MA in Heritage Management
A University of Kent and Athens University of Economics and Business (AUEB) collaborative programme
University of Kent

Finance for Cultural Organisations

Lecture 1: Introduction to Finance

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Overview and Objectives of the Course

- This course is specifically designed to provide non-financial professionals with the necessary knowledge of modern finance theory and practice for organisations managing cultural heritage.
- Strike a balance between
  - institutional details
  - theoretical foundations
  - practical applications
- At the end of the course you should be quite comfortable with the:
  - Understand the key issues affecting finance decisions.
  - Evaluate capital investment projects using different methodologies.
  - Build simple budgets and financial forecasts.
  - Understand the various financing options, sources and procedures for funding investments.

Course Evaluation

- Each session consists of a 2-hour lecture.
- Evaluation will be based on:
  - the final exams (60%),
  - a written assignment (40%).
- The written assignments will be submitted to the instructor via email until the first Sunday after the final exams of the course.

Readings

- **Main Textbook:**
  - Ross, S., Westerfield, R., Jordan, B. (2011) Essentials of Corporate Finance, 7th Edition, Mcgraw Hill (RWJ).
- **Supplement Textbooks:**
  - Harvard Business Essentials (2003), Finance for Managers, Harvard Business Press (HBP).
  - Atrill, P. and McLaney, E. (2011). Accounting and Finance for Non-Specialists, 7th edition, Prentice Hall (AMcL).
  - Notes & Papers will be provided by the tutor during the course.

Course Structure

- Introduction to Finance/Financial Management (Lecture 1)
- Introduction to Accounting/Financial Statements (Lecture 2)
- Time Value of Money (Lectures 3,4)
- Investment Appraisal (Lectures 5-7)
- Corporate Financing: Equity Valuation (Lectures 8,9)
- Corporate Financing: Bond/Loans Valuation (Lecture 10,11)
- Cost of Capital (Lecture 12)

Lecture 1: Introduction to Financial Management

Outline:

- Finance: A Quick Look
- What Is A Corporation?
- What is financial management
- The goal of financial management
- The Role of The Financial Manager
- Forms of Business Organization
- Separation of Ownership and Management

Reading

- RWJ Ch1, HBP Ch1, AMcL Ch1.

What is Finance

Specific questions addressed by finance:

- How should funds be acquired?
- How should funds be spent
- How should short-term assets/liabilities be managed?

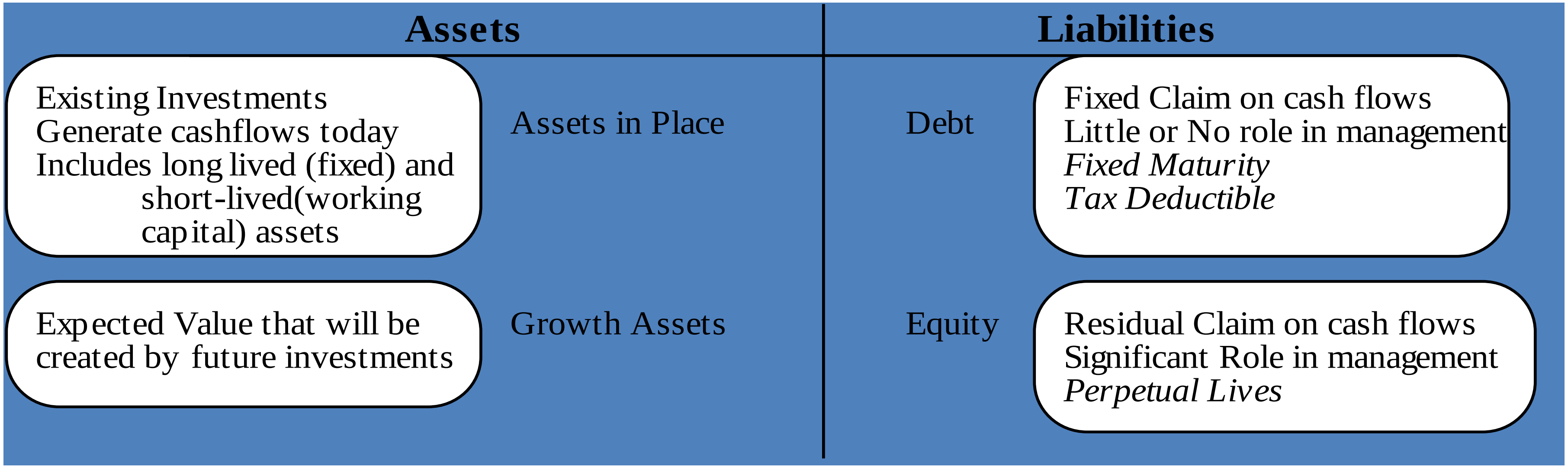
Basic Areas Of Finance

- Corporate finance
- Investments
- Financial institutions
- International finance

Why Study Finance?

