Financial Management in Construction CoTM

CHAPTER 1: Introduction
An Overview of Financial Management

- Capital Requirement of a Firm
- Fields of Finance
- Forms of business organization
- Goals of Financial Management
- Functions of Financial Management
- Organization of Finance Functions

What is Financial Management all about?

- FM is the planning for, acquiring and Utilizing of funds in order to maximize the efficiency and value of the firm
- It involves
  - Forecasting & Planning
  - Major investment and financing decisions
  - Coordination and Control
  - Risk Management

Cont'd

- **Suppose one is planning to start his own business. No matter what the nature the proposed business is and how it is organized, he has to address the following Questions**?
  - What capital investment should be made?
  - How and where the money to pay for the proposed capital investment will be raised?
  - How the day-to-day financial activities are handled**?**

Cont'd

It is now broaden to deal with issues like:

- Which new proposals for employing capital should be accepted by the firm?
- What steps can be taken to increase the value of the firm's common stock?
- How much working capital will be needed to support and expand the company's operation?
- Where should the firm go to raise the short and long-term capital demand and how much will it cost?
- Should a firm declare a cash dividend on its common stock and if so, how much a dividend should be declared?

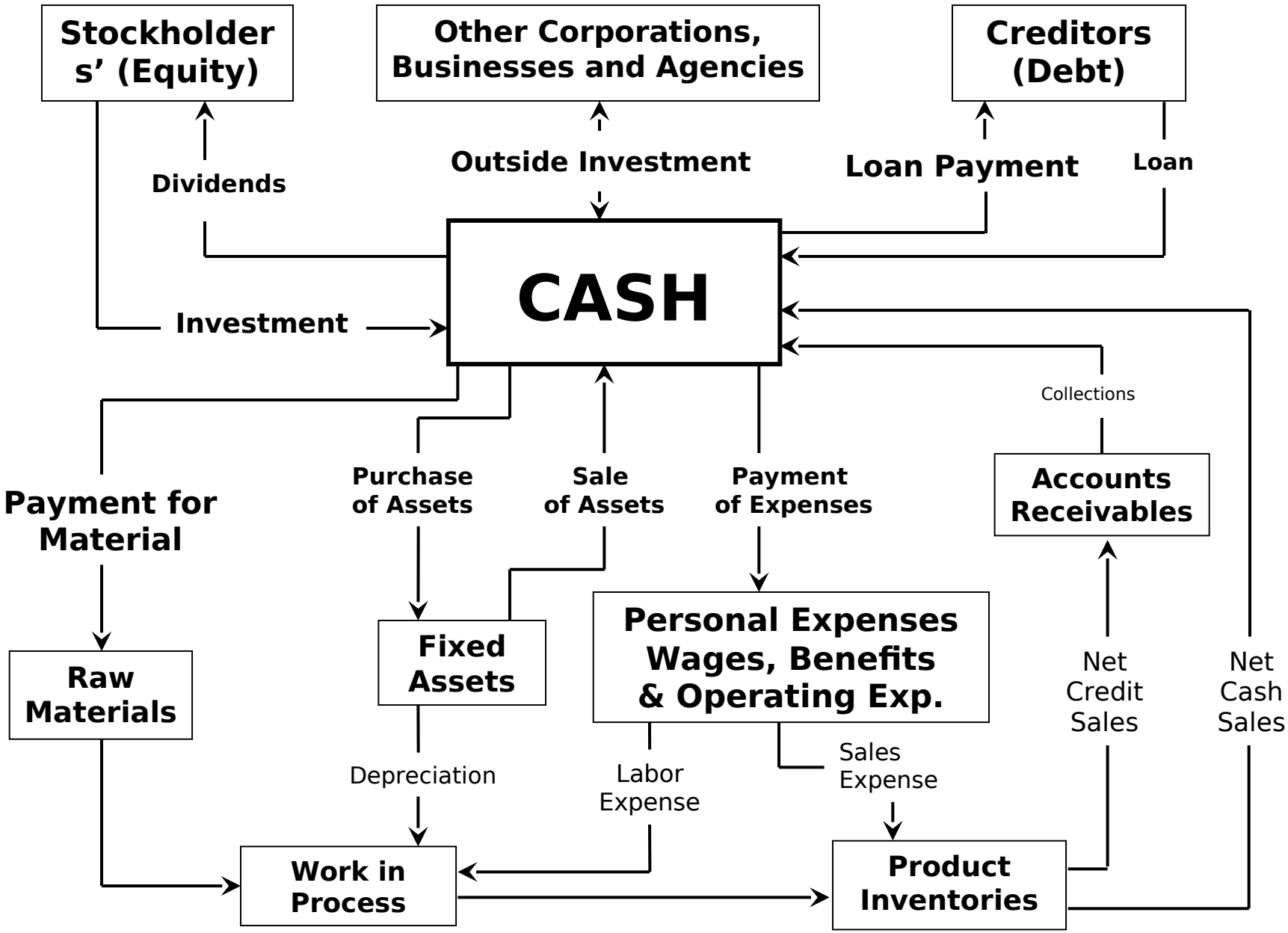
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- The term finance can be defined **as the management of the flows of money or its equivalent through an organization,** whether it is a *for* or *not-for* profit firms, corporation or non-corporate business, or government agency.

