Chapter 1 – Nature of Financial Management

- Explain the nature of finance and its interaction with other management functions
- Review the changing role of the finance manager and his/her position in the management hierarchy
- Focus on the Shareholders' Wealth Maximization (SWM) principle as an operationally desirable finance decision criterion
- Discuss agency problems arising from the relationship between shareholders and managers
- Illustrate the organization of finance function

Important Business Activities

- Production
- Marketing
- Finance

Real And Financial Assets

- **Real Assets:** *Can be Tangible or Intangible*
  - **Tangible real assets** are physical assets that include plant, machinery, office, factory, furniture and building.
  - **Intangible real assets** include technical know-how, technological collaborations, patents and copyrights.
- **Financial Assets** are also called **securities**, are financial papers or instruments such as shares and bonds or debentures.

Equity and Borrowed Funds

- **Shares** represent ownership rights of their holders. Shareholders are owners of the company. Shares can of two types:
  - Equity Shares
  - Preference Shares
- **Loans, Bonds or Debts**: represent liability of the firm towards outsiders. Lenders are not owners of the company. These provide **interest tax shield**.

Equity and Preference Shares

- **Equity Shares** are also known as **ordinary shares**.
  - Do not have fixed rate of dividend.
  - There is no legal obligation to pay dividends to equity shareholders.
- **Preference Shares** have preference for dividend payment over ordinary shareholders.
  - They get fixed rate of dividends.
  - They also have preference of repayment at the time of liquidation.

Finance and Management Functions

- All business activities involve acquisition and use of funds.
- Finance function makes money available to meet the costs of production and marketing operations.
- Financial policies are devised to fit production and marketing decisions of a firm in practice.

Finance Functions

Finance functions or decisions can be divided as follows

- **Long-term financial decisions**
  - Long-term asset-mix or investment decision or capital budgeting decisions.
  - Capital-mix or financing decision or capital structure and leverage decisions.
  - Profit allocation or dividend decision
- **Short-term financial decisions**
  - Short-term asset-mix or liquidity decision or working capital management.

Financial Procedures and Systems

- For effective finance function some routine functions have to be performed. Some of these are:
  - ✔ Supervision receipts and payments and safeguarding of cash balances
  - ✔ Custody and safeguarding of securities, insurance policies and other valuable papers
  - ✔ Taking care of the mechanical details of new outside financing
  - ✔ Record keeping and reporting

Finance Manager's Role

- Raising of Funds
- Allocation of Funds
- Profit Planning
- Understanding Capital Ma

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Financial Goals

- Profit maximization (profit after tax)
- Maximizing earnings per share
- Wealth maximization

Profit Maximization

- Maximizing the rupee income of firm
  - ✔ Resources are efficiently utilized
  - ✔ Appropriate measure of firm performance
  - ✔ Serves interest of society also

Objections to Profit Maximization

- It is Vague
- It Ignores the Timing of Returns
- It Ignores Risk
- Assumes Perfect Competition
- In new business environment profit maximization is regarded as
  - Unrealistic
  - Difficult
  - Inappropriate
  - Immoral

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Maximizing Profit after Taxes or EPS

- Maximising PAT or EPS does not maximise the economic welfare of the owners.
- Ignores timing and risk of the expected benefit
- Market value is not a function of EPS.
- Maximizing EPS implies that the firm should make no dividend payment so long as funds can be invested at positive rate of return—such a policy may not always work.

Shareholders' Wealth Maximization

- Maximizes the net present value of a course of action to shareholders.
- Accounts for the timing and risk of the expected benefits.
- Benefits are measured in terms of cash flows.
- **Fundamental objective**—maximize the market value of the firm's shares.

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Need for a Valuation Approach

- SWM requires a valuation model.
- The financial manager must know,
  - How much should a particular share be worth?
  - Upon what factor or factors should its value depend?

Risk-return Trade-off

- Financial decisions of the firm are guided by the **risk-return trade-off**.
- The return and risk relationship: **Return = Risk-free rate + Risk premium**
- Risk-free rate is a compensation for time and risk premium for risk.

