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Corporate Finance FOR DUMMIES®

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Learn to:

- Make sense of the maths and equations associated with corporate finance
- Understand the key concepts and terminology
- Get to grips with accounting statements, cash flow, business valuation, risk management and more

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Corporate Finance

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Contents at a Glance

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Introduction

In case you didn't already know, this book is about corporate finance. If you were looking for dog grooming, we're afraid you've picked up the wrong book.

Corporate finance is the study of how groups of people work together as a single organisation to provide something of value to society. If a company is using up more value than it's producing, it loses money and goes bust. So the job of people in corporate finance is to manage the organisation so that it uses resources efficiently (to the best advantage of the company), pursues the most valuable projects, remains competitive and people get to keep their job. You can accomplish this task through an easy process: measuring. In corporate finance, you measure value using money, because the final goal of all companies is to make money. When a company makes money – that is, when it's profitable – it's making sales that have more value than the things it buys and it's adding value to society rather than sucking the life out of it. Ensuring that a company is financially successful, however, is far more complicated than simply ensuring that it's profitable.

In this book, we discuss a wide range of topics in corporate finance. Think of it as a sampler or a greatest-hits album – an introductory book that provides everything you need to understand what corporate finance is and how to begin functioning at a basic level in the world of finance.

About This Book

This book is a little different from other corporate finance books. First of all, it's better! More useful than that, though, is that this book is written and organised so that people with absolutely no understanding of corporate finance can use it as a reference guide. It's also a wonderfully interesting read.

Everything in this book is written as if you're a complete newbie. The little details are pointed out, and when stuff gets complicated we just summarise the topic. We also explain – or at least clarify – everything, in down-to-earth language, without sounding technical. This book is all about making the subject of corporate finance accessible to everyone, while keeping it from being too dry. Corporate finance books can be really boring, which is sad because they don't need to be.

This book is organised to be used as a reference book. We still recommend reading it all, of course, but we break down and structure everything carefully to give the book what we like to call a disjointed continuity. This organisation makes looking things up without reading the entire book easy, while maintaining enough fluid continuity to make sense if you want to read the book from start to finish.

Foolish Assumptions

While writing this book, we did our best to assume that you know absolutely nothing. That being said, no one is perfect and we forgive you for failing to live up to the expectation that you're a complete dummy. In return, we'd appreciate it if you forgive us for the assumptions we made throughout this book. What we can do for you, though, is give you a heads up regarding some things you need to be aware of, know or perhaps prepare yourself with.

Unavoidably, this book involves a bit of maths. Yes, we know, maths is hard; we never liked it, either. That's why we supplement the majority of the maths with explanations of how to do the calculations that are simple enough to spare you from needing to know how to study maths. In other words, you can often skip over the majority of the equations and just read the paragraph(s) following them to get an understanding of what you're supposed to do. That's not always the case, though. To understand this book – to understand corporate finance at all – you do need a basic understanding of arithmetic (addition, subtraction, multiplication, division) as well as algebra (how to find x). We talk a bit about statistics and calculus in this book as well, but we provide you with careful, step-by-step instructions or simple summaries for that. We don't discuss anything that's very difficult. As long as you know arithmetic and a little algebra, you'll be fine – nothing's harder than $4 + x = 10$.

You can also supplement the information in this book by checking out *For Dummies* books on accounting. The two subjects have some overlap, and we bring up accounting subjects occasionally. Looking at *Accounting For Dummies* by John A. Tracy (Wiley), for example, can help give you more background about these topics. We try to include only those details relevant to the subject of corporate finance.

Other than that, if you're reading this right now, you're prepared to begin reading *Corporate Finance For Dummies!*

Icons Used in This Book

We scatter a few icons around the book to help you find relevant material. These icons highlight bits of information that are of particular importance to you. Here's what to look for.

Professionals get good at what they do by making stupid mistakes and learning from them. Now you can benefit from these stupid mistakes without the unfortunate side-effects of making them yourself. Just look for the Tip icon.

