Chapter 1

The Role of Financial Management

Learning Objectives

After studying Chapter 1, you should be able to:

1. Explain why the role of the financial manager today is so important.
2. Describe "financial management" in terms of the three major decision areas that confront the financial manager.
3. Identify the goal of the firm and understand why shareholders' wealth maximization is preferred over other goals.
4. Understand the potential problems arising when management of the corporation and ownership are separated (i.e., agency problems).
5. Demonstrate an understanding of corporate governance.
6. Discuss the issues underlying social responsibility of the firm.
7. Understand the basic responsibilities of financial managers and the differences between a "treasurer" and a "controller."

Topics

- What is Financial Management?
- The Goal of the Firm
- Corporate Governance
- Organization of the Financial Management Function

What is Financial Management?

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

- Investment Decisions
- Financing Decisions
- Asset Management Decisions

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?

What are assets? Introducing Balance Sheet

- A Balance Sheet is a summary of a firm's financial position on a given date that shows

  Total assets = Total liabilities + Owners' equity
- Total assets = Current assets + Fixed assets
- Current assets: cash, cash equivalent, inventory (raw materials, finished goods, work in progress WIP), account receivables (AR), etc.
- Fixed assets: building, land, equipment, etc.

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?

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Sources of finance? Introducing Balance Sheet

- Total liabilities: Borrowed funds (long-term or short-term), account payables (AP), etc.
- Owners' equity: investment by owners, retained earnings, etc.
- Total assets = Total liabilities + Owners' equity

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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.

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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.

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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.

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How much profit? Introducing Income Statement

- *Income Statement:* A summary of a firm's revenues and expenses over a specified period, ending with net income or loss for the period.

Top Line		Operating Revenue
	–	Cost of Goods Sold (CoGS)
		Gross Profit
	–	SG&A Expenses (Selling, General, & Admin.)
		EBIT (Earning Before Interest and Taxes)
	–	Interest Expenses
		EBT (Earning Before Taxes)
	–	Income Taxes
Bottom Line		EAT (Earning After Taxes, Net Profit)
	–	Cash Dividends
		Increase in Retained Earnings

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What companies say about their corporate goal*

- Cadbury Schweppes: "governing objective is growth in shareowner value"
- Credit Suisse Group: "achieve high customer satisfaction, maximize shareholder value and be an employer of choice"
- Dow Chemical Company: "maximize long-term shareholder value"
- ExxonMobil: "long-term, sustainable shareholder value"

**Refer to text for additional details*

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What companies say about their corporate goal*

- Associated Banc-Corp: "Creating superior shareholder value is our top priority"
- FedEx: "FedEx's main responsibility is to create shareholder value"
- McDonald's: "we [the Board of Directors] are united in our goal to ensure McDonald's strives to enhance shareholder value"
- Philips: "The desire to increase shareholder value is what drives our actions"

**Refer to text for additional details*

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The Modern Corporation

Modern Corporation

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

- Principals must provide *incentives* so that management acts in the principals' best interests and then *monitor* results.
  - Incentives include, stock options, perquisites, and bonuses.
  - *Agency Theory* is a branch of economics relating to the behavior of principals and their agents.
  - Jensen and Meckling developed a theory of the firm based on *agency theory*.

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Social Responsibility

- Wealth maximization does *not* preclude 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. (stakeholders)

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Social Responsibility & Sustainability

- Sustainability: Meeting the needs of the present without compromising the ability of future generations to meet their own needs.
- Proactive actions to address climate change, oil depletion, and energy usage.

Corporate Governance

- *Corporate governance: represents the system by which corporations are managed and controlled*.
  - Includes shareholders, board of directors, and senior management.

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).

Sarbanes-Oxley Act of 2002

- Sarbanes-Oxley Act of 2002 (SOX): addresses corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information
  - Imposes new penalties for violations of securities laws
  - Established the Public Company Accounting Oversight Board (PCAOB) to adopt auditing, quality control, ethics, disclosure standards for public companies and their auditors, and policing authority
  - Generally increasing the standards for corporate governance

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Organization of the Financial Management Function

Board of Directors

President
(Chief Executive Officer)

- VP of Operations
- VP of Finance
- VP of Marketing

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 Mgmt
- Tax Analysis/Planning

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