The Financial Environment

Financial Management

Financial management can be described in terms of three fundamental decisions:

- Investment
- Asset Management
- Financing

Financial management also requires financial planning and control, risk management, and communication with stakeholders

Investment

The objective of investment is to achieve optimal allocation of limited resources to ends that return the maximum return with minimum risk. The key questions facing investment decisions are:

- Which investments should be undertaken using the available capital resource?
- How can limited resources be used most effectively to achieve the corporate objectives?

Financing

The objective if financing is to raise the capital needed in the most efficient way that minimizes the cost of capital. The key questions facing financing decisions are:

- How should finance be raised in order to minimise cost of capital?
- What optimum finance structure with result in a minimized cost of capital?

Organization of the finance function in business

The finance function in most business units comprises of the accounting/controller and treasury unit.

The Goals of the Firm

The ultimate goal of any firm is to maximize the wealth of it's owners. This is also the primary financial object of the firm.

Secondary Financial Objectives

- Growth in Earnings Per Share (EPS)
- Sustainable Debt to equity ratio
- Adequate dividend cover
- Adequate cash flows from operations

Performance on Secondary financial objectives can be measured on a short-term basis.

Measuring Wealth Maximisation

In measuting wealth maximisation we can use these three metrics:

- Profit maximisation
- Growth in EPS
- Marquee Value of Shares

Profit Maximisation

- Does not reflect risks and timing of future cash flows
- May encourage short-termism in managerial decision-making

Not a good measure of wealth maximisation

Growth in EPS

- An improvement over profit maximisation
- Does not reflect financial risk, timing and duration of expected returns, and the effects of dividend policy

Market value of shares

- Overcomes the weakness of profit maximisation and growth in IPs as it reflects the timing and risk of future cash flows.
- Shareholder wealth is measured by dividend payments and change in share prices i.e.

$$\text{Dividend Yield} + \text{Capital Gains Yield} = \text{Return to the Owners}$$

Financial management from the perspective of the three decision areas facing the financial manager.

The three decisions facing the financial manager come in three categories:

- Investment
- Financing
- Asset Management

From the perspective of the financial manager the goal is to pursue investments that produce the maximum possible return on investment (ROI) with the least possible risk, and procure capital in a way that minimizes the cost of capital.

Goals of the firm and explain why owner's wealth maximisation is preferred over other goals.

The overarching goal of the firm is the maximization of the wealth of its owners, with secondary goals:

- Increase in EPS
- Sustainable Debt to equity ratio
- Adequate dividend cover

Owner's wealth maximization is preferred over the other goals as it reflects the timing and risk of future cash flows, which are not captured by the other goals and it is in the explicit interest of the shareholders who are the owners of the firm.

The Agency Problem

The issues underlying social responsibility of the firm.

Corporate Governance