Principles and Applications of Financial Management

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Published by: Bit & Oracle Press, 2025

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"Financial Management Principles and Applications" is a fundamental concept in the world of finance that plays a crucial role in the success of businesses and individuals alike. At its core, financial management involves the efficient and effective allocation of resources, particularly funds, to achieve the goals and objectives of an organization or an individual. This discipline encompasses a wide range of activities, including budgeting, financial planning, investment analysis, risk management, and capital allocation. It is essential for businesses to make sound financial decisions to maximize profits and shareholder value, while individuals benefit from financial management principles to ensure their long-term financial security and achieve their financial aspirations. In this dynamic and ever-changing field, understanding the principles and applications of financial management is vital for making informed decisions in a complex and interconnected global economy. Whether you are a business leader looking to optimize your company's financial performance or an individual striving for financial well-being, the principles and applications of financial management serve as a valuable guide in navigating the intricate world of finance.

Finance

Finance is the study of how people and businesses evaluate investments and raise capital to fund them. Our interpretation of an investment is quite broad. In 2016, when Fitbit introduced the Fitbit Blaze, an activity-focused smartwatch, it was clearly making a long-term investment. “The firm had to devote considerable expense to designing, producing, and marketing the smartwatch with the hope that it would eventually capture a sufficient amount of market share from the Apple Watch and Android Wear smartwatch to make the investment worthwhile. But Fitbit also makes an investment decision whenever it hires a fresh new graduate, knowing that it will be paying a salary for at least six months before the employee will have much to contribute.

Thus, three basic questions are addressed by the study of finance:

1. What long-term investments should the firm undertake? This area of finance is generally referred to as **capital budgeting**.

2. How should the firm raise money to fund these investments? The firm's funding choices are generally referred to as **capital structure** decisions.

3. How can the firm best manage its cash flows as they arise in its day-to-day operations?

This area of finance is generally referred to as **working capital management**.

We'll be looking at each of these three areas of business finance—capital budgeting, capital structure, and working capital management—in the chapters ahead.

Why Study Finance?

Even if you are not planning a career in finance, a working knowledge of finance will take you far in both your personal and your professional lives. Those interested in management will need to study topics such as strategic planning, personnel, organizational behavior, and human relations, all of which involve spending money today in the hope of generating more money in the future. For example, in 2016 GM made a strategic decision to invest $500 million in Lyft, the ride-hailing start-up. GM and Lyft have joined together to develop a network of self-driving cars that riders can call up on demand, and in the short run, GM will provide cars to Lyft drivers through short-term rentals in key U.S. cities. To say the least, this was a major strategic decision that will impact both GM andLyft for many years. Similarly, marketing majors will need to understand how to price products, when to price them aggressively, and how much to spend on advertising them. Because aggressive marketing costs money today but generates rewards in the future, it should be viewed as an investment that the firm needs to finance. Production and operations management majors will need to understand how best to manage a firm's production and control its inventory and supply chain. All these topics involve risky choices that relate to the management of money over time, which is the central focus of finance.

Although finance is primarily about the management of money, a key component of finance is the management and interpretation of information. Indeed, if you pursue a career in management information systems or accounting, finance managers are likely to be your most important clients. For the student with entrepreneurial aspirations, an understanding of finance is essential— after all, if you can't manage your finances, you won't be in business very long. Finally, an understanding of finance is important to you as an individual. The fact that you are reading this book indicates that you understand the importance of investing in yourself. By obtaining a college degree, you are clearly making sacrifices in the hope of making yourself more employable and improving your chances of having a rewarding and challenging career.

Some of you are relying on your own earnings and the earnings of your parents to finance your education, whereas others are raising money or borrowing it from the **financial markets**, institutions that facilitate financial transactions. Financial decisions are everywhere, both in your personal life and in your career. Although the primary focus of this book is on developing the corporate finance tools and techniques that are used in the business world, you will find that much of the logic and many of the tools we develop and explore along the way will also apply to decisions you will be making in your personal life. In the future, both your business and your personal lives will be spent in the world of finance. Because you're going to be living in that world, it's time to learn about its basic principles.

We will take an in-depth look at these principles at the end of this chapter. As you will see, you do not need an extensive knowledge of finance to understand these principles, and, once you know and understand them, they will help you understand the rest of the concepts presented in this book. When you are looking at more complex financial concepts, think of these principles as taking you back to the roots of finance.

Three Types of Business Organizations

Although numerous and diverse, the legal forms of business organization fall into three categories: the sole proprietorship, the partnership, and the corporation. provides a quick reference guide for these organizational forms.

Sole Proprietorship

The **sole proprietorship** is a business owned by a single individual who is entitled to all of the firm's profits and who is also responsible for all of the firm's **debt**—that is, what the firm owes. In effect, there is no separation between the business and the owner when it comes to being liable for debts or being sued. If sole proprietors are sued, they can lose not only all they invested in the proprietorship but also all their personal assets. A sole proprietorship is often used in the initial stages of a firm's life. This is in part because forming a sole proprietorship is very easy; there are no forms to file and no partners to consult—the founder of the business is the sole owner. However, these organizations usually have limited access to outside sources of financing. The owner of a sole proprietorship typically raises money by investing his or her own funds and by borrowing from a bank. However, because there is no difference between the sole proprietor and the business, there is no difference between personal borrowing and business borrowing. The owner of the business is personally liable for the debts of that business while profits are taxed at the owner's tax rate. In addition to bank loans, personal loans from friends and family are important sources of financing for sole proprietorships.

Partnership

A **general partnership** is an association of two or more persons who come together as co-owners for the purpose of operating a business for profit. Just as with the sole proprietorship, there is no separation between the general partnership and its owners with respect to being liable for debts or being sued. Its primary point of distinction from a sole proprietorship is that the **partnership** has more than one owner. Just like with a sole proprietorship, the profits of the partnership are taxed as personal income. An important advantage of the partnership is that it provides access to **equity**, or ownership, as well as financing from multiple owners in return for partnership **shares**, or units of ownership.

In a **limited partnership**, there are two classes of partners: general and limited. The **general partner** actually runs the business and faces unlimited liability for the firm's debts, whereas the **limited partner** is liable only up to the amount the limited partner invested. The life of the partnership is tied to the life of the general partner, just as that of the sole proprietorship is tied to the life of the owner. In addition, it is difficult to transfer ownership of the general partner's interest in the business—this generally requires the formation of a new partnership. However, the limited partner's shares can be transferred to another owner without the need to dissolve the partnership, although finding a buyer may be difficult.

Corporation

If very large sums of money are needed to build a business, then the typical organizational form chosen is the **corporation**. As early as 1819, U.S. Supreme Court Chief Justice John Marshall set forth the legal definition of a corporation as an artificial being, invisible, intangible, and existing only in the contemplation of law. The corporation legally functions separately and apart from its owners (the **shareholders**, also referred to as the **stockholders**). As such, the corporation can individually sue and be sued and can purchase, sell, or own property, and its personnel are subject to criminal punishment for crimes committed in the name of the corporation.

There are three primary advantages of this separate legal status. First, the owners' liability is confined to the amount of their investment in the company. In other words, if the corporation goes under, the owners can lose only their investment. This is an extremely important advantage of a corporation. After all, would you be willing to invest in American Airlines if you would be held personally liable if one of its planes crashed? The second advantage of separate legal status for the corporation is that the life of the business is not tied to the status of the investors. The death or withdrawal of an investor does not affect the continuity of the corporation. The management continues to run the corporation when the ownership shares are sold or passed on through inheritance. For example, the inventor Thomas Edison founded General Electric (GE) over a century ago. Edison died in 1931, but the corporation lives on. Finally, these two advantages result in a third advantage, the ease of raising capital.

It is much easier to convince investors to put their money in a corporation when they know that the most they can lose is what they invest and that they can easily sell their stock if they wish to do so.

The corporation is legally owned by its current set of stockholders, or owners, who elect a board of directors. The directors then appoint managers who are responsible for determining the firm's direction and policies. Although even very small firms can be organized as corporations, it is usually the larger firms that need to raise large sums of money for investment and expansion that use this organizational form. As such, this is the legal form of business that we will be examining most frequently in this textbook.

One of the drawbacks of the corporate form is the double taxation of earnings that are paid out in the form of **dividends**. When a corporation earns a profit, it pays taxes on that profit (the first taxation of earnings) and pays some of that profit back to the shareholders in the form of dividends. Then the shareholders pay personal income taxes on those dividends (the second taxation of earnings). In contrast, the earnings of proprietorships and partnerships are not subject to double taxation. Needless to say, this is a major disadvantage of corporations.

Business Form	Number of Owners	Are Owners Liable for the Firm's Debts?	Do Owners Manage the Firm?	Does an Ownership Change Dissolve the Firm?	Access to Capital	Taxation
Sole Proprietorship	One	Yes	Yes	Yes	Very limited	Personal Taxes
Partnership	Unlimited	Yes; each partner has unlimited liability	Yes	Yes	Very limited	Personal Taxes
Limited Partnership (with General Partners [GPs] and Limited Partners [LPs])	At least one GP, but no limit on LPs	GPs—unlimited liability LPs—limited liability	GPs—manage the firm LPs—no role in management	GPs—yes LPs—no, can change[1]	Limited	Personal Taxes
Limited Liability Company (LLC)	Unlimited	No	Yes	No	Dependent on size	Personal Taxes
Corporation	Unlimited	No	No—although managers generally have an ownership stake[2]	No	Very easy access	Double Taxation: Earnings taxed at corporate level Dividends taxed at personal level

It is common for LPs to require approval from the other partners before a partner's ownership can be transferred.

Owners are not prohibited from managing the corporation

When entrepreneurs and small business owners want to expand, they face a trade-off between the benefits of the corporate form and the potential loss of control and higher taxes that accompany it. For this reason, an attractive alternative to the corporation for such a small business is the **limited liability company (LLC)**, a cross between a partnership and a corporation. An LLC combines the tax benefits of a partnership (no double taxation of earnings) with the limited liability benefit of a corporation (the owners' liability is limited to what they invested).3 Thus, unlike with a proprietorship or partnership, there is a separation between the LLC and the owners with respect to being liable for debts or being sued. As a result, the most an LLC owner can lose is what he or she invested. Because LLCs operate under state laws, both the states and the Internal Revenue Service (IRS) have rules for what qualifies as an LLC, and different states have different rules. The bottom line is that if an LLC looks too much like a corporation, it will be taxed as one. As you can see in the corporation is the business form that provides the easiest access to capital. As a result, it is the most common choice for firms that are growing and need to raise money".

The Goal of the Financial Manager

In 2001, Tony Fadell turned to Apple, Inc. (AAPL), to develop his idea for a new MP3 player. Fadell's idea had already been rejected by his previous employer and another company, but the executives at Apple were enthusiastic about it. They hired Fadell, and the rest is history.

The successful sales of the new iPod MP3 player, coupled with efficient uses of financing and day-to-day funding, raised the firm's stock price. This exemplifies how a management team appointed by a corporate board made an important investment decision that had a very positive effect on the firm's total value.

As previously mentioned, we can characterize the financial activities of a firm's management in terms of three important functions within a firm. "These are illustrated here using Apple's iPod example:

• Making investment decisions (capital budgeting decisions): Apple's decision to introduce the iPod, which later led to the iPhone.

• Making decisions on how to finance these investments (capital structure decisions): Apple's decision on how to finance the development and production of the iPod and eventually the iPhone.

• Making decisions on how best to manage the company's day-to-day operations (working capital management): Apple's decision regarding how much inventory to hold.

In carrying out these tasks, financial managers must be aware that they are ultimately working for the firm's shareholders, who are the owners of the firm, and that the choices they make as financial managers will generally have a direct impact on their shareholders' wealth.

Maximizing Shareholder Wealth

With a publicly owned corporation such as Coca-Cola (KO), the shareholders who purchase stock in the company elect a board of directors that, among other duties, selects the company's CEO. These shareholders, ranging from individuals who purchase stock for a retirement fund to large financial institutions, have a vested interest in the company. Because they are the company's true owners, that company will commonly have a principal goal described as maximizing shareholder wealth, which is achieved by maximizing the stock price.

With all this in mind, let's take a look at Coca-Cola's vision statement. While maximization of shareholder wealth is included, it is surrounded by other goals that range from sustainable growth to being responsible. It also aims Coca-Cola's efforts toward creating a caring workplace and taking care of its customers. Clearly, Coca-Cola goes well beyond the traditional goal of maximization of shareholder wealth, but each of these goals plays a part in creating a successful business, which in turn should be beneficial to the shareholder in the long run. Now let's examine Google, Inc. (GOOG). For years, Google stated on the corporate portion of its website that its goal was to develop services that significantly improve the lives of as many people as possible, and its first motto was simply Don't be evil. When Google restructured under the conglomerate Alphabet, Inc., its motto became Do the right thing. Does this mean that Google—or Alphabet, as it is now called—doesn't care about money or the firm's owners (stockholders)? For the sake of all Alphabet stockholders, we certainly hope not. After all, why do you buy stock in a company in the first place? You do it in the hope of making money, right? It's nice to be altruistic and make the world a better place, but in reality, companies had better earn money if they expect banks to continue to loan them money and stockholders to continue to buy their shares.

Alphabet apparently believes both goals are possible: The company says that in addition to making the world a better place, it will optimize for the long-term rather than trying to produce smooth earnings for each quarter. We believe, as Alphabet does, that maximizing the wealth of your shareholders and doing the right thing can go hand in hand. Think of this goal not as moving *away* from creating wealth for shareholders but as moving *toward* what will truly increase the value of their shares in the long term. As we explain the concepts in this book, we will assume that businesses don't act out of greed to get rich quick and that they try to maximize the wealth of their shareholders by making decisions that have long-term positive effects. Very simply, managers can't afford to ignore the fact that shareholders want to see the value of their investments rise—they will sell their shares if it doesn't. This, in turn, will cause the company's share price to fall, jeopardizing the managers' jobs if they are seen to have an excessively short-term focus.

Ethical Considerations in Corporate Finance

Although ethics is not one of the five principles of finance, it is fundamental to the notion of trust and is therefore essential to doing business. The problem is that in order to cooperate, business participants have to rely on one another's willingness to act fairly. Although businesses frequently try to describe the rights and obligations of their dealings with others using contracts, it is impossible to write a perfect contract. Consequently, business dealings between people and firms ultimately depend on the willingness of the parties to trust one another.

Ethics, or a lack thereof, is a recurring theme in the news. Recently, finance has been home to an almost continuous series of ethical lapses. Financial scandals at companies such as Enron and WorldCom, Bernie Madoff's Ponzi scheme that cost investors billions of dollars, and the mishandling of depositor money by financial institutions such as Sanford Financial show that the business world does not forgive ethical lapses. Not only is acting in an ethical manner morally correct, but also it is a necessary ingredient of long-term business and personal success.