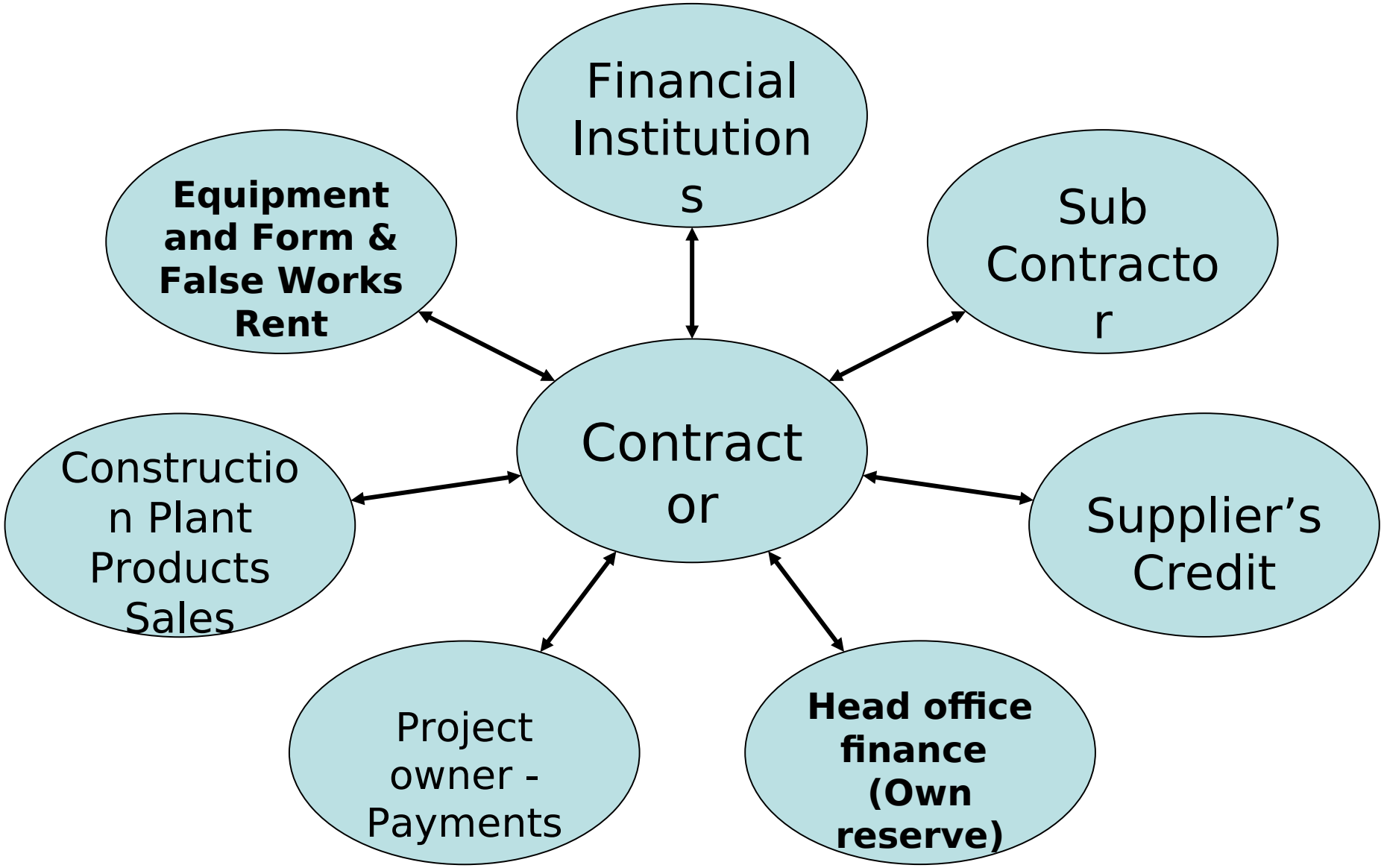
  Finance concerns itself with the actual flow of money as well as any claims against money.