Whenever you see this icon, it means that you may one day need to remember the information included. You may want to consider keeping it in mind.

When you see this icon, we're talking about something that may pose a serious threat. We're not being facetious, either. Corporate finance is a study in money, and this is an introductory book, and so in some instances you need to talk to a professional before you get yourself or others into financial or legal trouble.

This icon clues you into the fact that the paragraph contains some interesting but not essential-to-know information. If you prefer, you can skip this material secure in the knowledge that you aren't missing anything vital. But then again, if you want to gain that extra edge. . . .

Beyond the Book

As you walk your journey of discovery into the world of corporate finance, you can augment what you read here by checking out some of the access-anywhere extra goodies that we've hosted for you online.

You can find the book's e-cheat sheet online, at `www.dummies.com/cheatsheet/corporatefinanceuk`. The at-a-glance tips and info that we offer in this cheat sheet can help you to make room for the basic skills you need in order to understand corporate finance, to understand how behaviour affects corporate finance, and more.

Additionally, you can also find bonus content online, at `www.dummies.com/extras/corporatefinanceuk`, which includes an extra Part of Tens chapter – 'Ten Key Points about Islamic Finance' – and some great bonus articles.

Where to Go from Here

We didn't write the chapters in order and you don't have to read them in order. If we can make a recommendation, though, you may want to begin with the chapters in Parts II and III before attempting Parts IV and V. At least flip through the earlier pages to make sure that you're familiar with how to read financial statements and the time value of money before you attempt to move on to Parts IV and V. As long as you're familiar with those things (financial statements and the time value of money), nothing in this book is going to be out of your grasp.

Part I

Getting Started with Corporate Finance

For Dummies can help you get started with lots of subjects. Visit `www.dummies.com` to learn more and do more with *For Dummies.*

In this part . . .

- Bone up on the basics of corporate finance and become proactive with your corporate finance know-how.
- Navigate your journey through the complex world of corporate finance, stopping off at the major organisations and visiting the major roles involved along the way.
- Get to grips with how companies raise money by incurring debt and by selling equity.

Chapter 1

Introducing Corporate Finance

In This Chapter

- Understanding the meaning of money
- Looking at the study of corporate finance
- Seeing the role corporate finance plays in your life
- Making corporate finance work for you

Corporate finance is more than just a measure of money. In fact, as you discover in this chapter – where we talk about the nature of money, how it applies to corporate finance and how it connects to you and your life – money is somewhat incidental to finance. When you're discussing corporate finance, you're looking at the whole world in a brand new way that measures it and what it contains so as to make the information useful to people. You can calculate things in terms of corporate finance that you simply can't measure accurately in any other way.

Part of the role of this chapter is also to introduce you to the book as a whole. Therefore, as part of helping you become proactive with your corporate finance know-how, we clue you into other chapters to allow you to follow your personal interests quickly and easily.

Considering Corporate Finance and the Role of Money in the World

Corporate finance is the study of relationships between groups of people that quantifies the otherwise immeasurable. (Corporate finance can also refer to a department, such as the corporate finance department in an investment bank that deals with advice given to companies about financial arrangements.) To understand how this rather wordy definition makes any sense at all, you have to take a quick look at the role of money in the world.

According to Adam Smith, an 18th century economist, the use of money was preceded by a *barter system,* in which people exchanged goods and services of relatively equivalent value. For example, if you worked growing hemp and making rope out of it, you'd give that rope to people in exchange for food, clothes or whatever else you needed that the people around you were offering.

But what happens when someone wants rope but that person has nothing you want, or you need food but no one needs rope? These times caused people to start using a basic form of money. So, you sell your rope to someone with nothing you want and he gives you a credit note for his services that you're free to give to anyone else. You decide to go and buy some beer, giving the brewer the credit note, ensuring that the person who bought your rope would provide the brewer a service in exchange for giving you beer. Thus, the invention of money was born, though in a very primitive form.