You might ask yourself, As long as I'm not breaking society's laws, why should I care about ethics? The answer to this question lies in consequences. Everyone makes errors of judgment in business, which is to be expected in an uncertain world. But ethical errors are different. Even if they don't result in anyone going to jail, they tend to end careers and thereby terminate future opportunities. Why? Because unethical behaviour destroys trust, and businesses cannot function without a certain degree of trust. Throughout this book, we will point out some of the ethical pitfalls that have tripped up managers.

The Five Basic Principles of Finance

At first glance, finance can seem like a collection of unrelated decision rules. Nothing could be further from the truth. The logic behind the financial concepts covered in this textbook arises from five simple financial principles, each of which is described next.

Money Has a Time Value

A dollar received today is worth more than a dollar received in the future. Conversely, a dollar received in the future is worth less than a dollar received today. Perhaps the most fundamental principle of finance is that money has a time value. A dollar received today is more valuable than a dollar received one year from now. That is, we can invest the dollar we have today to earn interest so that at the end of one year we will have more than one dollar.

Because we can earn interest on money received today, it is better to receive money sooner rather than later. For example, suppose you have a choice of receiving $1,000 either today or a year from now. If you decide to receive it a year from now, you will have passed up the opportunity to earn a year's interest on the money. Economists would say you suffered an opportunity loss or an **opportunity cost**.

There Is a Risk-Return Tradeoff

We won't take on additional risk unless we expect to be compensated with additional return. Principle 2 is based on the idea that individuals are risk-averse, which means that they prefer to get a certain return on their investment rather than an uncertain return. However, the world is an inherently risky place, so at least some individuals will have to make investments that are risky. How are investors induced to hold these risky investments when there are safer alternative investments? By offering investors a higher *expected* rate of return on the riskier, investments.

Notice that we refer to *expected* return rather than *actual* return. As investors, we have expectations about what returns our investments will earn; however, a higher expected rate of return is not always a higher realized rate of return. For example, you may have thought Netflix (NFLX) would do well in 2015, but did you really expect it would return 139.2 percent? On the other hand, not many people who invested in Chesapeake Energy (CHK), the oil and gas producer, expected its actual return for 2015 to be –77.9 percent; if they had, they wouldn't have invested in it.,The risk-return relationship will be a key concept as we value assets and propose new investment projects throughout this text. We will also describe how investors measure risk. Interestingly, much of the work for which the 1990 Nobel Prize in Economics was awarded centered on the graph shown in 1.3 and how to measure risk. Both the graph and the risk-return relationship it depicts will reappear often in this text.

Cash Flows Are the Source of Value

Profit is an accounting concept designed to measure a business's performance over an interval of time. Cash flow is the amount of cash that can actually be taken out of the business over this same interval. You may recall from your accounting classes that a company's profits can differ dramatically from its cash flows. Cash flows represent actual money that can be spent, and, as we will later discuss, they are what determines an investment's value. Profits are different. To determine a company's accounting profit, its accountants have to make a judgment about how the business's costs and revenues are allocated to each time period. Consequently, different judgments result in different profit measurements. In fact, a firm can show a profit on paper even when it is generating no cash at all. This isn't to say that accounting profits are unimportant to investors. Investors see accounting profits as an important indicator of a firm's ability in the past—and perhaps in the future—to produce cash flows for its investors. Therefore, to the extent that profits affect investors' expectations, they mare an important source of information.

There is another important point we need to make about cash flows. Recall from your economics classes that people make the best choices when they look at marginal, or *incremental,* cash flows. That's why in this book we focus on the incremental cash flow to the company as a whole that is produced as a consequence of a decision. The incremental cash flow to the company as a whole is the difference between the cash flow to the company that would be produced with the potential new investment and the cash flow that would be produced without that investment. To understand this concept, let's think about the incremental cash flow produced by *Star Wars: The Force Awakens*. Not only did Disney make a lot of money on this movie, but also, once Disney finishes Star Wars Land, this movie will increase the number of people attracted to Disney theme parks, along with resulting in sales of all kinds of Star Wars items. Thus, if you were to evaluate *Star Wars: The Force Awakens*, you'd want to include its impact on sales of Star Wars T-shirts, lightsabers, action s, and all Star Wars related mitems throughout the entire company.

Market Prices Reflect Information

Investors respond to new information by buying and selling their investments. The speed with which investors act and the way that prices respond to the information determine the efficiency of the market. The prices of financial claims traded in the public financial markets respond rapidly to the release of new information. Thus, when earnings reports come out, prices adjust immediately to the new information, moving upward if the information is better than expected and downward if it is worse than expected. In efficient markets, such as those that exist in the United States and other developed countries, this process takes place *very* quickly.

As a result, it's hard to profit from trading on publicly released information. To illustrate how quickly stock prices can react to information, consider the following set of events: While Nike (NKE) CEO William Perez flew aboard the company's Gulfstream jet one day in November 2005, traders on the ground sold off a significant amount of Nike's stock. Why? Because the plane's landing gear was malfunctioning, and they were watching TV coverage of the event! While Perez was still in the air, Nike's stock dropped 1.4 percent. Once Perez's plane landed safely, Nike's stock price immediately bounced back. This example illustrates that in the financial markets there are ever-vigilant investors who are looking to act even *in anticipation of* the release of new information. Consequently, managers can expect their company's share prices to respond quickly to the decisions they make. Good decisions will result in higher stock prices. Bad decisions will result in lower stock prices.

Individuals Respond to Incentives

Incentives motivate, and the actions of managers are often motivated by self-interest, which may result in managers not acting in the best interests of the firm's owners. When this happens the firm's owners will lose value. Managers respond to the incentives they are given in the workplace, and, when their incentives are not properly aligned with those of the firm's stockholders, they may not make decisions that are consistent with increasing shareholder value. For example, a manager may be in a position to evaluate an acquisition that happens to be owned by his brother-inlaw. Other situations are much less straightforward. For example, a financial manager may be asked to decide whether or not to close a money-losing plant, a decision that, although saving money for the firm, will involve the personally painful act of firing the employees at the plant.

The conflict of interest between the firm's managers and its stockholders is called a *principal-agent problem*, or **agency problem**, in which the firm's common stockholders, the owners of the firm, are the principals in the relationship and the managers act as agents of these owners. If the managers have little or no ownership in the firm, they have less incentive to work energetically for the company's shareholders and may instead choose to enrich themselves with perks and other financial benefits—say, luxury corporate jets, expensive corporate apartments, or resort vacations. They also have an incentive to turn down risky investments that may jeopardize their jobs—even though their shareholders would like the company to pursue these projects. The lost shareholder value that results from managerial actions that are inconsistent with the goal of maximizing shareholder value is called an *agency cost*.

Agency problems also arise when the firm's executives are considering how to raise money to finance the firm's investments. In some situations, debt may be the cheapest source of financing, but managers may avoid debt financing because they fear the loss of their jobs if the firm is unable to pay its bills. Stockholders, on the other hand, might prefer that the firm use more debt financing because it puts pressure on management to perform at a high level. Agency costs are typically difficult to measure, but occasionally their effect on the firm's stock price can be seen. For example, upon the announcement of the death of Roy Farmer, the CEO of Farmer Brothers (FARM), a seller of coffee-related products, the firm's stock price rose about 28 percent. Many attributed the rise in price to the perceived benefits of removing a CEO who was not acting in accordance with general stockholder interests. Fortunately, there are several measures that can be taken to help mitigate the agency problem:

- Compensation plans can be put in place that reward managers when they act to maximize shareholder wealth.
- The board of directors can actively monitor the actions of managers and keep pressure on them to act in the best interests of shareholders.
- The financial markets can (and do) play a role in monitoring management by having auditors, bankers, and credit agencies monitor the firm's performance, while security analysts provide and disseminate information on how well the firm is doing, thereby helping shareholders monitor the firm.
- Firms that underperform will see their stock prices fall and may be taken over and have their management teams replaced.

To see the power of incentives, consider the case of football player Edgerrin James, a running back for the Indianapolis Colts for a number of years. While playing in a game against Detroit, he was told by his coach to get a first down and then fall down and run out the clock. That way the Colts wouldn't be accused of running up the score against a team they were already beating badly. However, because James's contract included incentive payments associated with rushing yards and touchdowns, he acted in his own self-interest and ran for a touchdown on the very next play. Following the play, he commented, I heard the cash register ringing the whole way.

Finance and the firm

The field of finance is broad and dynamic. Finance influences everything that firms do, from hiring personnel to building factories to launching new advertising campaigns. Because there are important financial dimensions to almost any aspects of business, there are many financially oriented careers opportunities for those who understand the basic principles of finance described in this textbook. Even if you do not see yourself pursuing a career in finance, you will find that an understanding of a few key ideas in finance will help make you a smarter consumer and a wiser investor with our own money".

Career opportunities in finance

Careers in finance typically fall into one of two broad categories: (1) financial services, and (2) managerial finance. Workers in both areas rely on a common analytical 'tool kit,' but the types of problems to which that tool kit is applied vary a great deal from one career path to the other.

Financial services are an area of finance concerned with the design and delivery of advice and financial products to individuals, businesses, and governments. It involves a variety of interesting career opportunities within the areas of banking, personal financial planning, investments, real estate, and insurance.

Managerial finance is concerned with the duties of the *financial manager* working in a business.

Financial managers administer the financial affairs of all types of businesses – private and public, large and small, profit-seeking and not for profit. They perform such varied tasks as developing a financial plan or budget, extending credit to customers, evaluating proposed large expenditures, and raising money to fund the firm's operations. In recent years, several factors have increased the importance and complexity of the financial manager's duties. These factors include the recent global financial crisis and subsequent responses by regulators, increased competition, and technological change. For example, globalisation has led US companies to increase their transactions in other countries, and foreign companies have done likewise in the United States. These changes increase the demand for financial experts who can manage cash flows in different currencies and protect against the risks that arise from international transactions. These changes increase the finance functions' complexity, but they also create opportunities for a more rewarding career. The increasing complexity of the financial manager's duties has increased the popularity of a variety of professional certification programmes outlined in the *Focus on practice* section below. Financial managers today actively develop and implement corporate strategies aimed at helping the firm grow and improving its competitive position. As a result, many corporate chief executive officers (CEOs) rose to the top of their organisations by first demonstrating excellence in the finance function. For instance, in South Africa 25 percent of directors of the top 200 companies on the JSE Limited are Chartered Accountants (CAs); 90 percent of CFOs of these top 200 companies are CAs, and 22 percent of the CEOs of the top 40 companies on the JSE are CAs.

Legal forms of business organisation

One of the most basic decisions that all businesses confront is how to choose a legal form of organisation. This decision has important financial implications because how a business is organised legally, influences the risks that the firm's owners must bear, how the firm can raise money, and how the firm's profits will be taxed. "The three most common legal forms of business organisation are the *sole proprietorship*, the *partnership*, and the *company*. More businesses are organised as sole proprietorships than any other legal form. However, the largest businesses are almost always organised as companies. Even so, each type of organisation has its advantages and disadvantages.

Sole proprietorships

A **sole proprietorship** is a business owned by one person who operates it for his/her profit. The typical sole proprietorship is small, such as a bike shop, personal trainer, or plumber – most sole proprietorships operating in the wholesale, retail, service, and construction industries.

Typically, the owner (proprietor), along with a few employees, operates the proprietorship. The proprietor raises capital from personal resources or by borrowing, and he/she is responsible for all business decisions. As a result, this form of organisation appeals to entrepreneurs who enjoy working independently. A major drawback to the sole proprietorship is **unlimited liability**, which means that liabilities of the business are the entrepreneur's responsibility, and creditors can make claims against the entrepreneur's assets if the business fails to pay its debts.

Managerial finance?

An understanding of the concepts, techniques, and practices presented throughout this text will fully acquaint you with the financial manager's activities and decisions. Because the consequences of most business decisions are measured in financial terms, the financial manager plays a key operational role. People in all areas of responsibility – accounting, information systems, management, marketing, operations, and so forth – need a basic awareness of finance so that they will understand how to quantify the consequences of their actions. Even if you are not planning to major in finance, you still will need to understand how financial managers think to improve your chance of success in your chosen career. Managers in the firm, regardless of their job descriptions, usually have to provide financial justification for the resources they need to do their job. Whether you are hiring new workers, negotiating an advertising budget, or upgrading the technology used in a manufacturing process, understanding the financial aspects of your actions will help you gain the resources you need to be successful. The 'Why this chapter matters to you' section that appears on each chapter opening page should help you understand the importance of each chapter in both your professional and personal life.

Goal of the firm

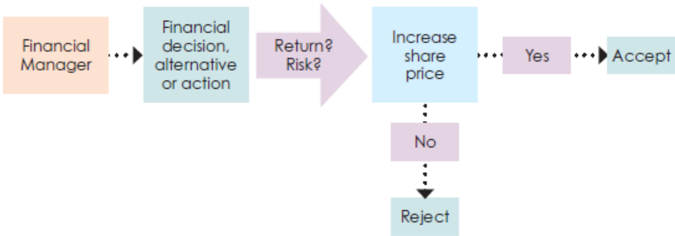
What goal should managers pursue? There is no shortage of possible answers to this question. Some might argue that managers should focus entirely on satisfying customers. Progress toward this goal could be measured by the market share attained by each of the firm's products. Others suggest that managers must first inspire and motivate employees; in that case, employee turnover might be the key success metric to watch. The goal that managers select will affect many of the decisions that they make, so choosing an objective is a critical determinant of how business should operate.

Maximise shareholder wealth

Finance teaches that a manager's primary goal should be to maximise the wealth of the firm's owners – the shareholders. The simplest and best measure of shareholder wealth is the firm's share price, so most textbooks (ours included) instruct managers to take actions that increase the firm's share price. A common misconception is that when firms strive to make their shareholders happy, they do so at the expense of other stakeholders such as customers, employees, or suppliers.

This line of thinking ignores the fact that in most cases, to enrich shareholders, managers must first satisfy the demands of these other interest groups. Recall that dividends that shareholders receive ultimately come from the firm's profits. It is unlikely that a firm whose customers are unhappy with it products, or whose employees are looking for jobs at other firms, or whose suppliers are reluctant to ship raw materials will make shareholders rich because such a firm will likely be less profitable in the long run than one that better manages its relations with these stakeholder groups. Therefore, we argue that the goal of the firm, and managers, should be to *maximise the wealth of the owners for whom it is being operated*, or equivalently, to maximise the share price.

This goal translates into a straightforward decision rule for managers – *only take actions that are expected to increase the share price.* Although that goal sounds simple, implementing it is not always easy. To determine whether a course of action will increase or decrease a firm's share price, managers have to assess what return (that is, cash inflows net of cash outflows) the action will bring, and how risky that return might be. 1.2 depicts this process. We can say that *the key variables that managers must consider when making business decisions are returns (cash flows) and risk*.



Share price maximisation. Financial decisions and share price.

Maximise profit

It might seem intuitive that maximising a firm's share price is equivalent to maximising its profits, but that is not always correct.