- The flow of fund is a continuous process

Cash Flow in a Firm



Cash flow of contractors towards project participants



Major financial demand required for Construction works include:

- Financial demand for Tendering
- Financial demand for Contracting
- Financial demand for Inputs (Resources)
- Financial demand for Supervision
- Financial demand for Payment Processing

The Financing Problem

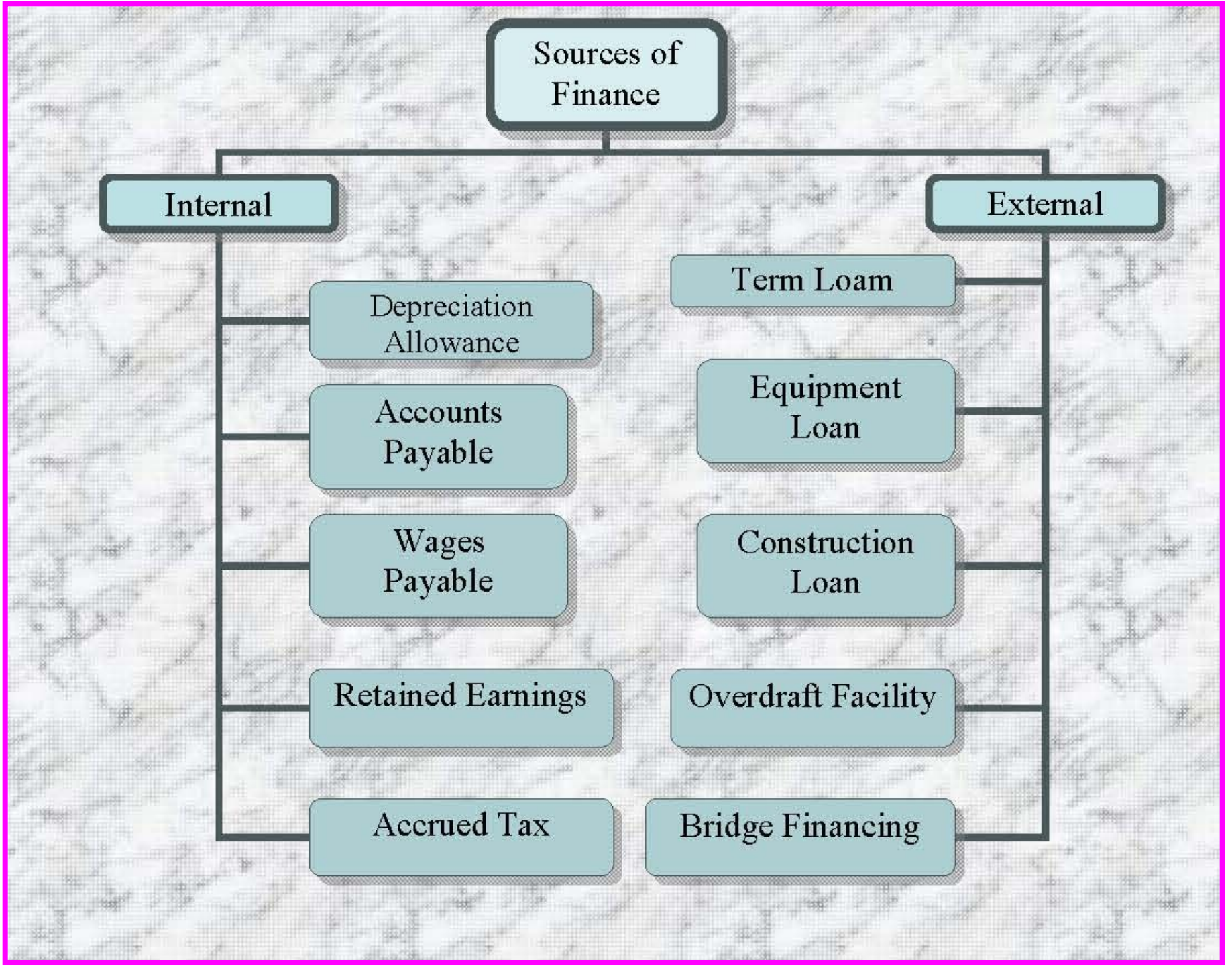
- **The project finance problem** is to obtain funds to bridge the time between making expenditures and obtaining revenues.