- Marketing
  - Budgets, marketing research, marketing financial products
- Accounting
  - Dual accounting and finance function, preparation of financial statements
- Management
  - Strategic thinking, job performance and profitability
- Personal finance
  - Budgeting, retirement planning, college planning, day-to-day cash flow issues

The Financial View of the Firm



Assets

Existing Investments
Generate cashflows today
Includes long lived (fixed) and short-lived(working capital) assets

Assets in Place

Expected Value that will be created by future investments

Growth Assets

Liabilities

Debt

Fixed Claim on cash flows
Little or No role in management
Fixed Maturity
Tax Deductible

Equity

Residual Claim on cash flows
Significant Role in management
Perpetual Lives

What is financial management?

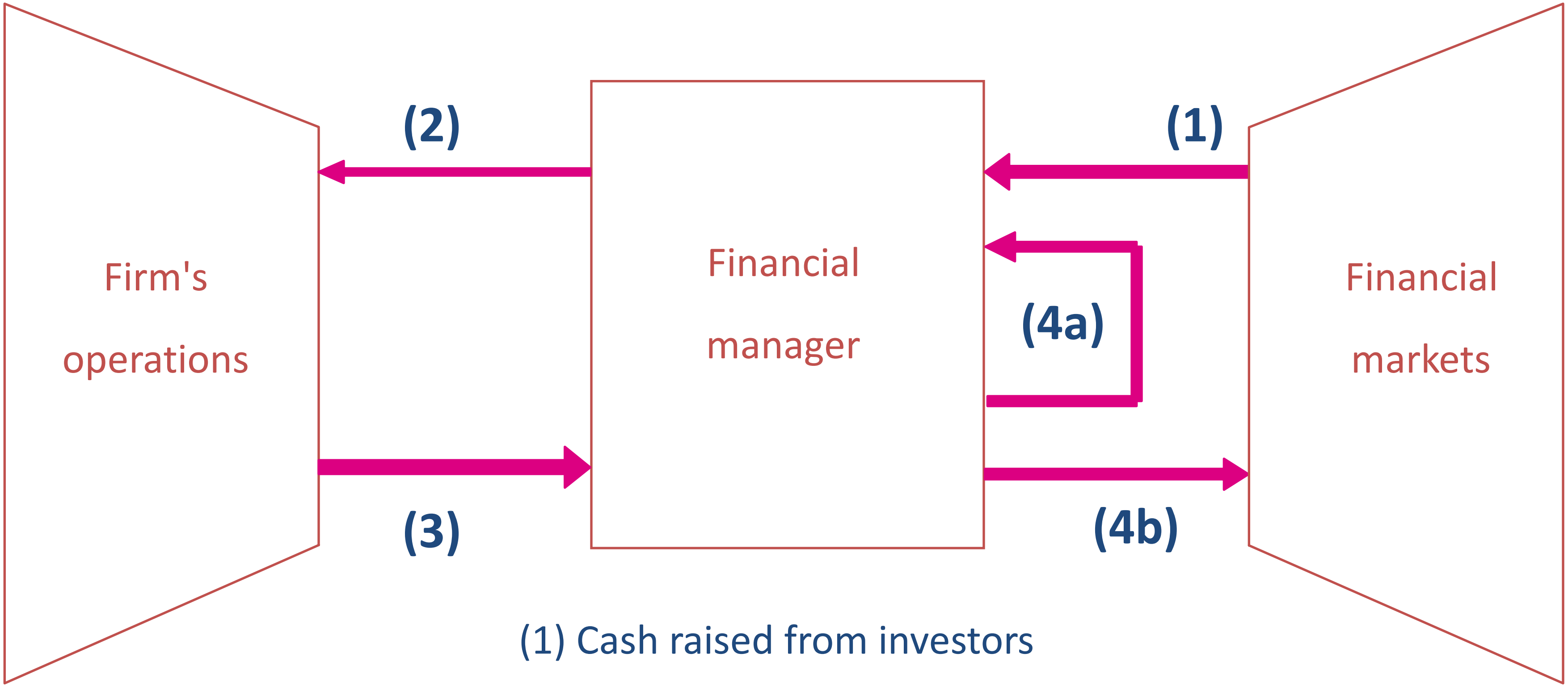
- Every decision that a business makes has financial implications, and any decision which affects the finances of a business is a financial management decision.