Companies commonly measure profits in terms of **earnings per share (EPS)**, which represents the amount earned during the period on behalf of each outstanding ordinary share. EPS are calculated by dividing the period's total earnings available for the firm's ordinary shareholders by the number of ordinary shares outstanding.

The profit that a firm report is simply an estimate of how it is doing, an estimate that is influenced by many different accounting choices that firms make when assembling their financial reports. Cash flow is a more straightforward measure of the money flowing into and out of the company. Companies have to pay their bills with cash, not earnings, so cash flow is what matters most to financial managers. Thirdly, risk matters a great deal. A firm that earns a low but reliable profit might be more valuable than another firm with profits that fluctuate a great deal (and therefore can be extremely high or exceptionally low at different times)”.

Timing

Because the firm can earn a return on funds it receives, *the receipt of funds sooner rather than later is preferred*. In our example, although the total earnings from Rotor are smaller than those from Valve, Rotor provides much greater earnings per share in the first year. The larger returns in year 1 could be reinvested to provide greater future earnings.

Cash flows

Profits do not necessarily result in cash flows available to the shareholders. There is no guarantee that the Board of directors will increase dividends when profits increase. In addition, the accounting assumptions, and techniques that a firm adopts, can sometimes allow a firm to show a positive profit even when its cash outflows exceed its cash inflows. Furthermore, higher earnings do not necessarily translate into a higher share price. Only when earnings’ increases are accompanied by increased future cash flows is a higher share price expected. For example, a firm with a high-quality product sold in a competitive market could increase its earnings by significantly reducing its equipment maintenance expenditures. The firm’s expenses would be reduced, thereby increasing its profits. But if the reduced maintenance results in lower product quality, the firm may impair its competitive position, and its share price could drop as many well-informed investors sell the share in anticipation of lower future cash flows. In this case, the earnings increase was accompanied by lower future cash flows, and therefore a lower share price.

Risk

Profit maximisation also fails to account for **risk** – the chance that actual outcomes may differ from those expected. A basic premise in managerial finance is that a trade-off exists between return (cash flow) and risk. *Return and risk are, in fact, the key determinants of share price, which represents the wealth of the owners in the firm.* Profit maximisation also fails to account for risk – the chance that actual outcomes may differ from those expected. A basic premise in managerial finance is that a trade-off exists between return (cash flow) and risk. Return and risk are, in fact, the key determinants of share price, which represents the wealth of the owners in the firm. Cash flow and risk affect share price differently: Holding risk fixed, higher cash flow is generally associated with a higher share price. In contrast, holding cash flow fixed, higher risk tends to result in a lower share price because the shareholders do not like risk. For example, when Apple's late CEO, Steve Jobs, took a leave of absence to battle a serious health issue, the firm's share suffered as a result. This occurred not because of any near-term cash flow reduction but in response to the firm's increased risk –there was a chance that the firm's lack of near-term leadership could result in reduced future cash flows. Simply put, the increased risk reduced the firm's share price. In general, shareholders are **risk-averse** – that is, they must be compensated for bearing risk. In other words, investors expect to earn higher returns on riskier investments, and they will accept lower returns on relatively safe investments. The key point, which will be fully developed in, is that differences in risk can significantly affect the value of different investments.

The role of business ethics

Business ethics are the standards of conduct or moral judgement that apply to persons engaged in commerce. Violations of these standards in finance involve a variety of actions: 'creative accounting', earnings management, misleading financial forecasts, insider trading, fraud, excessive executive compensation, options backdating, bribery, and kickbacks. The financial press has reported many such violations in recent years, involving well-known South African companies, such as Eskom, Tongat- Hullet, Masterbond and Macmed. As a result, the financial community is developing and enforcing ethical standards. The goal of these ethical standards is to motivate business and market participants to adhere to both the letter and the spirit of laws and regulations concerned with business and professional practice. Most business leaders believe businesses strengthen their competitive positions by maintaining high ethical standards.

Considering ethics

Robert A. Cooke, a noted ethicist, suggests that the following questions be used to assess the ethical viability of proposed action:1

1. Is the action arbitrary or capricious? Does it unfairly single out an individual or group?
2. Does the action violate the moral or legal rights of any individual or group?
3. Does the action conform to accepted moral standards?
4. Are there alternative courses of action that are less likely to cause actual or potential harm?

Considering such questions before acting can help to ensure its ethical viability. Today, many firms are addressing the issue of ethics by establishing corporate ethics policies. To promote ethical business practices in South Africa, Business Unity South Africa, an association of organised business in the country, promulgated the South African Charter of Ethical Business Practice that has set aspirational standards. Frequently, employees are required to sign a formal pledge to uphold the firm's ethics policies. Such policies typically apply to employee actions in dealing with all corporate stakeholders, including the public. "The *Focus on ethics* box provides an example of another aspect of ethical behaviour, namely, social responsibility in South Africa.

Managerial finance function

People in all areas of responsibility within the firm must interact with finance personnel and procedures to get their jobs done. For financial personnel to make useful forecasts and decisions, they must be willing and able to talk to individuals in other areas of the firm. For example, when considering a new product, the financial manager needs to obtain sales forecasts, pricing guidelines, and advertising and promotion budget estimates from marketing personnel The managerial finance function can be broadly described by considering its role within the organisation, its relationship to economics and accounting, and the primary activities of the financial manager.

Organisation of the finance function

The size and importance of the managerial finance function depend on the size of the firm. In small firms, the finance function is generally performed by the accounting department. As a firm grows, the finance function typically evolves into a separate department linked directly to the company managing director or CEO through the chief financial officer (CFO). The lower portion of the organisational chart in on shows the structure of the finance function in a typical medium- to large-size firm. Reporting to the CFO are the treasurer and the controller. The **treasurer** (the chief financial manager) typically manages the firm's cash, investing surplus funds when available and securing outside financing when needed. The treasurer also oversees a firm's pension plans and manages critical risks related to movements in foreign currency values, interest rates, and commodity prices. The **controller** (the chief accountant) typically handles the accounting activities, such as corporate accounting, tax management, financial accounting, and cost accounting. The treasurer's focus tends to be more external, whereas the controller's focus is more internal. If international sales or purchases are important to a firm, it may well employ one or more finance professionals whose job is to monitor and manage the firm's exposure to loss from currency fluctuations. A trained financial manager can 'hedge', or protect against such a loss, at a reasonable cost by using a variety of financial instruments. These foreign exchange managers typically report to the firm's treasurer.

Relationship to economics

The field of finance is closely related to economics. Financial managers must understand the economic framework and be alert to the consequences of varying levels of economic activity and changes in economic policy. They must also be able to use economic theories as guidelines for efficient business operation. Examples include supply-and-demand analysis, profit-maximising strategies, and price theory. The primary economic principle used in managerial finance is marginal cost-benefit analysis, the principle that financial decisions should be made, and actions taken only when the added benefits exceed the added costs. Nearly all financial decisions ultimately come down to an assessment of their marginal benefits and marginal costs.

Relationship to accounting

The firm's finance and accounting activities are closely related and generally overlap. In small firms, accountants often carry out the finance function, while in large firms, financial analysts often help compile accounting information. However, there are two basic differences between finance and accounting; one is related to the emphasis on cash flows and the other to decision-making.

Emphasis on cash flows

The accountant's primary function is to develop and report data for measuring the performance of the firm, assess its financial position, comply with and file reports required by securities regulators, and file and pay taxes. Using generally accepted accounting principles, the accountant prepares financial statements that recognise revenue at the time of sale (whether payment has been received or not) and recognise expenses when they are incurred. This approach is referred to as the accrual basis of accounting.

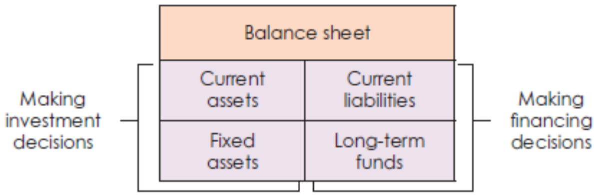
The financial manager, on the other hand, places primary emphasis on *cash flows*, the inflow and outflow of cash. He/she maintains the firm's solvency by planning the cash flows necessary to satisfy its obligations and to acquire assets needed to achieve the firm's goals. The financial manager uses this cash basis of accounting to recognise the revenues and expenses only with respect to actual inflows and outflows of cash. Whether a firm earns a profit or experiences a loss, *it must have a sufficient flow of cash to meet its obligations as they come due*.

Decision-making

The second major difference between finance and accounting has to do with decision-making. Accountants devote most of their attention to the *collection and presentation of financial data*. Financial managers evaluate the accounting statements, develop additional data, and *make decisions* based on their assessment of the associated returns and risks. Of course, this does not mean that accountants never make decisions, or that financial managers never gather data, but rather that the primary focuses of accounting and finance are distinctly different.

Primary activities of the financial manager

In addition to ongoing involvement in financial analysis and planning, the financial manager's primary activities are making investment and financing decisions. Investment decisions determine what types of assets the firm holds. Financing decisions determine how the firm raises money to pay for the assets in which it invests. One way to visualise the difference between a firm's investment and financing decisions is to refer to the balance sheet shown in 1.3. Investment decisions generally refer to the items that appear on the left-hand side of the balance sheet, and financing decisions relate to the items on the right-hand side. Keep in mind, though, that financial managers make these decisions based on their impact on the value of the firm, not on the accounting principles used to construct a balance sheet".



Financial activities. Primary activities of the financial manager.

Governance and agency

As noted earlier, most owners of a company are normally distinct from its managers. Nevertheless, managers are entrusted to only take actions or make decisions that are in the best interest of the firm's owners, its shareholders. "In most cases, if managers fail to act on behalf of the shareholders, they will also fail to achieve the goal of maximising shareholder wealth. To help ensure that managers act in ways that are consistent with the interests of shareholders and mindful of obligations to other stakeholders, firms aim to establish sound corporate governance practices.

Corporate governance

Corporate governance refers to the rules, processes, and laws by which companies are operated, controlled, and regulated. It defines the rights and responsibilities of the corporate participants such as the shareholders, Board of directors, officers and managers, and other stakeholders, as well as the rules and procedures for making corporate decisions. A well-defined corporate governance structure is intended to benefit all corporate stakeholders by ensuring that the firm is run lawfully and ethically, following best practices, and subject to all corporate regulations. A firm's corporate governance is influenced by both internal factors such as the shareholders, Board of directors, and officers as well as external forces such as clients, creditors, suppliers, competitors, and government regulations. The corporate organisation depicted earlier in on page 10 helps to shape a firm's corporate governance structure. In particular, the shareholders elect a board of directors, who in turn hire officers or managers to operate the firm in a manner consistent with the goals, plans, and policies established and monitored by the Board on behalf of the shareholders.

Individual versus institutional investors

To better understand the role that shareholders play in shaping a firm's corporate governance, it is helpful to differentiate between the two broad classes of owners – individuals and institutions. Generally, individual investors own relatively small quantities of shares, and as a result, do not typically have sufficient means to directly influence a firm's corporate governance. To influence the firm, individual investors often find it necessary to act as a group by voting collectively on corporate matters. The most important corporate matter individual investors vote on is the election of the firm's Board of directors. The Corporate Board's first responsibility is to the shareholders. The Board not only sets policies that specify ethical practices and provide for the protection of stakeholder interests, but it also monitors managerial decision-making on behalf of investors.

Although they also benefit from the presence of the Board of directors, institutional investors have advantages over individual investors when it comes to influencing the corporate governance of a firm. Institutional investors are investment professionals that are paid to manage and hold large quantities of securities on behalf of individuals, businesses, and governments. Institutional investors include banks, insurance companies, mutual funds, and pension funds. Unlike individual investors, institutional investors often monitor and directly influence a firm's corporate governance by exerting pressure on management to perform or communicating their concerns to the firm's Board. These large investors can also threaten to exercise their voting rights or liquidate their holdings if the Board does not respond positively to their concerns. Because individual and institutional investors share the same goal, individual investors benefit from the shareholder activism of institutional investors.

Government regulation

Unlike the impact that clients, creditors, suppliers, or competitors can have on a firm's corporate governance, government regulation generally shapes the corporate governance of all firms. During the past decade, corporate governance has received increased attention due to several high-profile corporate scandals involving abuse of corporate power and, in some cases, alleged criminal activity by corporate officers. The misdeeds derive from two main types of issues: (1)

false disclosures in financial reporting and other material information releases, and (2) undisclosed conflicts of interest between companies and their analysts, auditors, and attorneys and between corporate directors, officers, and shareholders. In South Africa, the Companies Act 71 of 2008 applies to all South African companies. The Act seeks to promote transparency and accountability in the corporate sector and has provisions that ensure these are legally enforceable. Corporate governance is institutionalised through the King Reports on Corporate Governance ('King Codes'). The King Codes are published by the King Committee that was formed under the auspices of the Institute of Directors of Southern Africa in 1992.

The agency issue

The financial manager has to maximise the wealth of the firm's owners. Shareholders give managers decision-making authority over the firm; thus, managers can be viewed as the agents of the firm's shareholders. Technically, any manager who owns less than 100 percent of the firm is an agent acting on behalf of other owners. Refer to the dashed horizontal line in , which is representative of the classic principalagent relationship, where the shareholders are the principals. In general, a contract is used to specify the terms of a principal-agent relationship. This arrangement works well when the agent makes decisions that are in the principal's best interest but does not work well when the interests of the principal and agent differ. In theory, most financial managers would agree with the goal of shareholder wealth maximisation. However, managers are also concerned with their personal wealth, job security, and fringe benefits. Such concerns may cause managers to make decisions that are not consistent with shareholder wealth maximisation. For example, financial managers may be reluctant or unwilling to take more than moderate risk if they perceive that taking too much risk might jeopardise their job or reduce their personal wealth.

The agency problem

An important theme of corporate governance is to ensure the accountability of managers in an organisation through mechanisms that try to reduce or eliminate the principal-agent problem; however, when these mechanisms fail, agency problems arise. Agency problem**s** arise when managers deviate from the goal of maximisation of shareholder wealth by placing their personal goals ahead of the goals of shareholders. These problems, in turn, give rise to agency costs**.** Agency costs are costs borne by shareholders due to the presence or avoidance of agency problems, and in either case, represent a loss of shareholder wealth. For example, shareholders incur agency costs when managers fail to make the best investment decision or when managers have to be monitored to ensure that the best investment decision is made because either situation is likely to result in a lower share price".

Management compensation plans

In addition to the roles played by corporate boards, institutional investors, and government regulations, corporate governance can be strengthened by ensuring that managers' interests are aligned with those of shareholders. A common approach is to *structure management compensation* to correspond with firm performance. In addition to combating agency problems, the resulting performance-based compensation packages allow firms to compete for and hire the best managers available. The two key types of managerial compensation plans are incentive plans and performance plans. Incentive plans tie management compensation to share price. One incentive plan grant share option to management. If the firm's share price rises over time, managers will be rewarded by being able to purchase shares at the market price in effect at the time of the grant and then to resell the shares at the prevailing higher market price.