Sources of Finance to Contractors

- **Internal**
  - Cash flow from operations
  - Sale of assets
- **External**
  - owners (equity)
  - creditors (debt)

Debt vs. Equity Financial Securities

- **Debt Security**
  - It arises when a firm borrows money from creditors. The firm incurs liability to repay the amount of money borrowed in some future maturity date
- **Equity Securities**
  - It represents ownership claim in the firm. People who purchase equity securities are entitled to rights and conditions that are different from those of firm's creditors


Sources of Finance
Internal
External
Depreciation Allowance
Accounts Payable
Wages Payable
Retained Earnings
Accrued Tax
Term Loam
Equipment Loan
Construction Loan
Overdraft Facility
Bridge Financing

2. Fields of Finance

Fields of finance	Fund owned by	Fund collected through	Use of fund
Public Finance	Federal, State and Local Government	Revenue from taxes and levies, Loan , Grant etc	To accomplish Social and Economic objectives. Perform non-profit oriented corporations.
Finance Securities	Individuals, Institutional investors	Purchase and sale of stocks and bonds.	Means of raising finance for institutional investors. Means of achieving profit for individuals.
International Finance	Individuals, businesses and governments involved in	Through International transactions	Means of collecting foreign currency.

Alternative Forms of Business Organization

1. Sole proprietorship

2. Partnership

- General Partnership
- Limited Partnership

3. Corporation

- Subsidiary
- Affiliate
- Division

4. Joint Venture

1. Sole Proprietorship

- **Advantages:**
  - Ease of formation
  - Subject to few regulations
  - No corporate income taxes
- **Disadvantages:**
  - Limited life
  - Unlimited liability
  - Difficult to raise capital

2. Partnership

- A general partnership has roughly the same advantages and disadvantages as a sole proprietorship.



3. Corporation

- **Advantages:**
  - Unlimited life
  - Easy transfer of ownership
  - Limited liability
  - Ease of raising capital
- **Disadvantages:**
  - Double taxation
  - Cost of set-up and report filing

Double Taxation of Corporate Profits/Income

Assume Corporate and Individual Tax = 50%

Earnings Before Taxes $100 EBT

($50) Corporate Tax

Net Income After Tax $50 NIAT (Profits)

Assume 100% Div. Payout $50 Dividend income

($25) Personal Income $25 After-tax Income

4. Joint Venture

- **A joint venture** is a partnership agreement in which two or more individual- or group-run businesses join together to carry out a single business project sharing the initial investment & risks.

In the Ethiopian Code:

"**A joint venture** is an agreement between partners on terms mutually agreed and is a subject to the general principles of law relating to the partnerships."