- Defined broadly, everything that a business does fits under the rubric of financial management.

Three Major Decisions in Financial Management

- The Allocation decision
  - Where do you invest the scarce resources of your business?
  - What makes for a good investment?
- The Financing decision
  - Where do you raise the funds for these investments?
  - Generically, what mix of owner’s money (equity) or borrowed money(debt) do you use?
- The Dividend Decision
  - How much of a firm’s funds should be reinvested in the business and how much should be returned to the owners?

Role of The Financial Manager


(2)
(1)
Firm's operations
Financial manager
(4a)
Financial markets
(3)
(4b)

(1) Cash raised from investors

(2) Cash invested in firm

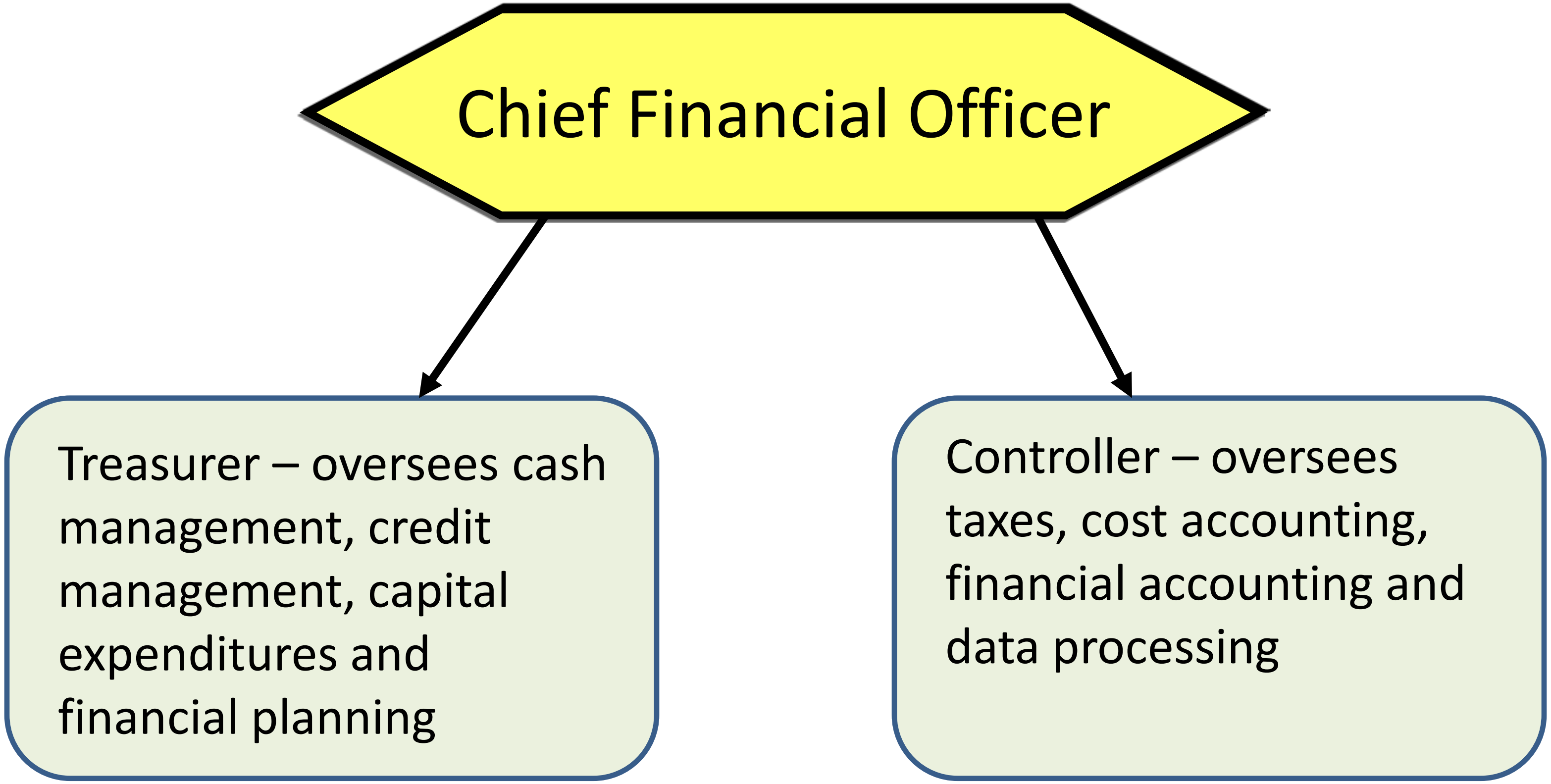
(3) Cash generated by operations

(4a) Cash reinvested

(4b) Cash returned to investors

Financial Manager

- Financial managers try to answer some or all of these questions
- The top financial manager within a firm is usually the Chief Financial Officer (CFO)



Chief Financial Officer

Treasurer – oversees cash management, credit management, capital expenditures and financial planning

Controller – oversees taxes, cost accounting, financial accounting and data processing

Forms of Organization

Three major forms in the united states

- Sole proprietorship
- Partnership
  - General
  - Limited
- Corporation
- S-Corp
  - Limited liability company
- Non-profit Organisations

Sole Proprietorship

- Advantages
  - Easiest to start
  - Least regulated
  - Single owner keeps all the profits
  - Taxed once as personal income
- Disadvantages
  - Limited to life of owner
  - Equity capital limited to owner’s personal wealth
  - Unlimited liability
  - Difficult to sell ownership interest

Partnership

- Advantages
  - Two or more owners
  - More capital available
  - Relatively easy to start
  - Income taxed once as personal income

- Disadvantages
  - Unlimited liability
    - General partnership
    - Limited partnership
  - Partnership dissolves when one partner dies or wishes to sell
  - Difficult to transfer ownership

Corporation

- Advantages
  - Limited liability
  - Unlimited life
  - Separation of ownership and management
  - Transfer of ownership is easy
  - Easier to raise capital
- Disadvantages
  - Separation of ownership and management
  - Double taxation (income taxed at the corporate rate and then dividends taxed at personal rate)