Many firms also offer performance plans that tie management compensation to performance measures such as earnings per share (EPS) or growth in EPS. Compensation under these plans is often in the form of performance shares or cash bonuses. Performance shares are ordinary shares given to management because of meeting the stated performance goals, whereas cash bonuses are cash payments tied to the achievement of certain performance goals. The execution of many compensation plans has been closely scrutinised, considering the past decade's corporate scandals and financial woes. Both individual and institutional shareholders, as well as the public, continue to publicly question the appropriateness of the multi-million rand compensation packages that many corporate executives receive. Most studies have failed to find a strong relationship between the performance that companies achieve and the compensation that

CEOs receive. In South Africa, the 2019 PwC's Executive Directors – Practices and Remuneration Trends Report recommends that CEOs commanding high remuneration should equally back it up by accepting a challenging set of key performance indicators. Furthermore, companies are expected to have contingency plans in place to recover incentives paid to executives who would have overseen large corporate failures. The goal of the King IV Report on Corporate Governance in South Africa is to standardise remuneration disclosure. Research by PwC shows that 83% of the top 40 JSE-listed companies have adopted some form of remuneration disclosure.

One of the current managements of higher education institutions in Indonesia refers to the National Higher Education Standards, in accordance with Permendikbud No. 3 of 2020. Referring to article 3 paragraph 1, Permendikbud No. 3 of 2020, "the goal of the national higher education standard is to ensure the achievement of the goals of higher education which play a strategic role in educating the nation's life, advancing science and technology by applying humanities values as well as the sustainable culture and empowerment of the Indonesian people; ensure that the quality of the Learning in Study, Research and Community Service Programs organized by Tertiary Education Institutions throughout the jurisdiction of the Republic of Indonesia reaches the quality according to the criteria set out in the National Higher Education Standards; and encouraging higher education institutions in all jurisdictions of the Republic of Indonesia to achieve the quality of learning, research, and community service beyond the criteria set out in the National

Higher Education Standards in a sustainable manner "(Permendikbud No. 3 of 2020) One of the important things that can support the achievement of higher education management goals according to national standards is the availability of the funds needed and good financial management. Finance in every organization, both companies and educational institutions, is an important foundation so that it can carry out its operations properly according to the objectives of the organization. Good and accountable financial management is needed to support the performance of the entire system in the organization. Therefore, modern financial management needs to be applied in higher education, so that it can carry out the activities of the Threefold Missions of Higher Education with quality and gain the trust of the wider community. Financial management is an activity of planning, managing, storing, controlling funds and assets owned by an institution, including universities. Financial Management is an essential part of the economic and non-economic activities which leads to decide the efficient procurement and utilization of finance with profitable manner. Financial management is one of the important parts of overall management, which is directly related with various functional departments like personnel, marketing, and production. In general, the goal of financial management is to get a good profile so that it leads to an organization that has good wealth to carry out organizational activities.

Financial management is the process of managing finances by considering the effectiveness and efficiency aspects related to the acquisition, funding, and management of assets, starting from planning, organizing, implementing, to monitoring. School financial management is a process of activities that are planned and carried out deliberately and seriously, as well as continuous guidance on school operational costs so that educational activities are more effective and efficient and help achieve educational goals. Educational finance, an important factor in the success in educational practices, is an analysis of revenue and expenditure used to effectively and efficiently manage education to achieve the goals that have been determined In general, there are 10 principles of financial management that must be considered in financial management, as follows: the risk-return trade off, time value of money, cashnot profit-is king, incremental cash flows, the curse of competitive market, efficient capital market, the agency problem, taxes bias business decisions, all risk is not equal, and ethical dilemmas are everywhere in finance. Financial management must be carried out properly so that it does not cause problems at present and in the future, by referring to the 10 principles of financial management and other operational supporting regulations. Financial and asset management must also consider future funding needs by preparing an endowment fund, so that universities can continue to carry out higher quality and reputable higher education services both at home and abroad. For example, US higher education has essentially the same financial model for 150 years. Tuition, taxpayer funding, and donations/grants provide revenues. Recently, however, the model has become increasingly challenged . In the face of pressing financial and technology forces for change, not-for-profit higher education institutions need to move from long-successful financial and curriculum models to new models that fit the vastly different conditions of the 21st century. Even among those most vested in the status quo, the expectation is that the future will be very different than today and will arrive soon . The use of funds at a private university must be well managed and reports on its use must be prepared so that it can be verified and audited by internal and external parties. Paramasivan, 2009 presented a model of financial statement analysis techniques that can be used as a reference in corporate financial management, including private universities. This model divides the analysis into several parts, making it easier to prepare and analyses financial reports.

"Financial Management Principles and Applications" is a comprehensive textbook that covers various aspects of financial management in both theory and practice. This book delves into key financial concepts such as budgeting, financial planning, investment analysis, risk management, and capital budgeting. It provides readers with a solid foundation in financial management principles, equipping them with the knowledge and skills needed to make informed financial decisions in a corporate or personal context. Throughout the text, real-world examples and case studies are used to illustrate the application of financial principles in different scenarios, making it a practical resource for students and professionals alike. Additionally, the book may also explore topics like financial markets, financial instruments, and the role of financial institutions in the broader economy. Overall, "Financial Management Principles and Applications" serves as a valuable resource for individuals seeking a deeper understanding of financial management and its relevance in today's financial landscape. "Financial Management Principles and Applications" also delves into the intricacies of financial decision-making within organizations. It discusses various financial strategies and tools that businesses can use to optimize their financial performance, such as financial statement analysis, cost of capital, and capital structure decisions. Furthermore, the book may explore advanced topics like international finance, mergers and acquisitions, and corporate governance, providing readers with a comprehensive view of the multifaceted world of finance. It emphasizes the importance of aligning financial strategies with the overall goals and objectives of the organization and how effective financial management can contribute to long-term success and sustainability. In addition, the text may include discussions on contemporary financial issues and trends, such as the impact of technological advancements on financial management and the evolving regulatory landscape. Overall, "Financial Management Principles and Applications" offers a holistic and up-to-date perspective on financial management, making it a valuable resource for students, professionals, and anyone interested in the field of finance.

Financial Statements and Analysis:

Financial statements are essential documents that provide a comprehensive overview of a company's financial performance and position. These statements, including the income statement, balance sheet, and cash flow statement, serve as vital tools for stakeholders, such as investors, creditors, and management, to assess the health and sustainability of a business. Through careful analysis of these financial statements, individuals and organizations can gain valuable insights into a company's profitability, liquidity, solvency, and overall financial stability. The process of financial statement analysis involves a series of techniques and methodologies that help interpret the data presented in these documents. These analyses play a pivotal role in decision-making processes, guiding investment choices, evaluating creditworthiness, and aiding in strategic planning. Furthermore, financial statement analysis is a dynamic field that evolves with changes in accounting standards, economic conditions, and industry trends. In this context, staying updated and adept in financial statement analysis is crucial for making informed financial decisions and maintaining a competitive edge in the business world. This introduction sets the stage for a deeper exploration of the significance and intricacies of financial statement analysis, delving into its various aspects and methodologies to empower individuals and organizations in their financial decision-making endeavors.

Financial statements and their analysis are the backbone of financial management and decision-making for businesses of all sizes and across various industries. These documents serve as a window into a company's financial health, revealing its strengths, weaknesses, and areas for improvement. By scrutinizing the income statement, investors can assess a company's revenue-generating capabilities, while the balance sheet offers insights into its assets, liabilities, and equity structure. The cash flow statement, on the other hand, provides crucial information about a company's ability to generate cash and meet its financial obligations. financial statement analysis extends beyond the examination of historical data. It also involves forecasting future financial performance, assessing risks, and identifying opportunities for growth and profitability. Financial analysts utilize a variety of ratios, metrics, and qualitative factors to draw conclusions about a company's financial prospects. These analyses are invaluable not only for external stakeholders but also for a company's management team, enabling them to make informed decisions about resource allocation, capital investments, and strategic direction. In a rapidly changing economic landscape, understanding financial statements and their analysis is essential for businesses to adapt and thrive. As accounting standards evolve and global markets become increasingly interconnected, the ability to interpret financial data accurately and strategically is more critical than ever. This ongoing process of evaluation and adaptation is fundamental to sound financial management, ensuring that organizations can navigate the complexities of the business world successfully. In the subsequent discussions, we will delve deeper into the specific tools, techniques, and considerations involved in financial statement analysis, equipping you with the knowledge and skills needed to make sound financial decisions in a dynamic and competitive environment. Financial statements and their analysis play an integral role in the broader landscape of corporate finance and investment. They provide a multifaceted view of a company's financial health and performance, serving as a foundational element in the decision-making process for a wide range of stakeholders. Investors rely on financial statements to assess the potential return and risk associated with their investments, while creditors use them to evaluate a company's creditworthiness and ability to meet its obligations. Additionally, management relies on these statements to monitor the company's progress, set financial goals, and make strategic adjustments.

One of the key aspects of financial statement analysis is benchmarking. Analysts often compare a company's financial performance to industry standards, historical data, and competitors' results. This comparative analysis helps identify areas where a company excels and where it may lag behind its peers. Moreover, financial statement analysis is not limited to numerical data alone; it also involves assessing the quality of financial reporting, the transparency of accounting practices, and the overall integrity of financial information. financial statement analysis is a dynamic field influenced by changes in accounting standards and regulations, technological advancements, and shifts in global economic conditions. With the increasing complexity of financial instruments and transactions, the need for robust analysis techniques has grown exponentially. Analysts must adapt to these changes and employ sophisticated methodologies to uncover hidden insights within financial statements. financial statements and their analysis are a cornerstone of modern finance and business management. They provide a comprehensive picture of a company's financial performance, liquidity, and solvency, and are instrumental in decision-making processes at both the micro and macro levels. Whether you are an investor seeking to maximize returns, a creditor assessing risk, or a manager steering a company's course, a deep understanding of financial statements and their analysis is indispensable for achieving financial success and sustainability in today's complex and competitive business environment. In the forthcoming discussions, we will delve into the various facets of financial statement analysis, equipping you with the knowledge and tools necessary to navigate this critical aspect of financial management effectively.

Metric	**Formula**	**Description**
income Statement Metrics		
Revenue Growth	(Current Period Revenue - Previous Period Revenue) / Previous Period Revenue	Measures the growth in a company's revenue fro
ross Profit Margin	(Gross Profit / Revenue) * 100	Indicates the percentage of revenue retained as profit after

		accounting for the cost of goods sold.
Operating Margin	(Operating Income / Revenue) * 100	Reflects the profitability of a company's core operations by subtracting operating expenses from revenue.
Net Profit Margin	(Net Profit / Revenue) * 100	Shows the percentage of revenue that remains as profit after accounting for all expenses, taxes, and interest.
Balance Sheet Metrics		
Current Ratio	Current Assets / Current Liabilities	Assesses a company's short-term liquidity and ability to meet its immediate obligations.

Debt-to-Equity Ratio	Total Debt / Shareholders' Equity	Compares a company's total debt to its shareholders' equity, indicating its leverage and financial risk.
Return on Assets (ROA)	Net Profit / Total Assets	Measures how efficiently a company utilizes its assets to generate profit.
Return on Equity (ROE)	Net Profit / Shareholders' Equity	Assesses the profitability generated with shareholders' equity.
Cash Flow Statement Metrics		
Operating Cash Flow	Net Cash from Operating Activities	Evaluates a company's ability to generate cash from its core operations.
Free Cash Flow	Operating Cash Flow - Capital Expenditures	Shows the cash available for debt repayment,

		dividends, and investments.
Cash Conversion Cycle	Days Inventory Outstanding + Days Sales Outstanding - Days Payable Outstanding	Measures the time it takes for a company to convert its investments in inventory and receivables into cash.
Ratio Analysis Metrics		
rice-to-Earnings (P/E) Ratio	Stock Price / Earnings per Share (EPS)	Compares a company's stock price to its earnings per share, helping investors gauge its valuation.
Price-to-Sales (P/S) Ratio	Stock Price / Revenue per Share	Compares a company's stock price to its revenue per share, indicating its sales efficiency.

Earnings Before Interest and Taxes (EBIT) Margin	(EBIT / Revenue) * 100	Measures a company's operating profitability before interest and taxes are taken into account.
Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) Margin	(EBITDA / Revenue) * 100	Examines operating profitability without the impact of depreciation and amortization expenses.

Financial statement analysis is a cornerstone of modern finance and business management, offering a comprehensive view of a company's financial health and performance. Beyond the numerical data presented in income statements, balance sheets, and cash flow statements, financial statement analysis encompasses a rich tapestry of metrics and ratios that unveil critical insights into a company's profitability, liquidity, solvency, efficiency, and market valuation. These insights are invaluable for a diverse array of stakeholders, including investors, creditors, management teams, and financial analysts, as they aid in decision-making processes ranging from investment choices and lending decisions to strategic planning and performance evaluation.As the global business landscape continues to evolve, financial statement analysis adapts in tandem. It is not a static discipline but rather a dynamic and evolving field, influenced by changes in accounting standards, technological advancements, and the ever-shifting economic environment. Staying well-versed in the principles and methodologies of financial statement analysis is crucial for adapting to these changes and making informed financial decisions in a competitive and complex world., this exploration of financial statement analysis aims to provide a deeper understanding of the various components and metrics involved, equipping individuals and organizations with the knowledge and tools needed to navigate the intricacies of financial decision-making successfully. Whether you are an investor seeking optimal returns, a creditor assessing risk, or a manager steering a company's course, a robust grasp of financial statement analysis is indispensable for achieving financial success and sustainability in today's dynamic business landscape.

Time Value of Money:

The concept of the Time Value of Money (TVM) lies at the heart of finance and plays a pivotal role in virtually every financial decision, whether personal or corporate. It is a fundamental principle that recognizes the idea that a sum of money today is worth more than the same amount in the future. This concept is rooted in the understanding that money has the potential to earn a return over time, and as a result, its value changes with the passage of time.At its core, TVM revolves around the notion that receiving a payment or cash flow today allows for various opportunities, including investment, consumption, or debt repayment, all of which can potentially yield financial benefits. Conversely, receiving the same amount at some point in the future carries inherent risks and foregone opportunities. Thus, a dollar today is inherently more valuable than the promise of a dollar tomorrow. The principles of TVM have far-reaching implications in finance, influencing a wide range of financial decisions, such as investment appraisal, loan structuring, retirement planning, and even everyday choices like saving or spending. Understanding the Time Value of Money empowers individuals and organizations to make informed decisions by quantifying the impact of time on the value of money, allowing for the comparison of cash flows occurring at different points in time on an equitable basis. In the subsequent discussions, we will delve deeper into the core concepts and practical applications of the Time Value of Money, exploring various tools and techniques that enable us to assess and account for the changing value of money over time. This understanding is vital for making sound financial decisions and optimizing the allocation of resources in a world where the timing of cash flows can significantly affect financial outcomes. The Time Value of Money (TVM) is a financial concept that recognizes the fundamental truth that money's worth changes over time. It acknowledges that a sum of money today is more valuable than an identical amount received in the future. This principal stems from the notion that money can earn returns when invested or used for various purposes, such as generating income, paying off debts, or making profitable investments. Consequently, the concept of TVM serves as the cornerstone of financial decision-making, shaping how individuals, businesses, and investors evaluate and compare financial opportunities.

