

Chapter 1

The Role of Financial Management

What is Financial Management?

Concerns the **acquisition**,
financing, and
management of assets
with some overall goal in
mind.

Investment Decisions

Most important of the three decisions.

- ◆ **What is the optimal firm size?**
- ◆ **What specific assets should be acquired?**
- ◆ **What assets (if any) should be reduced or eliminated?**

Financing Decisions

Determine how the assets (LHS of balance sheet) will be financed (RHS of balance sheet).

- ◆ **What is the best type of financing?**
- ◆ **What is the best financing mix?**
- ◆ **What is the best dividend policy (e.g., dividend-payout ratio)?**
- ◆ **How will the funds be physically acquired?**

Asset Management Decisions

- ◆ How do we manage existing assets *efficiently*?
- ◆ Financial Manager has varying degrees of operating responsibility over assets.
- ◆ Greater emphasis on **current asset management** than **fixed asset management**.

What is the Goal of the Firm?

*Maximization of
Shareholder Wealth!*

*Value creation occurs when
we maximize the share price
for current shareholders.*

Shortcomings of Alternative Perspectives

Profit Maximization

- ◆ Maximizing a firm's earnings after taxes.

Problems

- ◆ Could increase current profits while harming firm (e.g., defer maintenance, issue common stock to buy T-bills, etc.).
- ◆ Ignores changes in the risk level of the firm.

Shortcomings of Alternative Perspectives

Earnings per Share Maximization

- ◆ Maximizing earnings after taxes divided by shares outstanding.

Problems

- ◆ Does not specify timing or duration of expected returns.
- ◆ Ignores changes in the risk level of the firm.
- ◆ Calls for a zero payout dividend policy.

Strengths of Shareholder Wealth Maximization

- ◆ Takes account of: **current and future profits and EPS**; **the timing, duration, and risk of profits and EPS**; **dividend policy**; and all other relevant factors.
- ◆ Thus, share price serves as a barometer for business performance.

The Modern Corporation

Modern Corporation

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graph TD; A[Modern Corporation] --> B[Shareholders]; A --> C[Management];
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Shareholders

Management

**There exists a SEPARATION
between owners and managers.**

Role of Management

Management acts as an ***agent*** for the owners (shareholders) of the firm.

- ◆ An ***agent*** is an individual authorized by another person, called the principal, to act in the latter's behalf.

Agency Theory

- ◆ **Jensen and Meckling developed a theory of the firm based on *agency theory*.**
- ◆ ***Agency Theory* is a branch of economics relating to the behavior of principals and their agents.**

Agency Theory

- ◆ Principals must provide *incentives* so that management acts in the principals' best interests and then *monitor* results.
- ◆ Incentives include, *stock options*, *perquisites*, and *bonuses*.

Social Responsibility

- ◆ Wealth maximization does *not* prevent the firm from being **socially responsible**.
- ◆ Assume we view the firm as producing *both* private and social goods.
- ◆ Then **shareholder wealth maximization** remains the appropriate goal in governing the firm.