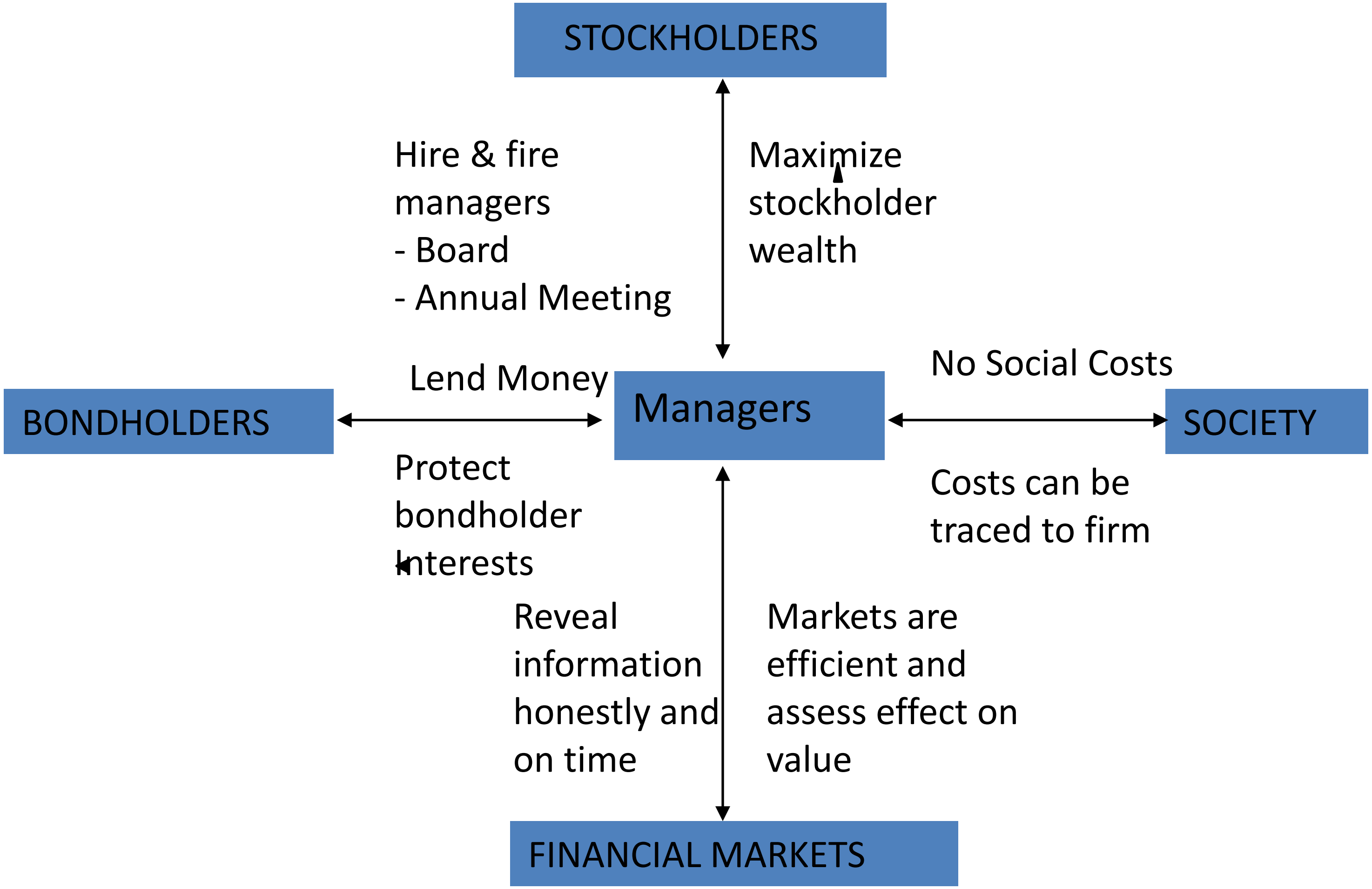
Goal Of Financial Management

- What should be the goal of a corporation?
  - Maximize profit?
  - Minimize costs?
  - Maximize market share?
  - Maximize the current value of the company’s stock?

Goal Of Financial Management

- In traditional corporate finance, the objective in decision making is to maximize the value of the firm.
- A narrower objective is to maximize stockholder wealth. When the stock is traded and markets are viewed to be efficient, the objective is to maximize the stock price.
- All other goals of the firm are intermediate ones leading to firm value maximization, or operate as constraints on firm value maximization.
- In practice we often focus on maximizing stock prices as opposed to firm value.
- Does this mean we should do anything and everything to maximize firm value or owner wealth?