Looking at money in this way, you come to realise that money is in fact debt. When you hold money, it means that you've provided goods or services of value to someone else and that you're now owed value in return. The development of a standardised, commonly used currency among large numbers of people simply increases the number of people willing to accept your paper or coin IOUs. Therefore, that currency becomes easier to exchange among a wider number of people, across greater distances and for a more diverse variety of potential goods and services (for additional gloss on this account, read the nearby sidebar 'Taxes started early').

Put simply, money is debt for the promise of goods and services that have an inherent usefulness, but money itself isn't useful except as a measure of debt. People use money to measure the value that they place on things.

Imagine that you're living in Ancient Egypt and you want to know the value of a goat. You can say that one goat is worth five chickens, but that doesn't help you much. You can say that a bricklayer's labour is worth half that of a brewer of beer, but you can't measure that mathematically. Using these methods, you have no real way to establish a singular, definitive measurement for the value that people place on different things.

Taxes started early

According to 21st century anthropologist David Graebner, early money was probably something closer to bartering with the government as a taxation, which meant providing goods and services to the government (for example, the emperor) and then being provided units of 'currency' worth product rations. So you can say that money was invented for the first government contractors as a method for the government to acquire resources in return for units of early currency worth specific amounts of resources, rather than a true barter.

So, how can you measure value? By determining the amount of money that people are willing to exchange for different things. This method allows you to determine very accurately how people interact, what they value and the relative differences in value between certain things or certain people's efforts. Much about the nature of people, the things they value and how they interact together become clearer when you develop an understanding of what they're spending money on and how much they're spending.

Eight millennia on from Ancient Egypt, in the modern era of money – well after the establishment of weighted coins to measure an equivalent weight of grain, the standardised minting of currency and after the origins of money were forgotten by the vast majority of the world's population (welcome to the minority) – money begins to take on a more abstract role. People use it as a way to measure resource allocations between groups and within groups. They even begin to measure how well a group of people are interacting by looking at their ability to produce more using less. Success is measured by their ability to hoard greater amounts of this inter-personal debt. The ability to hoard debt in this manner defines whether the efforts of one group of people are more or less successful than the efforts of another group.

People use money to place a value on everything, which allows them to compare different items. Which one is better, apples or oranges? The answer is the one on which people place more value based on the total amount of revenues. Higher revenues tell you that people place greater value on one of those two fruits, because they're willing to pay for the higher costs plus any additional profits.

When we say that corporate finance is the study of the relationships between groups of people, we're referring to measuring how groups of people are allocating resources among themselves, putting value on goods and services, and interacting with each other in the exchange of these goods and services. Corporate finance picks apart the financial exchanges of groups of people, all interconnected in professional relationships, by determining how effectively and efficiently they work together to build value and manage that value after it's acquired. The organisations that are more effective at developing a cohesive team of people who work together to build value in the marketplace are going to be more successful than their competitors.

In corporate finance, you measure all this information mathematically in order to assess the success of the corporate organisation, evaluate the outcome of potential decisions and optimise the efforts of those people who form economic relationships, even if for just a moment, as they exchange goods, services and value in a never-ending series of financial transactions.

Identifying What Makes Corporate Finance Unique

Corporate finance plays an interesting role in all societies. Finance is the study of relationships between people: how they distribute themselves and their resources, place value on things and exchange that value among each other. Therefore, all finance is really the science of decision-making. We're talking about studying human behaviour and how people make decisions regarding what they do with their lives and the things they own.

Corporate finance, as a result, studies decision-making in terms of what groups of people do when working together in a professional manner. This definition guides you in two primary directions connected to what makes corporate finance unique:

- Understanding that corporate finance is a critical aspect of human life as an intermediary that allows people to transfer value among themselves.
- Discovering how groups of people interact together as a single unit, a company, and how decisions are made on behalf of the company by its managers.

Money is just the unit of measure people use to calculate everything and make sense of it numerically, to compare things in absolute terms rather than relative ones. In contrast, corporate finance is a unique study that measures *value.* When you accept that fact, you see that everything in the world has value. Therefore, you can use corporate finance to measure everything around you that relates to a company, directly or indirectly (which, in the vast majority of the world, is everything).