TVM principles are grounded in the idea that, given a choice, most people would prefer to receive a payment today rather than in the future. This preference is due to the fact that having access to funds now allows for immediate consumption, investment, or debt reduction, all of which have the potential to enhance one's financial well-being. Conversely, receiving the same amount at a later date carries an opportunity cost, as it may mean forgoing potential gains or incurring additional costs. The implications of TVM are vast and profound. It permeates nearly every aspect of finance, from investment analysis and loan pricing to retirement planning and budgeting. Whether it involves calculating the future value of an investment, determining the present value of future cash flows, or comparing financing options, the Time Value of Money serves as a critical tool for assessing the desirability and feasibility of financial decisions. As we delve deeper into the realm of TVM, we will explore the core concepts, formulas, and applications that underpin this concept. We will also examine various financial instruments and tools, such as annuities, bonds, and investment appraisal methods, where TVM plays a pivotal role. In doing so, we will equip you with the knowledge and skills needed to navigate the complexities of time-related financial decisions effectively, enabling you to make informed choices that maximize your financial well-being and achieve your financial goals.The Time Value of Money (TVM) is a financial concept that transcends mere mathematics; it's a fundamental principle that governs the essence of finance itself. At its core, TVM encapsulates the idea that money has the power to grow or erode in value over time, depending on how it's managed and invested. This concept holds profound implications for individuals, businesses, and investors, shaping the very fabric of financial decision-making.Consider the scenario of a dollar received today versus a dollar received one year from now. TVM asserts that the dollar received today is more valuable because it can be put to work immediately, whether through investment, spending, or debt reduction. In contrast, the dollar promised for the future carries uncertainty and foregone opportunities. This core tenet influences how we evaluate the attractiveness of financial options and informs decisions ranging from whether to invest in a project, save for retirement, or negotiate the terms of a loan.TVM is the linchpin of financial analysis, enabling us to compare the worth of cash flows occurring at different points in time. Whether calculating the future value of investments, determining the present value of future cash flows, or assessing the cost of borrowing, TVM provides the analytical framework necessary for making informed choices. It's the tool that helps us answer critical questions such as "What is the value of an investment over time?" and "How much should I save today to achieve a future financial goal?"In our exploration of TVM, we will delve into the intricate world of interest rates, compounding, discounting, and the various formulas and techniques that empower us to quantify the effects of time on money. We will apply these principles to real-world scenarios, such as valuing investments, evaluating loan options, and making retirement planning decisions. Ultimately, understanding the Time Value of Money is not just a matter of financial acumen; it's a passport to making sound, forward-looking financial decisions that can shape your financial destiny and secure your financial future.The Time Value of Money (TVM) is a concept that goes to the very core of financial decision-making, affecting every aspect of our lives where money is involved. It is the understanding that money today is worth more than the same amount of money in the future due to its potential earning capacity, investment opportunities, and inflation. This fundamental principle is the bedrock upon which financial decisions are made by individuals, businesses, and investors.

Consider the scenario of receiving $100 today versus receiving it a year from now. TVM tells us that the $100 today is more valuable because it can be invested, generating returns, or used immediately for various purposes like paying bills or making purchases. In contrast, the $100 promised for the future may not carry the same potential for growth and may lose value due to inflation. The applications of TVM are far-reaching and touch nearly every facet of finance. It informs investment decisions, helping individuals and businesses assess the attractiveness of different opportunities by comparing their future values. It guides borrowing decisions, allowing borrowers to understand the real cost of loans when interest and time are factored in. TVM plays a central role in retirement planning, budgeting, and even personal finance choices like buying a home or saving for education. As we delve deeper into the realm of TVM, we will explore the mechanisms of compounding and discounting, examining how interest rates and time periods impact the value of money. We will learn to calculate future values, present values, annuities, and perpetuities. Armed with this knowledge, you will be empowered to make more informed financial decisions, whether it's assessing the potential return on an investment, determining the affordability of a mortgage, or planning for your financial future. In essence, understanding the Time Value of Money is akin to having a financial compass that can guide you through the complexities of the financial world, helping you make choices that enhance your wealth and financial well-being.

Risk and Return:

Risk and return are two of the most fundamental and interconnected concepts in the field of finance. They are the yin and yang of investment decision-making, guiding investors and financial professionals in evaluating the trade-offs between potential rewards and uncertainties. At its core, the relationship between risk and return is about striking a balance between seeking higher returns and managing the associated risks. This balance is crucial because, in the financial world, no investment is entirely free from risk, and understanding how risk and return are intertwined is paramount to making informed financial decisions.

Risk and Return Table:

To appreciate the interplay between risk and return, let's examine a simplified table that illustrates different investment options and their corresponding risk-return profiles:

Investment	**Expected Return (%)**	**Risk (Standard Deviation of Returns)**
Stock A	10%	15%
Stock B	8%	12%
Bond X	5%	4%
Bond Y	3%	2%
Savings Account	2%	1%

In this table, we have various investment options, including stocks (A and B), bonds (X and Y), and a savings account. Each investment comes with an expected return and a measure of risk, represented by the standard deviation of returns. Stock A, for example, offers a higher expected return of 10% but carries a higher risk of 15% compared to Stock B, which has an expected return of 8% and a lower risk of 12%.

Risk-Return Trade-off:

The table illustrates a fundamental principle: higher potential returns are typically associated with higher levels of risk. Investors must decide which investments align with their risk tolerance and financial goals. Some investors may be willing to accept greater risk in pursuit of higher returns, while others may prioritize capital preservation and opt for lower-risk options like bonds or savings accounts.

The key is to strike a balance that aligns with one's financial objectives and risk appetite. This balance often involves constructing a diversified portfolio that includes a mix of assets with varying risk-return profiles. Diversification allows investors to spread risk and optimize returns based on their specific risk tolerance.

In the subsequent discussions, we will delve deeper into various aspects of risk and return, including risk assessment techniques, portfolio construction, and strategies for managing and mitigating risk in investment portfolios. Understanding this critical relationship is essential for making sound investment decisions that align with individual financial goals and risk preferences.

Portfolio B: Conservative

investment	**Expected Return (%)**	**Risk (Standard Deviation of Returns)**
Bond X	5%	4%
Bond Y	3%	2%
Savings Account	2%	1%
Total Portfolio	3.33%	2.33% (weighted average)

In Portfolio A, comprised of stocks with higher expected returns, the total portfolio's expected return is 12.33%, but it carries a higher risk of 21%. In contrast, Portfolio B, consisting of conservative assets like bonds and a savings account, offers a lower expected return of 3.33% but comes with significantly lower risk at 2.33%. This demonstrates the trade-off: Portfolio A offers the potential for higher returns but at the cost of higher risk, while Portfolio B prioritizes lower risk but offers lower potential returns.

Diversification:

One way to manage risk while optimizing returns is through diversification. By combining assets with different risk-return profiles, investors can create portfolios that aim to achieve a desired balance. Here's an example:

Diversified Portfolio:

Investment	Expected Return (%)	Risk (Standard Deviation of Returns)
Stock A	12%	20%
Bond X	5%	4%
Savings Account	2%	1%
Total Portfolio	6.33%	7.44% (weighted average)

In this diversified portfolio, combining stocks, bonds, and a savings account yields an expected return of 6.33%, with a moderate risk level of 7.44%. Diversification helps spread risk across different asset classes, potentially reducing overall portfolio volatility while still aiming for reasonable returns.

As we delve deeper into the world of risk and return, we will explore various asset classes, investment strategies, and risk management techniques. Whether you are an individual investor planning for retirement or a financial professional managing portfolios for clients, a thorough grasp of the risk-return relationship is essential for achieving financial goals while mitigating potential losses.

Valuation of Financial Assets: An In-depth Perspective

Valuation of financial assets is a cornerstone of financial analysis and investment decision-making. Financial assets encompass a broad spectrum, including stocks, bonds, derivatives, and other securities. The essence of valuation lies in determining the intrinsic or market value of these assets, which serves as the foundation for various financial decisions, such as buying, selling, or holding investments.

Market-Based Valuation: In many cases, the market itself provides a fair and readily accessible valuation of financial assets. For publicly traded stocks and bonds, their market prices reflect the collective wisdom and expectations of investors. The most common metric here is the price of the asset multiplied by the number of units held, determining the total market value. For instance, the market value of a stock is determined by multiplying its current share price by the number of outstanding shares.

Intrinsic Valuation: Intrinsic valuation methods aim to estimate the fundamental or "true" value of an asset, independent of market sentiment. This approach often involves discounted cash flow (DCF) analysis, which calculates the present value of expected future cash flows generated by the asset. For instance, in valuing a company's stock, analysts may forecast future earnings, apply a discount rate to account for the time value of money, and arrive at an intrinsic value.

Comparative Valuation: Comparative valuation relies on the principle of benchmarking an asset's value against similar assets in the market. Common metrics include price-to-earnings (P/E) ratios for stocks or yield-to-maturity for bonds. For instance, if a stock has a lower P/E ratio than its industry peers, it might be considered undervalued.

Challenges in Valuation:

Valuing financial assets is both art and science, and it comes with its own set of challenges. One of the primary challenges is dealing with uncertainty. Future cash flows, interest rates, and market conditions are uncertain, which can lead to varying valuation outcomes. Additionally, market sentiment and behavioral factors often influence asset prices, leading to deviations from intrinsic values.

Practical Applications:

Valuation is not solely the domain of investors. It also plays a crucial role in corporate finance, where it informs decisions such as capital budgeting, mergers and acquisitions, and financial reporting. For example, a company may use valuation techniques to determine whether to invest in a new project by comparing the expected cash flows to the project's initial cost.

Advanced Valuation Techniques:

While basic valuation methods such as market-based, intrinsic, and comparative valuation provide a solid foundation, more advanced techniques are often employed for complex financial assets. These may include options pricing models like the Black-Scholes model for valuing stock options, or Monte Carlo simulations for assessing the value of complex derivatives with multiple variables. In the world of fixed income securities, advanced yield curve modeling is used to determine bond prices more accurately.

Behavioral Finance and Valuation:

The field of behavioral finance has shed light on the psychological factors that influence investors' decisions and asset prices. Understanding the cognitive biases and emotions that can lead to market inefficiencies is essential for practitioners of financial asset valuation. Behavioral finance suggests that asset prices can deviate from rational valuations due to factors like overconfidence, herd behavior, or fear, creating opportunities for savvy investors who can identify and exploit these mispricings.

Real-World Applications:

Valuation extends beyond simply assessing the worth of assets. It is integral to a multitude of financial decisions across diverse industries. In mergers and acquisitions, for example, valuation is central to determining the purchase price of a company or its assets. In real estate, property valuation guides decisions on buying, selling, or leasing properties. In private equity, venture capital, and startup financing, valuation plays a crucial role in negotiations and investment decisions. Additionally, government entities use valuation methods for taxation and regulatory purposes.

Challenges and Uncertainty:

Valuation is inherently challenging because it requires predicting future cash flows, which are subject to various uncertainties. Economic conditions, interest rates, and market sentiment can change rapidly, impacting asset prices. Additionally, the choice of valuation model and assumptions can introduce subjectivity into the process. Expertise in risk assessment and sensitivity analysis is essential to address these challenges.

Implications of Valuation:

The outcomes of valuation have far-reaching consequences. For investors, it informs buy or sell decisions and portfolio allocation strategies. For companies, it influences capital allocation, dividend policies, and financial reporting. In the broader context, accurate valuation contributes to market efficiency by aligning asset prices more closely with their intrinsic values, ultimately promoting economic stability.

Valuation of financial assets is both a science and an art, combining quantitative analysis with an understanding of market psychology. It is a discipline that evolves alongside financial innovation and market dynamics. Mastery of valuation techniques is an invaluable skill for investors, financial analysts, corporate finance professionals, and policymakers alike. It empowers individuals and organizations to make well-informed financial decisions in a world where asset values are constantly changing and where precision in valuation can make the difference between financial success and failure.

Advanced Valuation Concepts:

In addition to the fundamental valuation methodologies, advanced concepts and techniques further enrich the field of financial asset valuation. These include:

Option Pricing Models: Complex financial derivatives, such as options and swaps, require specialized models for valuation. The Black-Scholes-Merton model, for instance, is widely used to calculate the fair value of options, taking into account factors like volatility and time to expiration.

Real Options Valuation: This approach extends traditional valuation methods to incorporate the value of strategic options that may arise in uncertain business environments. It is particularly relevant for industries like pharmaceuticals, where decisions to invest in drug development projects are akin to financial options.

Mark-to-Market vs. Mark-to-Model: Financial assets that do not have readily observable market prices often rely on valuation models. However, this can introduce discrepancies and debates regarding the appropriate model and assumptions, especially in the context of complex structured products like mortgage-backed securities.

Real-World Applications:

Valuation is pervasive across industries and financial activities:

Private Equity and Venture Capital: Investors in private companies must assess the value of these non-publicly traded assets, often using methods like discounted cash flow analysis or comparable company analysis.

Real Estate: Property valuation is fundamental to the real estate market. Appraisers use methods such as the sales comparison approach, income approach, and cost approach to determine property values.

Startup Financing: Startups often require valuation for equity financing rounds. The valuation process involves assessing the company's growth prospects, market potential, and comparable transactions in the industry.

Fair Value Accounting: Financial reporting standards require companies to report their financial assets and liabilities at fair value. Valuation plays a crucial role in financial statements, influencing reported asset values, and impacting investors' perceptions of a company's financial health.

Challenges and Risks:

Subjectivity: The choice of valuation model and key assumptions can introduce subjectivity into the process. Analysts must exercise judgment and transparency in their assessments.

Market Volatility: Asset prices can fluctuate rapidly due to market sentiment and economic events, challenging the accuracy of valuations.

Illiquidity: Some assets, such as certain types of private equity or real estate investments, may lack readily available market prices, making valuation more complex.

Market Efficiency and Implications:

Valuation plays a crucial role in maintaining market efficiency. Accurate and timely valuations help align asset prices with their intrinsic values, reducing opportunities for arbitrage and speculative bubbles. This, in turn, contributes to overall financial market stability.