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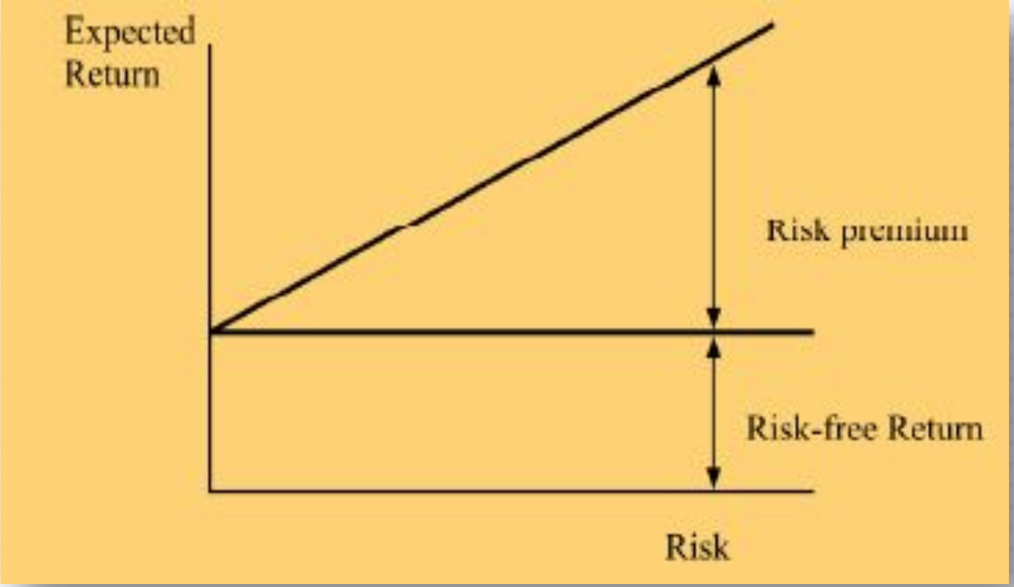
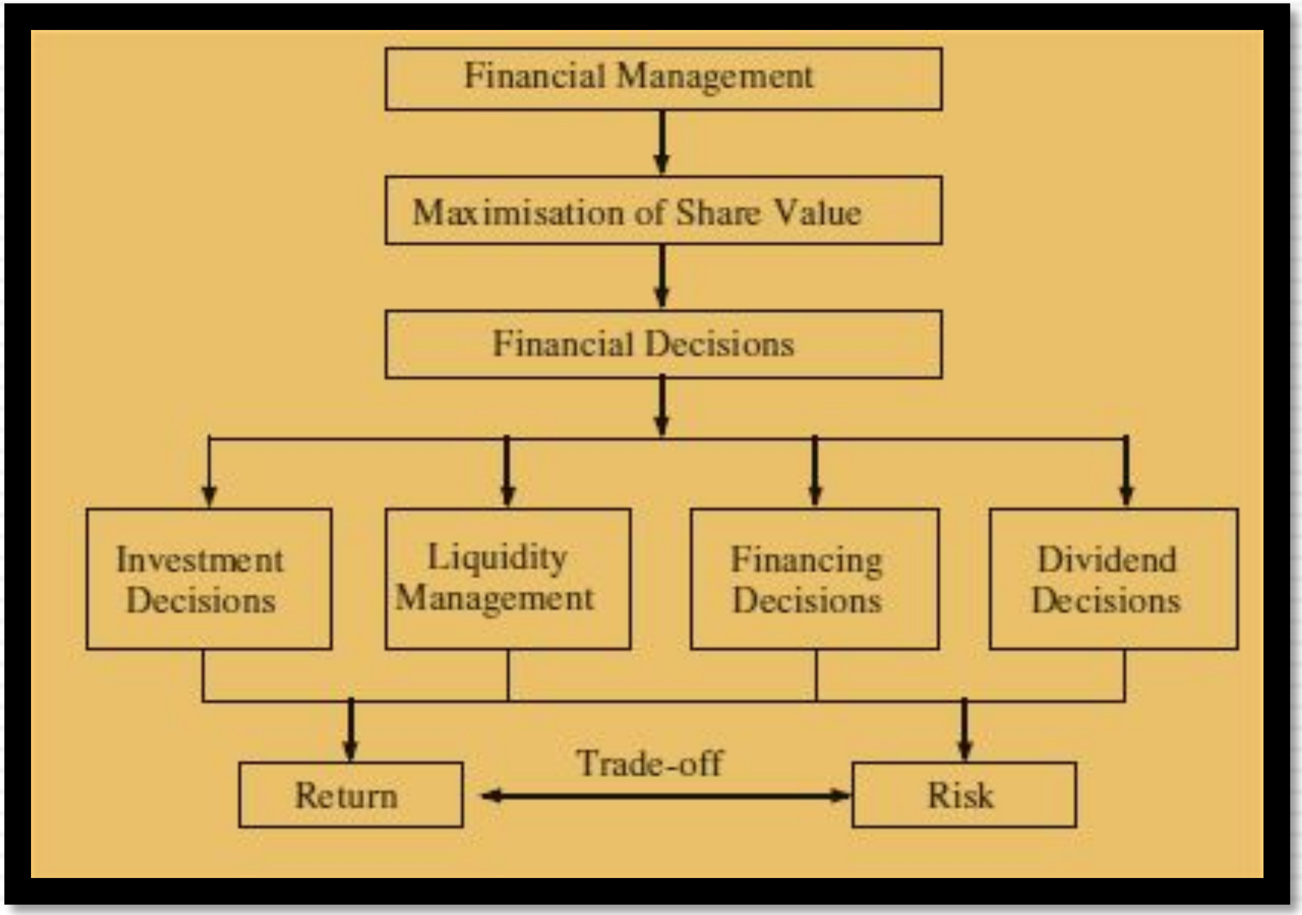
Risk Return Trade-off