The Classical Objective Function



STOCKHOLDERS

Hire & fire managers
- Board
- Annual Meeting

Maximize stockholder wealth

Lend Money

BONDHOLDERS

Managers

No Social Costs

SOCIETY

Protect bondholder Interests

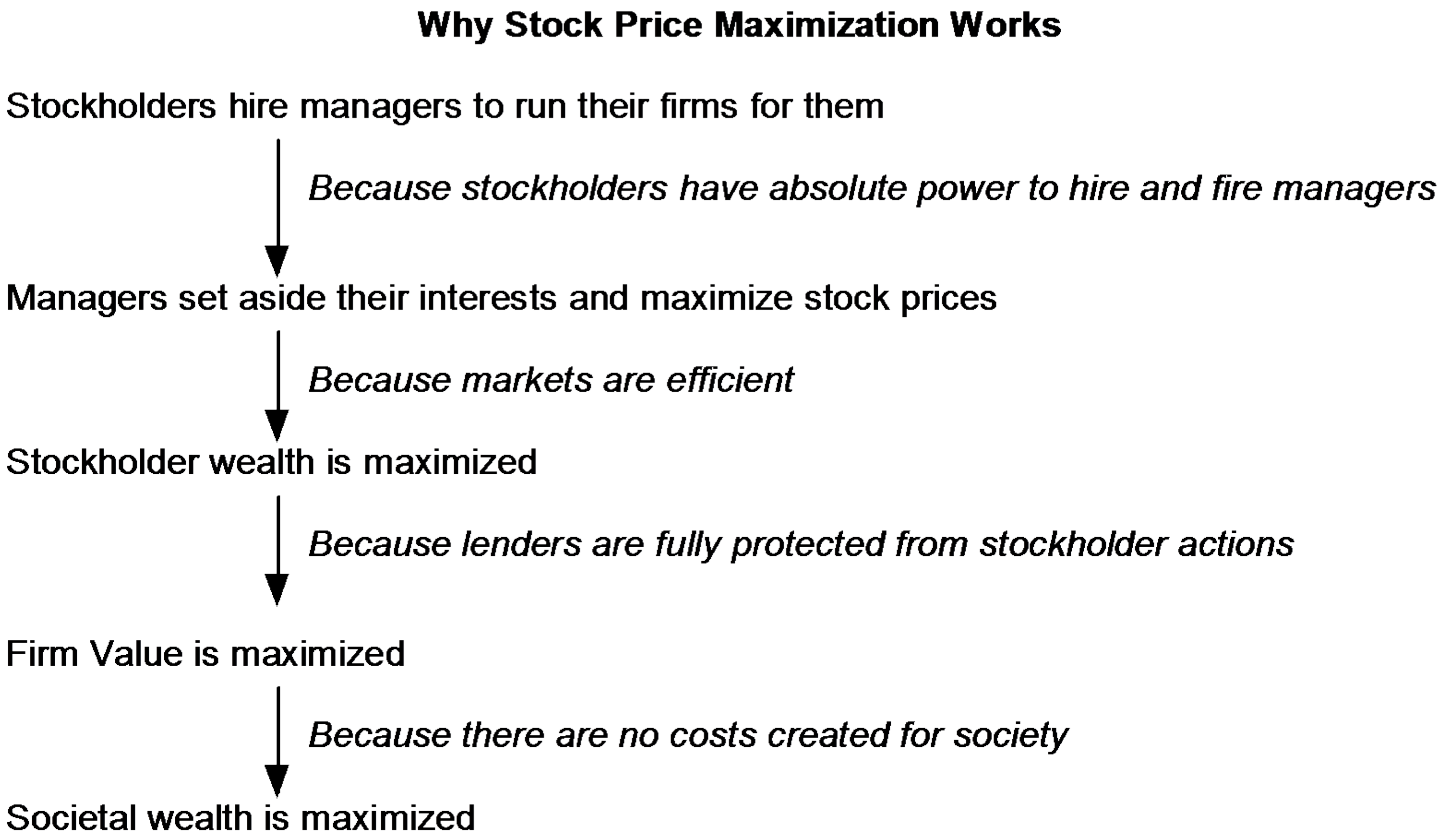
Costs can be traced to firm

Reveal information honestly and on time

Markets are efficient and assess effect on value

FINANCIAL MARKETS

Another Way of Presenting this is...



