i.e.
  - Equity(owners' capacity, dividend is earned).
  - Debt (borrowed fund with cost attached-interest rate).
- Controlling looks at the utilization of the available resources.
- Ability to put firm's resources into good use to avoid deficits and surpluses(idle resources) i.e., investing into long and short term opportunities.

# Role of financial management

- **1.Raise fund**, looking for cheaper sources of finance, equity or debt or both (financing mix). This is by determining cost of capital involved and the higher the cost of capital the higher the financial risk.
- Financing mix is the mixture of sources of finance used.
- A risk is the variation in the expected and the actual return.
- Financial risk is the variation in the firm's actual return from the expected one as result of source of finance used.
- **Causes (examples) of financial risk**
  - Interest rate risk
  - Foreign exchange risk
  - Inflation risk
  - Etc..

# Role of financial management c'tnue

- **2. Allocation of resources** (Investment of firm's fund) either into short or long term ventures or both (asset mix).
- Asset mix is appropriation of firm's investment in long and short term assets. There is business risk involved.
- Short term avenues- buying more stocks (raw materials & finished goods), debtors... Long term avenues-buying long term assets, etc....
- Business risk is the variation in the firm's actual return from the expected one as result of nature of the asset/business.
- **Causes (examples of business risk)**
  - Change in taste and preference
  - Competition
  - Political risk
- **3. Risk assessment and management**, identifying, measuring and adjusting.
- **Etc..**

# Financial Management Functions/Scope/Decisional Areas

## 1. The financing decision (financing structure and capital structure)

- Financial structure is the combination of all the sources of finance (debt and equity).
- Financing leverage is the use of long term debt as a source of financing alongside equity funds by a firm.
- Capital structure is a mixture of long term sources of finance (long term debt and equity).
- The goal/end results for this decision is availability of funds to perform firm's activities.

## 2. The capital budgeting decision

- This is the firm's decision to commit its resources into long term assets.
- It determines firm's asset mix and influences the long term capacity for firm to achieve its desired objectives.
- The end result is value addition/creation of more wealth to the shareholders (business owners)

# Decisional Areas c'tnue

## 3. Working capital management decisions or Liquidity decision.

- Firm's decision to invest into current asset in order to be liquid.
- Being liquid means the firm is able to settle its short term obligations as and when they fall like paying for raw materials, utilities bills, salaries for workers for a smooth operations.

## 4. The dividends decision (earnings management decision)

- It involves the firm making a decision on its earnings;
  - Pay all as dividend.
  - Retain all (reinvest).
  - Retain part and pay the balance as dividend.

# Financial Manager

- Financial manager is an individual/entity in charge of the financial health of the firm.
- Is the entity in every firm responsible for shaping the fortune of the firm by efficiently and effectively using the available resources.
- At a strategic level of the firm, e.g. these roles are played by **Finance director, Chief Finance Officer...etc.**
  - i. Raise fund (identification of cheaper source of finances)
  - ii. Allocation of resources into viable avenues.
  - iii. Profit planning.
  - iv. Dealing with financial markets (understanding how financial market works).
  - v. Coordinating with other departments
  - vi. Risk assessment and management.

# Financial manager c'tnue

- At lower level of operation, the financial manager roles are played more often (daily) or routine compare to at a strategic level.

E.g. Bursar, assistant accounting officer, cashier, treasurer ..etc.

- i. Custody of cash balance.
- ii. Receiving and making payments.
- iii. Custody of firm's valuable documents like certificate of policies, insurance policy documents.
- iv. Record keeping and reporting.
- v. Read.

# Objectives of firms-aims or intentions owners wants to achieve

1. **Profit maximization**- primary reason for carrying out the business.

- Profit is the excess of revenues over total cost from operation for a given period of time.

Profits = Total Revenue – Total Cost

- This objective requires a firm to maximize its revenue while minimizing the cost of operations.

## Advantages of Profit maximization

- i. Performance measurement
- ii. Economic survival of firms- reduction in cost
- iii. It can be used in allocation of capital
- iv. Source of finance
- v. Reduces the risk of a business
- vi. End of teacher's contribution

# Disadvantages/Criticism of profit maximization

- i. Ignores TVM
- ii. Ignores risk and uncertainties
- iii. Its meaning is vague
- iv. Conflicts with other stake holders' interest like employees welfare

**2. Wealth maximization-** wealth is the net benefits expected/generated from assets in which the firm have invested in.

$$\text{Wealth max (NPV)} = \sum_{t=1}^n \frac{A}{(1+k)^t} - I_0$$

A – cash flow expected in period t

K - discount rate/factor

$I_0$  - initial cash outflow

t - period over which a firm is expected to receive benefits from an investment

## **Advantages of wealth maximization**

- i. Wealth maximization focuses on cash flows and not accounting profits.
- ii. It takes into account time value of money.
- iii. It considers the objective of other stakeholders by involving all the stakeholders to avoid the agency problem.

## **Disadvantages of wealth maximization**

- i. Creates agency problem arising from owner-management conflict when the managers does not involve the other stakeholders in making the decisions.
- ii. The ultimate aim of the wealth maximization objectives is to maximize the profit.
- iii. Wealth maximization can be activated only with the help of the profitable position of the business concern.
- iv. It is difficult to measure; in other wards wealth is relative from person (business) to person (business).

## **Other Objectives**

- i. Maximization of market share
- ii. Maximization of earnings per share
- iii. Maximization of employee welfare
- iv. Survival in a competitive industry
- v. Corporate Social responsibility
- vi. Others...

# The concept of Risk and Return Relationship

- Risk refers to the likelihood that an actual return from an investment may be different from the expected return.
- Returns refers to the expected benefits from an investment in form of interest, dividend or increase in stock price.
- The risk-return trade-off states that a rational investor when choosing between two or more projects that give the same expected return will prefer the less risky one.
- The concept of risk and return is grounded on the assumption that an investment associated with low level of risk is likely to generate low level of returns while investments associated with high level of risk is likely to generate higher returns

# Risk Return trade off

Expected returns