Risk and expected return move in tandem; the greater the risk, the greater the expected return.

Overview of Financial Management



Agency Problems: Managers Versus Shareholders' Goals

- **There is a Principal Agent relationship between managers and shareholders.**

- In theory, Managers should act in the best interests of shareholders.

- In practice, managers may maximise their own wealth (in the form of high salaries and perks) at the cost of shareholders.

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Agency Problems: Managers Versus Shareholders' Goals

- Managers may perceive their role as reconciling conflicting objectives of stakeholders. This stakeholders' view of managers' role may compromise with the objective of SWM.

- Managers may avoid taking high investment and financing risks that may otherwise be needed to maximize shareholders' wealth. Such "satisfying" behaviour of managers will frustrate the objective of SWM as a normative guide.

- ***This conflict is known as Agency problem and it results into Agency costs.***

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Agency Costs

- Agency costs include the less than optimum share value for shareholders and costs incurred by them to monitor the actions of managers and control their behaviour.

Financial Goals and Firm's Mission and Objectives

- Firms' primary objective is maximizing the welfare of owners, but, in operational terms, they focus on the satisfaction of its customers through the production of goods and services needed by them.
- Firms state their vision, mission and values in broad terms.
- Wealth maximization is more appropriately a *decision criterion*, rather than an *objective* or a *goal*.
- Goals or objectives are missions or basic purposes of a firm's existence.

Financial Goals and Firm's Mission and Objectives

- The shareholders' wealth maximization is the second-level criterion ensuring that the decision meets the minimum standard of the economic performance.
- In the final decision-making, the judgement of management plays the crucial role.
- The wealth maximization criterion would simply indicate whether an action is economically viable or not.

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Organisation of the Finance Functions

- Reason for placing the finance functions in the hands of top management
  - Financial decisions are crucial for the survival of the firm.
  - The financial actions determine solvency of the firm
  - Centralisation of the finance functions can result in a number of economies to the firm.

Status and Duties of Finance Executives

- The exact organisation structure for financial management will differ across firms.
- The financial officer may be known as the financial manager in some organisations, while in others as the vice-president of finance or the director of finance or the financial controller.