Capital Budgeting:

Capital budgeting is a critical financial process that organizations use to evaluate and make decisions about long-term investment projects. It involves analyzing potential projects, estimating their costs and benefits, and determining whether they align with the company's strategic objectives. One of the primary tools in capital budgeting is Net Present Value (NPV) analysis, which assesses the profitability of an investment by calculating the present value of expected cash flows, discounted at a predetermined rate. A positive NPV indicates that the project is expected to generate more cash than it costs, making it a viable investment. Similarly, the Internal Rate of Return (IRR) is another essential metric that helps organizations assess the potential return on an investment. The IRR is the discount rate that makes the NPV of a project equal to zero, and it serves as a benchmark for evaluating projects; a higher IRR is generally preferred as it implies a higher return. the Payback Period is a simpler metric that calculates the time it takes for an investment to generate enough cash flow to recover its initial cost. While it's a straightforward measure, it does not consider the time value of money, making it less precise than NPV or IRR. Nevertheless, it can be a useful tool for evaluating projects with shorter time horizons or when liquidity is a significant concern.Sensitivity analysis is another crucial aspect of capital budgeting, as it assesses how changes in key assumptions or variables (such as revenue, costs, or discount rates) impact the project's feasibility. This helps companies understand the risks associated with an investment and make informed decisions.capital budgeting often involves considering various financing options, such as debt or equity, to fund the investment. The choice of financing can have a significant impact on the project's overall cost and risk profile. Companies need to balance the benefits of leveraging debt, which can amplify returns, with the associated interest and repayment obligations. capital budgeting is a complex and critical process that requires careful analysis and evaluation of long-term investment opportunities. It relies on financial metrics like NPV, IRR, and Payback Period, as well as sensitivity analysis, to make informed decisions about allocating resources to projects that will contribute to a company's growth and profitability while aligning with its strategic goals. Moreover, the choice of financing plays a pivotal role in shaping the financial structure of an organization and should be considered alongside the investment evaluation process.

let's delve deeper into the various aspects of capital budgeting. One critical factor in this process is risk assessment. Every investment project comes with inherent uncertainties, and understanding and quantifying these risks is crucial. Companies often use techniques such as scenario analysis and Monte Carlo simulations to assess how different scenarios might affect the project's financial outcomes. This allows decision-makers to gain a more comprehensive view of potential outcomes and make more informed choices.the time horizon considered in capital budgeting can vary significantly. Some investments, like infrastructure projects or research and development initiatives, may have a long gestation period before they start generating returns. Companies need to consider the time factor when evaluating these projects and factor in not only the initial investment but also ongoing operational and maintenance costs and potential revenue streams over the project's entire life cycle.Another important concept in capital budgeting is the concept of opportunity cost. When a company invests in one project, it often means forgoing other potential investments. Evaluating the opportunity cost of choosing one project over another is essential for optimizing capital allocation. Companies must weigh the potential benefits of each project against what they could have gained from alternative investments. companies must take into account external factors such as macroeconomic conditions, regulatory changes, and market trends when making capital budgeting decisions. These external factors can significantly impact the feasibility and risk profile of an investment.In addition to traditional financial metrics, companies may also consider non-financial factors when evaluating investment projects. These can include environmental, social, and governance (ESG) criteria, which are increasingly important in today's business landscape. ESG considerations can affect a project's reputation, customer perception, and long-term sustainability. ongoing monitoring and post-implementation evaluation are crucial to capital budgeting. Once a project is underway, it's essential to track its progress, costs, and benefits to ensure that it aligns with the initial expectations and objectives. Adjustments may be necessary based on changing circumstances or unforeseen challenges. capital budgeting is a multifaceted process that involves not only financial analysis but also risk assessment, time horizon consideration, opportunity cost evaluation, external factor assessment, and, in some cases, non-financial considerations. Continuous monitoring and evaluation are essential to ensure that investments deliver the expected returns and contribute to a company's long-term success. It's a dynamic process that requires careful consideration of both quantitative and qualitative factors to make well-informed decisions about resource allocation.

Cost of Capital:

The cost of capital varies over time. Periods when the cost of capital is high are followed by periods of returns that are above normal, on average, and a low cost of capital tends to precede subpar returns.2 Companies access external capital from investors, primarily in the form of debt and equity, and invest it with the intention of earning a return in excess of the cost of capital. The expected risk and return are lower for debt holders than for equity holders because debt has a senior claim on cash flows. Debt holders get paid before equity holders do. The terms of debt financing, the magnitude and timing of cash flows, are established by contract. Investors are left to determine only the risk that the company will fail to fulfill its obligations and what they might recover in the case of default. Changes in interest rates, inflation, and overall economic conditions influence the cost of debt, but the rights of the debt holders are stated plainly. You can think of equity as a residual claim, or what's left over after subtracting the claims of debt holders and preferred shareholders. Companies that earn a return on investment in excess of the cost of capital create value for shareholders because other claims have been satisfied and the additional value accrues to the equity holders. This report is a practical guide to estimating the weighted average cost of capital (WACC) for a company. Academic approaches to estimating the cost of capital have been criticized in recent decades, and we will discuss some of the issues of concern.3 Our goal is to find a figure that reflects opportunity cost sensibly, is economically sound, and provides the investor and businessperson with a solution to apply to the problem. Estimating the cost of debt is relatively straightforward because the details of the agreement between the company and the investor are clear. Investors may disagree with the market's assessment of a bond price, but the company's obligations are in plain view. Estimating the cost of equity is more difficult because none of the determinants of value are explicit. Dividends, which do reflect elements of the magnitude and timing of cash flows, are at best a quasi-commitment to return cash to shareholders. And unlike a measure such as yield to maturity on a bond, there is no transparent method to observe a stock's expected return. Equity investors need to assess the expectations for the magnitude, timing, and riskiness of future cash flows. Ascribing a value to equity is almost always harder than to debt for this reason. Methods to assess the cost of equity are commonly based on a model of asset pricing. The capital asset pricing model (CAPM) is the most popular among financial executives and investors.4 Despite its widespread use, the CAPM has come under fire in recent decades. The focal point is beta, which attempts to capture risk by measuring the sensitivity of a stock's returns relative to those of the market. Beta does a poor job of predicting actual reward. Academics have introduced additional factors in an attempt to better reflect the relationship between risk and reward. We are not defenders of the faith in the CAPM. But we believe the model, especially with methods to reduce the error in beta, is a useful complement to other indicators of risk and reward that have market prices, including bond yields and implied volatility in option prices. These measures can provide guidance and context for establishing a reasonable cost of capital. Nearly all investors acknowledge that the present value of future cash flows determines the value of a stock, but many believe a discounted cash flow (DCF) model is unreliable. For example, they point out that predicting cash flows is challenging, much of the value commonly resides beyond the explicit forecast period and has to be captured in the continuing value, and the overall output is very sensitive to small changes in the cost of capital.

One common solution is to avoid DCF models altogether and to default to multiples. These include price/sales (P/S), price/earnings (P/E), enterprise value/earnings before interest, taxes, depreciation, and amortization (EV/EBITDA), and price/book (P/B). Indeed, a survey of almost 2,000 professional equity analysts found that "market multiples" were "[b]y far the most popular approach to valuation." Analysts use P/E and EV/EBITDA multiples most frequently.6 The problem is that multiples are at best a proxy for the process of valuation. Using a multiple does not circumvent the problems with forecasting cash flows and discount rates but rather buries them. We believe that it is better to make the assumptions explicit, debate them, and consider alternative scenarios. There is not a lot of upside in coming up with a sensible cost of capital but there is a lot of downside in applying a figure foolishly. The goal is to blend the economic logic of an asset pricing model with market prices in order to estimate intelligently the opportunity cost of capital. The danger is applying formulas without thought. Charlie Munger, vice chairman of Berkshire Hathaway, has said, "People calculate too much and think too little."7 A sound estimate of the cost of capital requires some thinking. Successful investing is ultimately about properly anticipating revisions in expectations about future cash flows. The rate at which those cash flows are discounted is important but is overwhelmed in the long run by getting the cash flows right. We recommend settling on a practical cost of capital and then allocating the bulk of analytical time and attention to thinking about the potential paths of cash flows.

Estimating the Cost of Debt

The cost of debt is the effective after-tax rate a company has to pay on its long-term debt. The yield to maturity on a company's long-term, option-free bonds is a good estimate for the pre-tax cost of debt for a company with securities that are rated as investment grade. This is debt that is deemed to have a relatively low risk of default and hence receives a higher rating from the credit agencies (Baa or above from Moody's and BBB or above from S&P Global and Fitch). You can observe this rate directly for most firms. For companies that have only short-term or illiquid debt, you can take some steps to estimate the cost of debt indirectly. First, determine the credit rating on the company's unsecured long-term debt. Second, look at the average yield to maturity on a portfolio of bonds with a similar credit rating. Bond investors often express this as a spread over a Treasury rate, usually the 10-year note. The treasury yield is a proxy for the risk-free rate. It is appropriate to use an option-adjusted spread (OAS) for a fixed income security that embeds options. For example, a bond may include an option for the investor to sell it back to the issuer on a specific date at a set price. Or the issuer may have the option to call back, or redeem, the bond at a predetermined time and price. Some companies finance themselves predominantly with short-term debt. In this case, it may appear appropriate to use the short-term rates as the cost of debt, but the problem is that short-term rates do not reflect expectations about long-term inflation. The time horizon for estimating the cost of capital should match the time horizon of forecasted cash flows, which is rarely less than ten years. "The long-term rate is a better approximation of interest costs over time even for companies that roll over their short-term debt because long-term rates capture the expected cost of repeated borrowing. If a company exclusively relies on short-term debt, use its credit rating to approximate the cost of long-term debt. Free cash flow, or net operating profit after taxes (NOPAT) less investment needs, does not reflect financial leverage. This is useful for comparing companies with different capital structures. But debt creates a valuable tax shield free cash flow does not capture because some of the interest expense is generally tax deductible.16 To capture the value of the tax shield, you must adjust debt from a pre-tax rate to an after-tax rate. To do this, multiply the pre-tax cost of debt by one minus the marginal tax rate. The marginal tax rate is the tax rate a company pays on its last dollar of taxable income. This is how the benefit of the tax shield that debt creates finds its way into the calculation of WACC. The formula is: After-tax cost of debt = pre-tax cost of debt × (1 – marginal tax rate) Not all companies can take all of their interest expense as a deduction from taxes. For example, the Tax Cuts and Jobs Act of 2017 sets a limit on the tax deductibility of interest at 30 percent of earnings before interest and taxes (EBIT) for U.S. companies with sales of $25 million or more. This went into effect in 2022.

We estimate that this affected about 25 percent of the companies in the Russell 3000 that had positive EBIT in 2022. The Russell 3000 tracks the largest stocks by market capitalization in the United States. The effective rate is commonly lower than the marginal rate because companies have net operating losses (NOLs), tax loss carrybacks, or investment tax credits. The cost of debt should reflect the marginal rate, including state and local taxes, of the countries where the company earns its operating profit. This can create a sizeable difference between the tax rate in a company's home country and the tax rate it must actually pay for firms with a large presence outside of their domicile.

For companies with tax loss carryforwards, it may make sense to value the company in two stages. First, assume the company pays normal taxes in its free cash flows. This, of course, will lead to a value that is too low. Second, calculate the present value of the tax savings. To do this, calculate the annual tax savings and discount that savings at the cost of debt. Note that the company has to produce operating income to realize tax savings. Add that amount back to the value of the firm assuming full tax payment. These two stages allow for comparability to profitable peers and specify the value of the tax savings. The Tax Cuts and Jobs Act of 2017 also changed the rules for NOLs. Prior to the act, companies could carry back NOLs for two years, carry them forward for 20 years, and offset all taxable income when carried back or forward. Starting in 2018, carrybacks were eliminated and companies are only allowed to use a net operating loss carryforward for up to 80 percent of taxable income. The book value of debt is in many cases a sensible proxy for the market value of debt. But make an adjustment in your debt-to-total capital ratio if the debt is trading at a substantial premium or discount to par. The yield to maturity is a reasonable proxy for the pre-tax cost of debt for companies with debt that is rated as investment grade. That yield can be expressed as a spread over a risk-free rate. Exhibit 3 shows a decomposition of expected returns, calculated monthly, for BBB bonds from 2008 to 2022. The components of the expected return include the real yield on the 10-year U.S. Treasury note, inflation expectations, and the BBB credit spread. The nominal yield on the 10-year U.S. Treasury note equals the real yield plus inflation expectations.

Working Capital Management:

The availability of money was high in the years prior to the financial crisis of 2008. Companies did not have to look far for capital to fund expansions and thus, goals to increase sales were common. The outbreak of the financial crisis affected more or less the entire world economy. Many companies where faced with new difficulties, having to fight for their existence in an environment with highly reduced liquidity. With the supply of money drying up, the importance of streamlining operations and collecting every penny possible increased. The result of the changing business environment thus forced companies' to turn their attention towards minimizing cost and managing assets. Working capital management (WCM) refers to the managing of short-term finances. The basic idea is that assets should be allocated so that their optimal potential is realized and thus minimize waste. Directing attention towards WCM has been proven to be popular during recessions and similar patterns in shifting attention has been observed at previous crises e.g. the oil crises of 1970's. .The focus on WCM slowly disappeared and remained mainly in smaller-sized companies when the economic climate improved. One explanation for this is that larger-sized companies can, in general, more easily acquire financial support by external means, as they are likely to e.g. have higher credit ratings and have the ability to issue bonds. Because of this, one explanation to the shifts in attention towards WCM is the varying availability of liquidity, which affects the importance of WCM and the impact it has on companies. the concept of WCM is often discussed in relation to profitability. As one of the goals of WCM is to increase profitability it should make it attractive even over time, in good economic climate as well as in harsh .However, according to a recent report by that investigates the 1000 largest public companies in Europe, the amount of attention directed to WCM tend to decrease when companies gain strength again after a recession. Instead, companies turn their attention towards efforts aiming to generate revenue growth. Furthermore, the recent development since 2012 has been that general increases in revenue have required increasingly larger amounts of Net Working Capital (NWC). This indicates that companies are using their working capital less efficiently and thus, that growing revenue is becoming more expensive. In 2009, Danske Bank studied a number of Nordic companies' opinions regarding WCM together with. Their report aligns with the arguments of who identified a pattern in the shifting attention towards working capital. research indicates that working capital is seen as more important during recessions when liquidity is of greater concern for companies. Moreover, the findings show that during economic prosperity there is also a greater focus on growth. Hence, there might be a trade-off between focusing on WCM and revenue growth according to Furthermore, the report by indicates that the shift in attention is causing companies to get less bang for their buck in their attempts to grow.

Working capital and wcm

Working capital refers to the capital that a company needs in order to run its operations, i.e. the short-term financing of the company. Because of this, the properties of working capital are such that it does not earn interest (e.g. capital tied up in Inventory). Therefore, it is important that companies manage the working capital levels well in order to ensure that it provides the company sufficient amounts of profit (to counter the cost of capital). Working capital is made up of the net sum of current assets minus current liabilities and is often referred to as the net working capital (NWC). WCM is referring to any actions aimed at managing companies' working capital levels and thus does not refer to any specific managing-model or framework. In contrast to long-term financial decisions, WCM deals with the issues of short-term financing. For example, deciding the level of credit a company gives their clients as well as how much credit they should demand from their suppliers. These types of short-term financing decisions are important for the sustainability of companies, as it affects liquidity and profitability.

