Chapter 1: Fundamentals of Financial Management

The Role of Financial Management in Public and Private Sectors

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Learning Objectives

- An overview of financial management
- The Goal of a Firm and the Agency Problem
- Finciancial Management Functions
- Compare forms of business organization
- Understand corporate taxes and depreciation
- Recognize tax effects on financing and investment
- Appreciate role of financial markets and institutions

The Role of Financial Manager

- **Early role (pre-1950s):** Mainly raising funds and managing cash.
- **Post-1950s:** Adoption of present value concepts $\rightarrow$ focus on capital investment decisions.
- **Today:** Financial managers face external challenges:
  - Competition, technology, inflation, interest rates
  - Exchange rate volatility, tax law changes
  - Environmental and ethical concerns
- Finance now plays a **strategic role** in value creation.
- Successful managers must:
  - Adapt to change and uncertainty
  - Value flexibility (real options approach)
  - Balance raising funds, investing, and asset management
- Efficient financial management contributes to firm success & economic growth.

The Scope of Financial Management

- Financial management deals with:
  - **Acquisition of assets**
  - **Financing of assets**
  - **Management of assets**
- Decision areas can be grouped into three categories:
  1. **Investment decisions** – selecting projects and allocating capital
  2. **Financing decisions** – choosing capital structure and raising funds
  3. **Asset management decisions** – efficient use of current and fixed assets
- All decisions are guided by the firm's overall goal.

Investment Decision

- **Most important decision** for value creation.
- Begins with determining the **total assets** required by the firm.
- Involves decisions on the **composition of assets**:
  - Cash, inventory, receivables
  - Fixed assets and long-term projects
- Must also consider **disinvestment**:
  - Reducing or eliminating assets that no longer create value
  - Replacing outdated or unproductive resources
- Think of the left side of the balance sheet (assets) — size and structure are central.

Financing Decision

- Concerned with the **right-hand side of the balance sheet** (liabilities & equity).
- Firms differ in their use of debt vs equity:
  - Some are highly leveraged (more debt)
  - Others are nearly debt free
- Key questions:
  - Does financing mix affect firm value?
  - Is there an **optimal capital structure**?
- **Dividend policy** is part of financing decision:
  - Dividend-payout ratio $= \frac{\text{Dividends}}{\text{Earnings}}$
  - Trade-off between paying dividends vs retaining earnings for reinvestment
- Once mix is chosen, financial manager decides how to raise funds:
  - Short-term loans, long-term leases, issuing bonds or equity

Asset Management Decision

- Third major decision: **managing assets efficiently**.
- Comes after assets are acquired and financing arranged.
- Financial manager has responsibility over:
  - **Current assets**: cash, receivables, inventories
  - (Greater focus here due to daily liquidity needs)
- Management of **fixed assets** is largely handled by operating managers.
- Goal: ensure assets are used productively to maximize firm value.

The Goal of the Firm

- Efficient financial management requires a clear **objective**.
- The overall goal of the firm: **maximize shareholder wealth**.
- Shareholder wealth is measured by the **market price per share** of common stock.
- Market price reflects the outcomes of:
  - Investment decisions
  - Financing decisions
  - Asset management decisions
- Success of a business decision is judged by its **impact on share price**.

Value Creation vs. Profit/EPS Maximization

- **Profit maximization** is inadequate:
  - Could increase profits by issuing stock and investing in T-bills
  - Leads to lower earnings per share (EPS) for owners
- **EPS maximization** also falls short:
  - Ignores **timing** of returns (time value of money)
  - Ignores **risk** (project risk, financial leverage)
  - Ignores **dividend policy** effects on share price
- **Market price per share** is the better objective:
  - Reflects present & future earnings, timing, risk, and dividends
  - Acts as a **barometer of performance** — continuous judgment by investors
  - Dissatisfied shareholders can sell, pushing price down
- Thus, managers must focus on **creating shareholder value** through investment, financing, and asset management choices.

What Companies Say About Their Corporate Goal

"Creating superior shareholder value is our top priority."
Source: Associated Banc-Corp 2006 Annual Report.

"The Board and Senior Management recognize their responsibility to represent the interests of all shareholders and to maximize shareholder value."
Source: CLP Holdings Limited, the parent company of the China Light & Power Group, Annual Report 2006.

"FedEx's main responsibility is to create shareholder value."
Source: FedEx Corporation, SEC Form Def 14A for the period ending 9/25/2006.

". . . we [the Board of Directors] are united in our goal to ensure McDonald's strives to enhance shareholder value."
Source: McDonald's Corporation 2006 Annual Report.

"The desire to increase shareholder value is what drives our actions."
Source: Philips Annual Report 2006.

". . . the Board of Directors plays a central role in the Company's corporate governance system; it has the power (and the duty) to direct Company business, pursuing and fulfilling its primary and ultimate objective of creating shareholder value."
Source: Pirelli & C. SpA. Milan Annual Report 2006.

Forms of Business Organization

- **Sole Proprietorship**: simple, unlimited liability
- **Partnership**: general vs limited partners
- **Corporation**: separate legal entity, limited liability, double taxation
- **LLC**: limited liability, partnership-style taxation

Corporate Taxes

- Taxable income = revenues – expenses (incl. interest, depreciation)
- Corporate tax system is graduated (marginal vs average rates)
- Firms make quarterly estimated payments

Table Placeholder

Corporate Tax Rate Schedule (Ch.2)

Depreciation and MACRS

- Depreciation reduces taxable income (non-cash expense)
- U.S. firms use **MACRS** system (accelerated recovery)
- Example: bonus depreciation provisions affect cash flows

Table Placeholder

MACRS Depreciation Recovery Percentages (Ch.2)

Financing and Tax Effects

- Interest is tax-deductible, dividends are not
- Creates a tax advantage for debt financing
- Depreciation timing affects after-tax project returns

Financial Markets and Institutions

- Allocate funds between savers and borrowers
- Primary vs secondary markets
- Role of intermediaries: banks, mutual funds, pension funds
- Yield curve: term structure of interest rates

Key Learning Points (Ch.2)

- Business form affects liability, taxation, fundraising
- Corporate tax rules and depreciation matter for finance decisions
- Financial markets channel funds and price risk