Corporate Governance

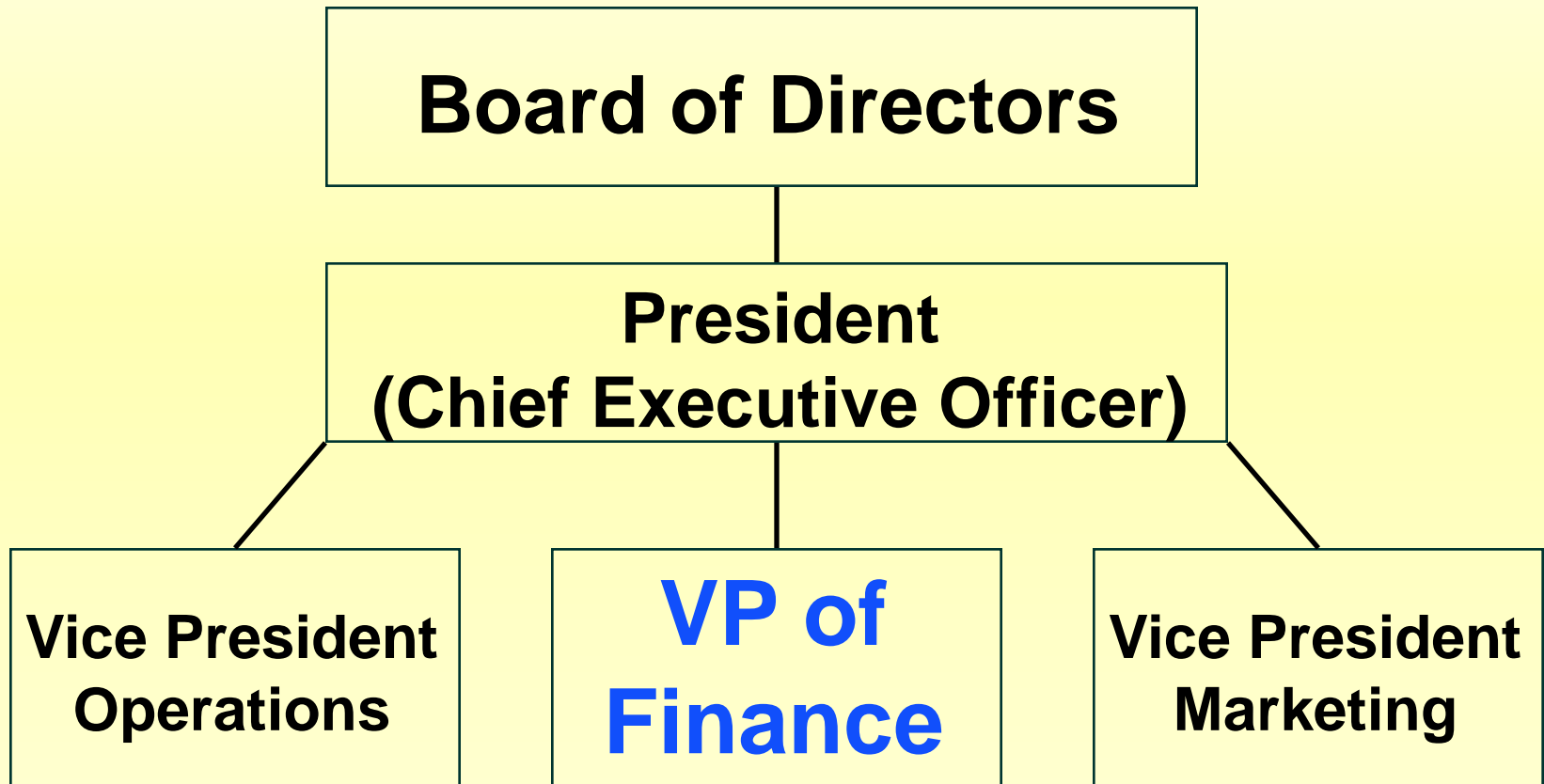
- ◆ ***Corporate governance: represents the system by which corporations are managed and controlled.***
 - ◆ Includes shareholders, board of directors, and senior management.
- ◆ Then ***shareholder wealth maximization*** remains the appropriate goal in governing the firm.

Board of Directors

◆ Typical responsibilities:

- ◆ Set company-wide policy;
 - ◆ Advise the CEO and other senior executives;
 - ◆ Hire, fire, and set the compensation of the CEO;
 - ◆ Review and approve strategy, significant investments, and acquisitions; and
 - ◆ Oversee operating plans, capital budgets, and financial reports to common shareholders.
- ◆ CEO/Chairman roles commonly same person in US, but separate in Britain (US moving this direction).

Organization of the Financial Management Function



Organization of the Financial Management Function

VP of Finance

Treasurer

**Capital Budgeting
Cash Management
Credit Management
Dividend Disbursement
Fin Analysis/Planning
Pension Management
Insurance/Risk Mngmt
Tax Analysis/Planning**

Controller

**Cost Accounting
Cost Management
Data Processing
General Ledger
Government Reporting
Internal Control
Preparing Fin Stmts
Preparing Budgets
Preparing Forecasts**