NET working CAPITAL (PENMAN, 2013)

The net balance between current assets and current liabilities is important as the current assets are expected to turn into cash within one year, while current liabilities are commitments that are due to mature within one year. NWC is thereby a measurement of short-term financial stability as it indicates if the company will be able to live up to its short-term commitments. From this nature, working capital is of high interest from a short-term financing perspective and liquidity analysis. However, working capital is also important for companies' long-term financing because the indication of short-term survival strength and financial-health through short-term liquidity will impact the companies' ability to attain attractive long-term financing. A company with poor financial health is likely to have a higher cost of capital than a company with better finances, because of the higher credit risk.

WCM deals with decisions regarding the trade-off between liquidity and profitability. In short, Aravindan and Ramanathan (2013) mean that WCM is the managing and planning of liquidity and profitability. A company with poor WCM may run the risk of locking-up surplus amounts of capital (e.g. excess inventories) and on the other hand a shortage of working capital can damage the flow of operations. the financial manager, WCM will put focus on three main current assets: inventories, accounts receivable (AR) and cash (and cash equivalents), while the main current liability is accounts payable (AP). Managing current assets is of importance for many companies as it often accounts for the major part of the company's total assets. However, the details of how these assets should be handled to achieve optimal levels of working capital is dependent on a number of factors such as the nature of business as well as seasonal variations that might affect product demand. Additionally, the cost of capital in terms of the opportunity cost needs to be considered when referring to optimal levels of working capital.

Inventory, ar & ap

Inventories could be made out of both raw materials, work in process as well as finished goods, depending on the nature of business as well as the business strategy. Regardless of how inventory is kept, the need arises from the risk of unexpected increases in demand as well as the increased cost of smaller production runs (economies of scale). By having inventory, companies can thus reduce the risk of not being able to deliver goods at a set time as well as cutting costs by allowing larger production runs. On the other hand there's also a cost of keeping to much inventory as capital is tied up in assets that does not earn interest. The inventory could also need insurance as well as storage space, both adding costs for the company. Managing inventory levels thus means handling the trade-off between the abovementioned costs. One method to use is the just-in-time principle, which helps companies calculate the right level of inventory in order to answer to the demand so that as little capital as possible is inactive .

As goods are being delivered to customers there is a need of handling invoices in order to ensure payment. AR is made out by trade credit (for B2B) and consumer credit (for B2C), which are created due to time differences in sales and payment. AR will therefore be dependent on the terms of sale and credit policy that the company applies to their customers. Factors that might impact credit management are for example the credit rating of the customer as well as the importance of a specific customer. By keeping track of the level of AR, a company can measure the efficiency by which it turns sales into cash. If a company's AR is increasing faster than their sales are growing it indicates that the company is selling their products without actually getting paid for them. It also means that more excess capital is being tied up, at the price of the opportunity cost.

It has been argued that it is common that companies disregard from the AR side of WCM, because the ball is in the payees' court. this is a misperception: It's not the client paying you, it's you initiating the collection. There are several ways to ensure that the customer pays on time. For example, one important aspect is to ensure efficient handling of invoicing.

Cash conversion cycle

There is a close connection between the components of working capital and the cash conversion cycle (CCC) since the cycle measures the amount of days it takes to receive payment from investments in resources. The CCC can thus be used as a tool to measure the net changes in levels of inventory, AP and AR in order to keep desirable levels. The CCC model is not connected to investments in general, but directly to a company's refining process of supplies.

The traditional view of the CCC is that by following the model it is possible to increase a company's profitability, since the working capital is being handled in a more effective way . However, there are also direct downsides to using the CCC. If the cycle is driven too tight, there is a trade-off as it could create problems for some departments in the company, such as sales and customer relations. It may not be possible to deliver the same customer satisfaction when placing a higher focus on reducing the CCC. Thus, connecting a shorter CCC to higher profitability is not as simple as it might seem and conclusions should not be made too quickly .The CCC calculates the amount of days it takes to receive payments from investments. It can further be broken down into three individual components, which make up the cycle .These are: days inventory outstanding (DIO), days sales outstanding (DSO) and days payable outstanding (DPO). By analyzing the cycle, companies can identify inefficiencies in the use of capital and thus take appropriate action.

Cash flow

The terminology of cash flow has for a long time been used to attract investors to projects and operations in need of capital .The fact that a project is estimated to generate cash is one of our time's most efficient arguments for possible investments. The cash flow is directly affected by changes in the inventory, AR and AP and thus influenced by WCM decisions .The net cash flow is the summarized incomes from operating, financing and investing activities. Operating activities are the daily actions that are supposed to generate the most income to a company while income from finance and investments could be seen as the use of spare capital. However, the use of finance and investment activities can also be seen as strategic actions in order to drive development.

NET CASH FLOW

Revenue growth

Revenue is the gross income generated by a company's operations and can thus be used as an indicator if a company is expanding, stagnating or even decreasing in volume. As mentioned earlier, it has been popular over the years to compare working capital with profitability. However, as revenue is not influenced by accounting decisions to the same extent as profits are, which for various reasons could be window dressed, it could be argued that revenue is more suitable as a proxy for measuring company growth and expansion.

Revenue calculation

In order to grow a company, its management needs to decide on taking on new projects and investments. Most investments will in addition to the project or initial investment also require investments in working capital . The different financing options for new investment will depend on capital structure policies, that is, how much equity versus debt the company should hold. Decisions regarding the financing are likely to impact the WCM as the cash balance will be affected i.e. the company can decide to use cash to invest in a long-term asset. Theory thereby suggest that poor WCM would cripple companies' ability to grow as it puts restrictions on capital by increasing the total capital requirements to run the company. By streamlining the working capital and reducing the excess capital tied up, companies could instead use the capital to fund new growth projects.

Working capital and corporate performance

Baños-Caballero, Garcia-Teruel and Martinez-Solano argue that large capital allocation to the components of working capital will constrain companies' capability of investing for long-term financial growth. This is due to the fact that short-term assets and liabilities receive more focus. Hence, there is a trade-off between capital allocations to working capital and focusing on other value-creating investments. is also a general acceptance that working capital affects firm value. However, opinions vary in which direction. By raising levels of working capital e.g. by agreeing to longer credit terms, companies are able to increase sales and direct more attention towards satisfying customers. However, as the level of working capital increases, so does the credit risk. Furthermore, the marginal benefit will decrease because of the cost of capital. The balancing of these types of benefits and costs is dependent on the specific situation of each company. It is managers' assignment to continuously follow up operations in order to follow the optimal level of investments in working capital.

Management attention

As mentioned previously, there has been a shift in management attention from working capital towards suggests that management attention is limiting and selective. This means that different areas of interest that receive attention from management are limited and will vary continuously. Furthermore, Ocasio) suggests that direction of management attention will shape the organization in many ways, such as overall corporate strategy and subsequently what decisions are made and what organizational goals that are pursued. Management attention and organizational decision-making is highly connected since it is the top management that decides how to run a company and what goals that should be pursued. management tend to look forward. This means that after a recession, development and growth is likely to be back on the agenda. Moreover, the agenda of decision-makers are also connected to type of industry and the company's culture and social structure. Hence, management attention is crucial to company development and according to the single most important factor when it comes to organizational improvement.

wcm and revenue growth united

In regards of working capital and revenue growth, the nature of current assets and current liabilities are such that they are likely to increase as the revenues grow. As sales grow, increases of inventory, AR and AP are likely to, in effect, grow as well. The WCM task is therefore to ensure that every increase in working capital results in the optimal output. As for growing revenue, this means that efficient WCM will strive to ensure that every increase in working capital can be motivated by the generated revenue increase. As stated by management attention is limiting. Thus, in order to sustainably address both the working capital issues as well as the revenue growth issues, goals that create alignment and coherency need to be set up. One way of creating coherency among growth and working capital goals is by putting attention to goals that ensure both sides are being cared for. E.g. by connecting rewards for sales people to the actual payment of goods or services, attention is paid both to the growth as well as to minimizing the APs. Furthermore, working capital is closely connected to many aspects of the daily operations. This stresses the importance of a holistic, cross-functional approach that aligns all the different aspects and creates incentives to coordinate actions between the different departments, necessary for successful WCM (e.g. by coordinating actions between production and sales, the risk of building up too much inventory will decrease) .History has shown that by focusing on goals that lack alignment between revenue growth and working capital the result is a loss of attention over time. By incorporating the WCM goals with the revenue growth strategy this loss of attention is less likely to occur as they are, in effect, automatically connected to the growth goals. Furthermore, theory suggests that the components of working capital are interdependent and thus need to be considered in relation to one another .

The efficiency of working capital and how companies continually work with WCM. There was a starting point from theoretical sources in order to understand what kind of empirical findings that were needed to answer the aim of the study. Hence, the research was both deductive and inductive. The combination is known as abductive and combines the two different approaches in order to conduct a flexible study of a chosen topic .A negative aspect of using an abductive approach was that it could be hard to stay objective during the process since theories used might influence the direction of the thesis. However, the abductive approach was nonetheless fitting this study since it was meant to combine theories with empirical findings in order to further investigate how organizations behave in a certain matter of interest

Interviews

Interviews held during this research were conducted with the main purpose to create a strong foundation of keywords used in practice of WCM. This applied input would enable a stricter questionnaire survey and be better targeted towards practitioners. Hence, the interviews were used in order to identify what questions the sampled companies would need to answer in order to provide information relevant to the aim of the study. With the strategy of combining the theory with the information from the interviews it was possible to increase the response rate, as close-ended surveys are completed more rapidly and to a higher extent than open-ended surveys Semi-structured interviews with given topics were preferred since the authors interest was to capture as much relevant information as possible regarding the theoretical concepts connected to WCM and to see the research topic from a wide scope. The interviews aimed to widen the theoretical scope by adding relevant insight from a practitioner's standpoint, which increases the relevance of the study. Hence, possible interviewees that could bring such value to the research were identified through their professional background.

The first interview was held with the Head of Corporate Analytics at Danske Bank who participated in the .By conducting this interview the authors were able to collect information about managing working capital as well as attaining real-life examples about challenges that companies encounter in their WCM. Tips and tricks were also discussed so that errors could be avoided when proceeding with the process of collecting information from the questionnaire and the quarterly reports. Except a face-to-face meeting to conduct interviews, the second interview was conducted through email with a Finance Director at Thermo

Fisher Scientific. This was a person who had practical knowledge regarding working capital from the company's daily operations. Thus, it was possible to get a deeper understanding about how practitioners interpret the WCM and its cornerstones in real-life situations. This increased the accuracy of the questionnaire survey further. The approach of interviewing through email was suitable when trying to reach out to respondents with, for any reason, limited accessibility. Furthermore, it was cheap and questions could be answered anywhere when time was given. However, it was important to keep in mind that additional information that could have been covered in a discussion, when people can explain themselves and share thoughts, might have been overlooked . An additional advantage connected to this type of interview was that the respondent could collect information during the process in order to give more accurate and precise answers.

In order to extract the necessary information from the interviews, theories related to WCM, such as the CCC, the components of working capital and management attention were used in developing the structure and questions for the interviews. This resulted in an added practical input that was needed in order to determine the most relevant aspects that are involved in the WCM as well as tov highlight the connections between the different aspects. As an example, theory implies that there are differences in WCM depending on the industry being studied. Questions related to this could therefore help to determine how and why industry might be a factor affecting WCM and thus help to improve the questions in the questionnaire survey. Further, relevant information following the thesis' aim was collected and is presented in the empirical findings, such as the interviewees thoughts about the possibility of combining attention towards both WCM and revenue growth simultaneously".

A basic idea in finance, Financial Management Principles and Applications is an essential component that plays an essential part in the achievement of success for both people and enterprises. Budgeting, financial planning, investment analysis, risk management, and capital allocation are all examples of activities that fall under this category. It includes the effective distribution of resources in order to accomplish the aims and objectives of the business. In order to make educated choices in a global economy that is both complicated and interdependent, it is essential to have a solid understanding of these concepts. The study of ways in which individuals and corporations assess investments and generate funds to support such investments is referred to as finance. Budgeting for capital expenditures, making choices on capital structure, and managing working capital are the three fundamental problems that finance addresses. Learning about money is necessary for both personal and professional success since it assists in the areas of strategic planning, personnel management, organisational behaviour, and how to interact with people. For instance, General Motors' choice to invest in Lyft in 2016 was a strategic move that will have repercussions for both businesses for many years to come. Students majoring in marketing are required to have an understanding of how to price items, manage manufacturing, and handle inventories and supply chains. All of these tasks include making hazardous decisions that are tied to the management of money over time. The management of one's personal finances, as well as one's money and information, is directly related to finance. Students who have dreams of becoming entrepreneurs should make it a priority to acquire good financial management abilities since these skills are necessary for achieving success in company. Financial choices are common in both personal life and professional life, and it is vital to have a fundamental grasp of money in order to be successful in both your personal life and your professional life. The sole proprietorship, the partnership, and the corporation are the three different forms of business organisations. A company that is held by a single person and that person is liable for all of the earnings and debts of the firm is known as a sole proprietorship. This form is often used in the early phases of a company's existence due to the fact that it is straightforward and does not need any consultation with partners. The owner obtains capital via personal investments as well as by borrowing money from financial institutions; nevertheless, there is no distinction between personal personal borrowing and company business borrowing. Profits are subject to taxation at the owner's rate, therefore it is essential for sole proprietorships to get personal loans from friends and family members in order to finance their operations. In order to run a company for the purpose of making a profit, a general partnership is an organisation that consists of two or more individuals who join together as co-owners. Regarding the possibility of being sued or being accountable for debts, there is no distinction between the general partnership and its owners. Unlike a single proprietorship, a partnership is comprised by more than one owner, which is the major contrast between the two establishments. When it comes to taxes, the earnings of the partnership are considered personal income. The fact that the partnership allows for access to equity, also known as ownership, as well as funding from various owners in exchange for partnership shares is recognised as a significant benefit of the partnership. General partners and limited partners are the two categories of partners that may be found in a limited partnership. On the other hand, the limited partner is only accountable for the amount that they have invested in the business, while the general partner is responsible for running the company and is subject to limitless responsibility for the obligations of the company. In the same way that the life of a single proprietorship is connected to the life of the owner, the life of a partnership is connected to the life of the general practitioner of the partnership. Nevertheless, the limited partner's shares may be transferred to another owner without the need to dissolve the partnership; nevertheless, it may be challenging to find a buyer for these shares inside the partnership. A corporation is the conventional organisational structure that is used when a significant amount of capital is required to establish a firm. The legal definition of a corporation was established by Chief Justice John Marshall of the United States Supreme Court in the year 1819. According to Marshall, a corporation is an artificial body that is invisible, intangible, and exists only in the contemplation of law. Legally speaking, the corporation operates independently and apart from its owners, who are known as stockholders. This gives the corporation the ability to sue and be sued on its own, as well as buy, sell, or own property. Additionally, its employees are subject to criminal punishment for crimes that are committed in the name of the corporation. The owners' responsibility is limited to the amount of their investment in the company, the life of the firm is not connected to the status of the investors, and the simplicity with which capital may be raised are the three key benefits that come with having a distinct legal standing. Corporations are legally owned by their current sets of shareholders, who are responsible for electing a board of directors and appointing management who are responsible for defining the direction and policies of the company. The fact that earnings that are distributed in the form of dividends are subject to double taxation is, however, one of the disadvantages of the corporate form of organisation. In the event that a corporation generates a profit, it is required to pay taxes on that profit, which is the initial taxation of earnings. Additionally, the corporation distributes a portion of that profit to its shareholders in the form of dividends. The most that an owner of a limited liability company can lose is the amount that they initially invested. Because limited liability companies (LLCs) are subject to state laws, the Internal Revenue Service (IRS) and the states each have their own set of guidelines that define what constitutes an LLC, and these guidelines vary from state to state. If an LLC appears to be too similar to a corporation, then it will be taxed as a corporation. Tony Fadell hired Apple in 2001 to develop his idea for a new MP3 player, which ultimately resulted in the successful sales of the iPod and the iPhone. A management team that was appointed by a corporate board made a significant investment decision that had a very positive effect on the total value of the company. This example illustrates how the management team made this decision. The financial activities of a company's management can be characterised in terms of three important functions within a company: making decisions regarding investments (capital budgeting decisions), making decisions regarding how to finance these investments (capital structure decisions), and making decisions regarding the most effective way to manage the day-to-day operations of the company (working capital management).