Serving as an intermediary

The easiest way to understand how corporate finance acts as a critical intermediary process between groups of people is to look at the role of financial institutions in the greater economy. Financial institutions, such as banks and credit unions, have a role that involves redistributing money between those who want money and those who have excess money, all in a manner that the general population believes is based on reasonable terms.

Now, whether financial institutions as a whole are fully successful in their role is no longer a matter of debate: they aren't. The cyclical role being played out time and again prior to the Great Depression, prior to the 1970's economic troubles and prior to the 2008 collapse are the legacies of a systematic operational failure yet to be resolved.

For the most part, however, the role that financial institutions play is necessary. They facilitate the movement of resources across the entire world. They accept money from those who have more than they're using and offer interest rate payments in return. Then they turn around and give that money to those seeking loans, charging interest for this service. In this role, financial institutions are intermediaries that allow people on both sides of these sorts of transactions to find each other by way of the bank itself. Without this role, investments and loans would very nearly come to a total halt compared to the extremely high volume and value of the current financial system.

REMEMBER

Corporate finance plays a similar role as an intermediary for the exchange of value of goods and services between individuals and organisations. Corporate finance, as the representation of the value developed by groups of people working together towards a single cause, studies how money is used as an intermediary of exchange between and within these groups to reallocate value as is deemed necessary.

We'd like to backtrack for a moment. What on earth is an investment, anyway? An *investment* is anything that you buy for the purpose of generating greater value than you spent to acquire it. Yes, yes, shares and bonds are good examples; you buy them, they go up in value and you sell them. But no doubt you can think of other examples that work in different ways. A house that you buy to generate income is a good example of an investment: you buy it, generate revenue as its tenants pay their rent and after the house goes up in value, you sell it. (In contrast, your own home usually isn't considered an investment.)

Analysing interactions between people

Money places an absolute value on transactions that take place, and so you can measure easily not only these transactions, but also all the several potential options in a given decision. In other words, you can measure the outcome of a decision before it's made, thanks to corporate finance.

REMEMBER

That's the second thing (after its role as an intermediary process) that makes corporate finance a unique study: it analyses the value of interactions between people, the value of the actions taken and the value of the decisions made, and then compiles that information into a single collection based on professional interconnectedness in a single company.

This analysis allows you to measure how effectively you're making decisions and optimise the outcome of future decisions you have to make. The decisions that companies make tend to have far-reaching consequences, influencing the lives of employees, customers, suppliers, investors and the greater national economy, and so ensuring that a company is making the correct decisions is of the utmost importance. Corporate finance allows you to do this. So if you have a favourite company, hug the financial analysts next time you see them (or maybe just send a box of chocolates; you may freak someone out if you just randomly starting hugging people).

Recognising How Corporate Finance Rules Your Life

Unless you're in the rare minority and live as a secluded and self-sufficient recluse, practically every aspect of your life is strongly influenced, directly or otherwise, by corporate finances. For instance, the price and availability of the things you buy are decided using financial data and the chances are high that your job relies heavily on decisions made using financial data, as do your savings and investments. Your house, car, where you live and even the laws in your area are all determined using financial information about companies.

From the beginning, a company needs to decide how it plans to fund its *start-up:* the time when it first begins purchasing supplies to start operating. This single decision decides a significant amount about the company's costs, which, in turn, decide a lot about the prices it's going to charge. Where it sells its goods depends greatly on whether the company can sell them at a price high enough to generate a profit after the costs of production and distribution, assuming that competitors can't drive down prices in that area. The number of units that the company produces depends entirely on how productive its equipment is, and the company only purchases more equipment if doing so doesn't cost more than the organisation can make in profits.

These factors affect your job, too; the company recruits more people who add value to the company only if doing so is profitable. Where your job is located depends greatly on where in the world it's cheapest to locate operations related to your line of work. The decision to outsource your job to another nation depends entirely on whether that role within the company can be done more cheaply elsewhere, without incurring risks that are too expensive. That's right, even risk can be measured mathematically in financial terms.