Why Stock Price Maximization Works

Stockholders hire managers to run their firms for them

Because stockholders have absolute power to hire and fire managers

Managers set aside their interests and maximize stock prices

Because markets are efficient

Stockholder wealth is maximized

Because lenders are fully protected from stockholder actions

Firm Value is maximized

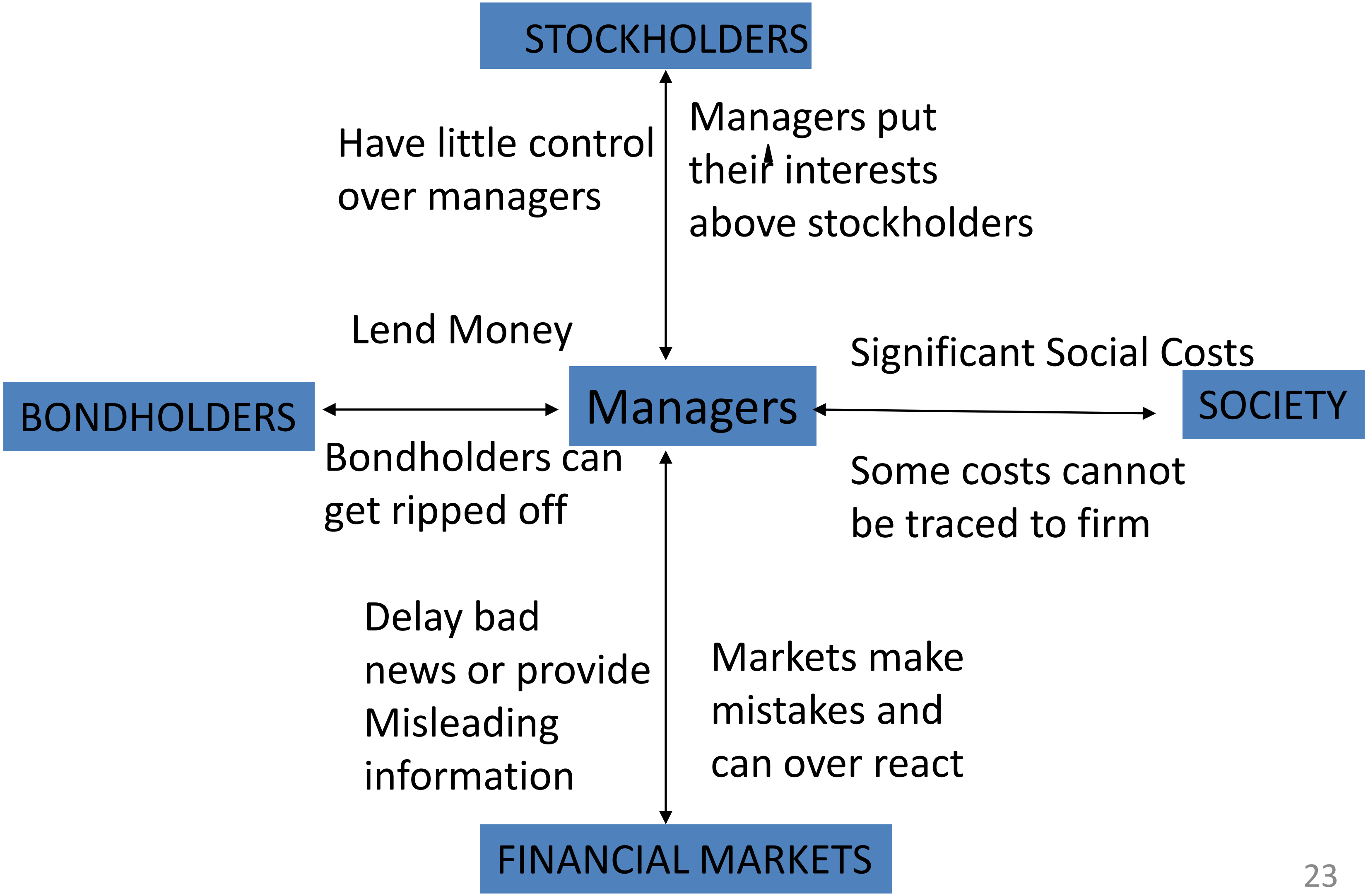
Because there are no costs created for society

Societal wealth is maximized

The Principal-Agent (PA) Problem

- The interests of managers, stockholders, bondholders and society can diverge. What is good for one group may not necessarily for another.
  - Managers may have other interests (job security, perks, compensation) that they put over stockholder wealth maximization.
  - Actions that make stockholders better off (increasing dividends, investing in risky projects) may make bondholders worse off.
  - Actions that increase stock price may not necessarily increase stockholder wealth, if markets are not efficient or information is imperfect.
  - Actions that makes firms better off may create such large social costs that they make society worse off.
- PA problem refers to the conflicts of interest that arise between all of these different groups.

What can go wrong?



STOCKHOLDERS

Have little control over managers

Managers put their interests above stockholders

Lend Money

BONDHOLDERS

Managers

Significant Social Costs

SOCIETY

Bondholders can get ripped off

Some costs cannot be traced to firm

Delay bad news or provide Misleading information

Markets make mistakes and can over react

FINANCIAL MARKETS

Wealth maximization and societal welfare (Adam Smith, 1776)

"As every individual, endeavours as much as he can both to employ his capital in the industry, and to direct that industry that its produce may be of the greatest value, every individual necessarily labours to render the annual revenue of the society as great as he can. In doing so he generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Thus, by pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who pretended to trade for the public good."

So what do you think?

- At this point in time, the following statement best describes where I stand in terms of the right objective function for decision making in a business

□ Maximize stock price or stockholder wealth, with no constraints

□ Maximize stock price or stockholder wealth, with constraints on being a good social citizen.

□ Maximize profits or profitability

□ Maximize market share

□ Maximize Revenues

□ Maximize social good

□ None of the above

Agency Costs and Residual Losses

- The Agent Problem can never be perfectly eliminated
- Agency costs are the costs of monitoring management and the incentive schemes used to try to align management with shareholders
- Residual losses are the losses that remain due to the divergence of interests between managers and shareholders