When carrying out these responsibilities, financial managers need to be conscious of the fact that they are ultimately working for the shareholders of the company, who are the owners of the company, and that the decisions they make as financial managers will typically have an effect on the wealth of their shareholders. In the case of a publicly traded corporation like Coca-Cola (KO), the shareholders who purchase stock in the company are the ones who elect a board of directors, which is responsible for a variety of responsibilities, including the selection of the CEO of the company. These shareholders, which can range from individuals who buy stock for a retirement fund to large financial institutions, have a vested interest in the company where they have invested their money. They are the true owners of the company, and as such, they will typically have a primary objective that is described as maximising shareholder wealth.

This objective can be accomplished by increasing the stock price to its maximum potential. Despite the fact that each of these aims contributes to the creation of a successful company, which in turn should be advantageous to the shareholder in the long term, the vision statement of Coca-Cola goes well beyond the conventional purpose of maximising the wealth of shareholders. One of the mottos of Google, Inc. (GOOG) is "working toward what will actually raise the value of their shares over the long term." This motto goes beyond the concept of producing wealth for shareholders. If the value of their assets does not increase, shareholders will sell their shares, thus managers cannot afford to disregard the reality that shareholders want to see an increase in the value of their investments. This, in turn, may result in a decrease in the share price of the firm, which will put the managers' careers in jeopardy if it is seen that they have an excessive commitment to the short term. In the realm of corporate finance, ethical issues are not only crucial to the concept of doing business, but they are also essential to the concept of trust. It is necessary for players in the corporate world to depend on one another's desire to behave in a fair manner in order to collaborate. It is difficult to construct a flawless contract, despite the fact that companies routinely attempt to communicate the rights and duties associated with their operations with other parties via the use of contracts. Consequently, the desire of the parties involved to trust one another is ultimately the determining factor in the success of economic transactions between individuals and companies. There is a consistent thread in the news that pertains to ethics, or the lack thereof. Recently, the financial sector has been the site of a nearly unending string of unethical lapses, including financial scandals at companies such as Enron and WorldCom, the Ponzi scheme perpetrated by Bernie Madoff that resulted in the loss of billions of dollars for investors, and the mismanagement of depositor money by financial institutions such as Sanford Financial. Conducting oneself in an ethical way is not only the ethically proper thing to do, but it is also an essential component of long-term success in both career and personal endeavours. Understanding the financial ideas and decision-making processes that are prevalent in the world of finance is made easier with the help of The Five Basic Principles of Finance, which is a thorough reference. It highlights the significance of money having a temporal value, which indicates that a dollar acquired now is more valuable than a dollar obtained in the future. This is because money accumulates value with time. Given that this concept allows for the accumulation of interest on the money, it is recommended that money be received sooner rather than later. This is because it allows for the accumulation of interest.

The idea of a risk-return tradeoff is yet another basic notion that underpins investment and finance. The majority of people are risk averse, and they would rather have a guaranteed return on their investments than another that is questionable. Due to the fact that the world is fundamentally dangerous, it is possible that some people may be required to undertake investments that include risk. When there are safer alternatives available, investors are provided a greater projected rate of return on the riskier assets. This is done in order to convince investors to continue holding these riskier products. When it comes to assessing assets and coming up with new investment ventures, the risk-return connection is an essential concept to understand. It was for its work on the graph and how to quantify risk that researchers were given the Nobel Prize in Economics in the year 1990. A discussion of the graph and the risk-return connection will be included throughout the article. In addition, the work that was done on evaluating risk was recognised with the Nobel Prize in Economics in the year 1990. Additionally, cash flows are regarded to be the source of value in the field of finance. When it comes to accounting, profit is a concept that is created to quantify the success of a company over a period of time, while cash flows are the real money that may be spent. As a result of the fact that accountants are required to make decisions on the manner in which the company's expenses and revenues are distributed over each time period, profits might be quite different from cash flows. Cash flows that are integrated are very important to investors because they influence the expectations of investors and give information that is of great value. For instance, the additional cash flow that was generated by Star Wars: The Force Awakens is an illustration of the influence that a choice has on the total cash flow of the firm or organisation. Understanding the financial ideas and decision-making processes that are involved in the realm of finance may be accomplished via the use of a comprehensive framework that is provided by the Five Basic Principles of Finance. When investors have a solid comprehension of these concepts, they are able to make well-informed judgments about their investments and investments in general.

Because investors react to new information by purchasing and selling their assets, market prices are a reflection of the information that is available. The rate at which investors take action and the manner in which prices react to new information respectively are the two factors that affect the efficiency of the market. When new information is released, prices in public financial markets rapidly adapt to reflect the new information. Prices go higher if the information is better than anticipated, and they move lower if the information is worse than predicted respectively. In highly efficient markets, such as those found in the United States and other industrialised nations, this process occurs at a very rapid pace. The activities of managers are often driven by self-interest, which may lead to managers not behaving in the best interests of the firm's owners. Individuals react to incentives, and the actions of managers are typically motivated by self-interest. All of the owners of the company will suffer a loss of value if this occurs. When the incentives that managers receive in the workplace are not properly aligned with those of the stockholders of the company, it is possible that they will not make decisions that are in line with increasing shareholder value. Managers respond to the incentives that they are given in the workplace. The conflict of interest that exists between the managers of the company and its stockholders is referred to as a principal-agent problem, also known as an agency problem. In this type of problem, the owners of the company, who are the common stockholders of the company, are the principals in the relationship, and the managers in the company act as agents of these owners. If the managers have little to no ownership in the business, they have less of an incentive to work hard for the shareholders of the company. Instead, they may opt to enrich themselves with bonuses and other financial rewards of their own choosing. In addition, they have an incentive to decline riskier investments that may put their employment in jeopardy, despite the fact that their stockholders would prefer for the firm to undertake these initiatives. The total amount of shareholder value that is lost as a consequence of management activities that are not in accordance with the objective of maximising shareholder value is referred to as agency costs. Agency difficulties can develop when the management of the company are contemplating the means by which they might obtain capital in order to fund the investments of the company. Although debt may be the most cost-effective source of financing in certain circumstances, managers may choose not to use debt financing because they are concerned about the possibility of losing their jobs in the event that the company is unable to pay its bills. It is possible that stockholders would wish for the company to make greater use of debt financing because this would put additional pressure on management to perform at a high level. There are a number of different measures that can be taken to help mitigate the agency problem. Some of these measures include compensation plans that reward managers when they act to maximise shareholder wealth, active monitoring of the actions of managers by the board of directors, financial markets playing a role in monitoring management by having auditors, bankers, and credit agencies monitor the firm's performance, and firms that underperform seeing their stock prices fall and possibly being taken over and having their management teams replaced. Due to the fact that it has an impact on everything that businesses do, including the employment of employees, the construction of factories, and the introduction of new advertising campaigns, finance plays a vital role in the area of finance. When people have a better understanding of the fundamental concepts of finance, they are able to become more astute consumers and more cautious investors with their own money.

The managerial finance function in a firm depends on its size and importance, with small firms typically performing this function through the accounting department. As a firm grows, the finance function typically evolves into a separate department linked directly to the company managing director or CEO through the chief financial officer (CFO). In a typical medium- to large-size firm, the finance function is divided into the treasurer and the controller, who report to the CFO. The treasurer manages the firm's cash, invests surplus funds when available, and secures outside financing when needed. They also oversee a firm's pension plans and manages critical risks related to movements in foreign currency values, interest rates, and commodity prices.The field of finance is closely related to economics, as financial managers must understand the economic framework and be alert to the consequences of varying levels of economic activity and changes in economic policy. They must also be able to use economic theories as guidelines for efficient business operation, such as supply-and-demand analysis, profit-maximising strategies, and price theory. The primary economic principle used in managerial finance is marginal cost-benefit analysis, which suggests that financial decisions should be made only when the added benefits exceed the added costs.The firm's finance and accounting activities are closely related and generally overlap. In small firms, accountants often carry out the finance function, while in large firms, financial analysts often help compile accounting information. However, there are two basic differences between finance and accounting: one is related to the emphasis on cash flows and the other to decision-making.Accountants focus on developing and reporting data for measuring the firm's performance, assessing its financial position, complying with and filing reports required by securities regulators, and filing and paying taxes. They use generally accepted accounting principles to prepare financial statements that recognize revenue at the time of sale and expenses when they are incurred. The financial manager places primary emphasis on cash flows, planning the cash flows necessary to satisfy obligations and acquire assets needed to achieve the firm's goals.Decision-making is another major difference between finance and accounting. Accountants devote most of their attention to the collection and presentation of financial data, while financial managers evaluate accounting statements, develop additional data, and make decisions based on their assessment of associated returns and risks. The primary activities of the financial manager include making investment and financing decisions, which determine the types of assets the firm holds and how the firm raises money to pay for the assets in which it invests.Corporate governance refers to the rules, processes, and laws by which companies are operated, controlled, and regulated. It defines the rights and responsibilities of corporate participants such as shareholders, Board of directors, officers, and managers, as well as the rules and procedures for making corporate decisions. A well-defined corporate governance structure is intended to benefit all corporate stakeholders by ensuring that the firm is run lawfully and ethically, following best practices, and subject to all corporate regulations.

Suppliers play a crucial role in shaping a firm's corporate governance by electing a board of directors, who in turn hire officers or managers to operate the firm in a manner consistent with the goals, plans, and policies established and monitored by the Board on behalf of the shareholders. Individual investors, who own relatively small quantities of shares, do not typically have sufficient means to directly influence a firm's corporate governance. To influence the firm, they often find it necessary to act as a group by voting collectively on corporate matters. The most important corporate matter individual investors vote on is the election of the firm's Board of Directors.Institutional investors, such as banks, insurance companies, mutual funds, and pension funds, have advantages over individual investors when it comes to influencing a firm's corporate governance. They often monitor and directly influence a firm's corporate governance by exerting pressure on management to perform or communicating their concerns to the firm's Board. These large investors can also threaten to exercise their voting rights or liquidate their holdings if the Board does not respond positively to their concerns. Because individual and institutional investors share the same goal, individual investors benefit from the shareholder activism of institutional investors.Government regulation generally shapes the corporate governance of all firms. In South Africa, the Companies Act 71 of 2008 applies to all South African companies, promoting transparency and accountability in the corporate sector. Corporate governance is institutionalized through the King Reports on Corporate Governance ('King Codes'), published by the King Committee formed under the auspices of the Institute of Directors of Southern Africa in 1992.The agency issue arises when financial managers have to maximize the wealth of the firm's owners. Shareholders give managers decision-making authority over the firm, and managers can be viewed as the agents of the firm's shareholders. However, when these mechanisms fail, agency problems arise. Agency problems arise when managers deviate from the goal of maximising shareholder wealth by placing their personal goals ahead of the goals of shareholders. These problems, in turn, give rise to agency costs, which are costs borne by shareholders due to the presence or avoidance of agency problems, and in either case represent a loss of shareholder wealth. corporate governance plays a crucial role in ensuring the accountability of managers and maximizing shareholder wealth. By addressing the agency issues and implementing effective mechanisms to reduce or eliminate the principal-agent problem, companies can ensure that their corporate governance practices are upheld and that their shareholders benefit from a more sustainable and ethical business environment.Corporate governance can be strengthened by aligning managers' interests with those of shareholders. Two key types of managerial compensation plans are incentive plans and performance plans. Incentive plans tie management compensation to share price, allowing firms to compete for and hire the best managers available. Performance plans tie management compensation to performance measures such as earnings per share (EPS) or growth in EPS. Compensation under these plans is often in the form of performance shares or cash bonuses.

The execution of many compensation plans has been closely scrutinized, considering the past decade's corporate scandals and financial woes. Both individual and institutional shareholders, as well as the public, continue to question the appropriateness of the multi-million rand compensation packages that many corporate executives receive. Most studies have failed to find a strong relationship between the performance that companies achieve and the compensation that CEOs receive. In South Africa, the 2019 PwC's Executive Directors – Practices and Remuneration Trends Report recommends that CEOs commanding high remuneration should equally back it up by accepting a challenging set of key performance indicators. Furthermore, companies are expected to have contingency plans in place to recover incentives paid to executives who would have overseen large corporate failures.

One of the current managements of higher education institutions in Indonesia refers to the National Higher Education Standards, in accordance with Permendikbud No. 3 of 2020. The goal of the national higher education standard is to ensure the achievement of the goals of higher education, which play a strategic role in educating the nation's life, advancing science and technology by applying humanities values, as well as the sustainable culture and empowerment of the Indonesian people. One of the important things that can support the achievement of higher education management goals according to national standards is the availability of funds needed and good financial management.Financial management is an essential part of economic and non-economic activities, leading to the efficient procurement and utilization of finance with profitable manner. It is one of the important parts of overall management, directly related with various functional departments like personnel, marketing, and production. The goal of financial management is to get a good profile so that it leads to an organization that has good wealth to carry out organizational activities.Educational finance is an important factor in the success in educational practices, as it involves an analysis of revenue and expenditure used to effectively and efficiently manage education to achieve the goals that have been determined. There are 10 principles of financial management that must be considered in financial management, such as the risk-return trade off, time value of money, cash not profit-is king, incremental cash flows, the curse of competitive market, efficient capital market, the agency problem, taxes bias business decisions, all risk is not equal, and ethical dilemmas. Financial management must be carried out properly to avoid problems at present and in the future, by referring to the 10 principles of financial management and other operational supporting regulations management compensation plans play a crucial role in corporate governance and the success of higher education institutions. By ensuring that managers' interests are aligned with those of shareholders, companies can compete for and hire the best managers available.

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