Goals of Financial Management

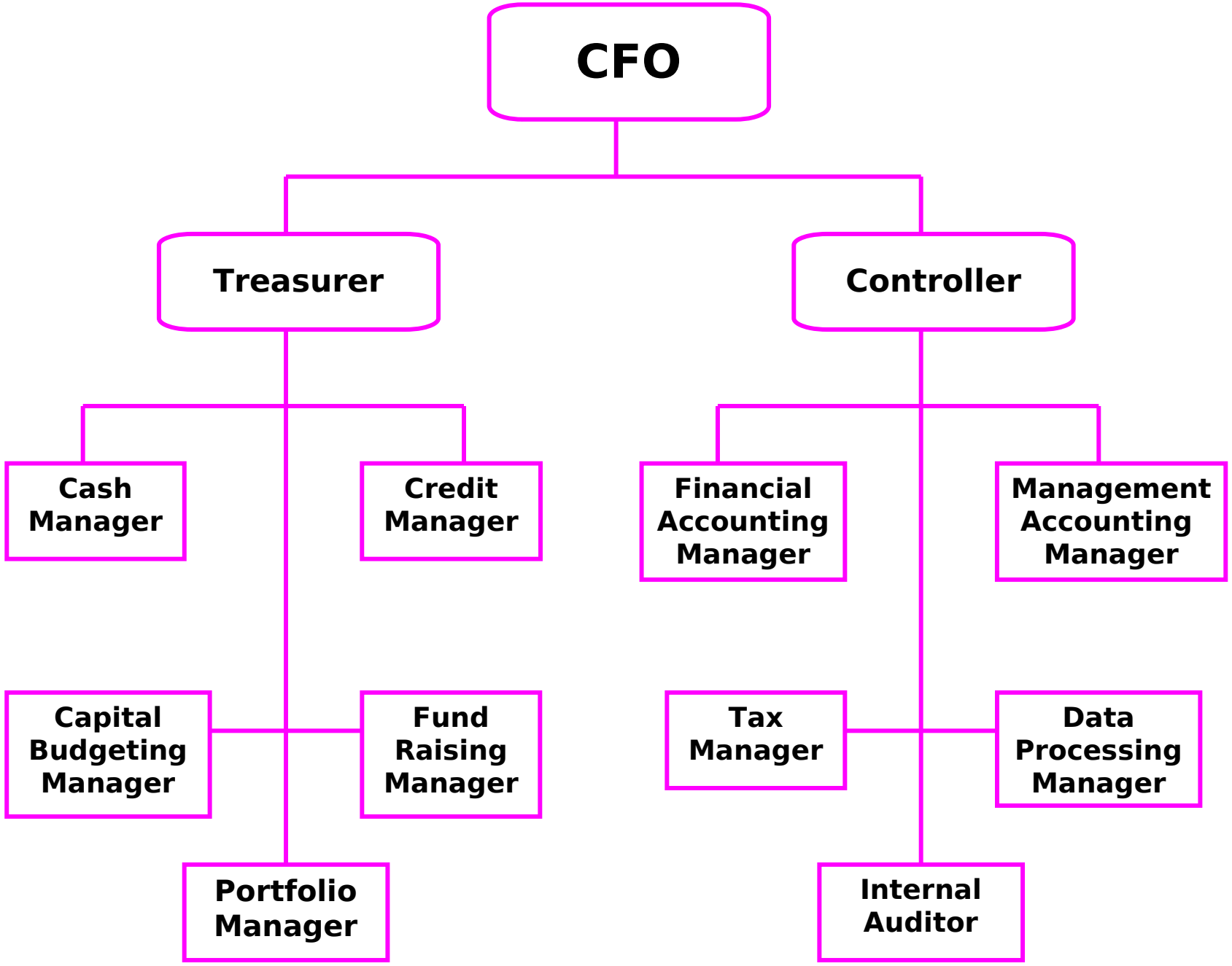
- **Profit Maximization:**
  - It is vague(not clear in meaning: stated in a way that is general & not specific)
  - It leaves consideration of timing and duration undefined
  - It overlooks future aspects
- **Wealth Maximization:**
  - Avoid high level of risk
  - Pay consistent dividend
  - Seek growth in Sales
  - Maintain market Price of Stocks

Functions of Financial Management

- **Liquidity functions**
  - Forecasting Cash flow
  - Raising Funds
  - Managing the flow internal funds
- **Profitability functions**
  - Cost Control
  - Pricing
  - Forecasting profits
  - Profit-risk analysis
- **Managing assets**

Organization of Finance Function

- Most firms designate three major financial positions
  - Chief Financial Officer (CFO)
  - Treasurer
    - Managing cash flows
    - Forecasting financial need
    - Relations with FI
  - Controller
    - Financial accounting, internal auditing, taxation, payroll functions


CFO
Treasurer
Controller
Cash Manager
Credit Manager
Financial Accounting Manager
Management Accounting Manager
Capital Budgeting Manager
Fund Raising Manager
Tax Manager
Data Processing Manager
Portfolio Manager
Internal Auditor

End of Chapter 1