

### Chapter 1

# The Role of Financial Management





### **Learning Objectives**

#### After studying Chapter 1, you should be able to:

- 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?

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# What are assets? Introducing Balance Sheet

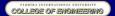
- A Balance Sheet is a summary of a firm's financial position on a given date that shows
  - Total assets = Total liabilities + Owners' equity
- Total assets = Current assets + Fixed assets
- Current assets: cash, cash equivalent, inventory (raw materials, finished goods, work in progress WIP), account 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?





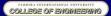
# Sources of finance? Introducing Balance Sheet

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



# **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, <u>share price</u> serves as a barometer for business performance.



#### How much profit? **Introducing Income Statement** Income Top Line **Operating Revenue** Statement: A Cost of Goods Sold (CoGS) summary of a **Gross Profit** firm's revenues SG&A Expenses (Selling, General, & Admin.) and expenses EBIT (Earning Before Interest and Taxes) over a specified Interest Expenses period, ending **EBT** (Earning Before Taxes) with net income **Income Taxes** or loss for the **Bottom Line** EAT (Earning After Taxes, Net Profit) period. Cash Dividends Increase in Retained Earnings COLLEGE OF ENGINEERING



# What companies say about their corporate goal\*

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

\*Refer to text for additional details

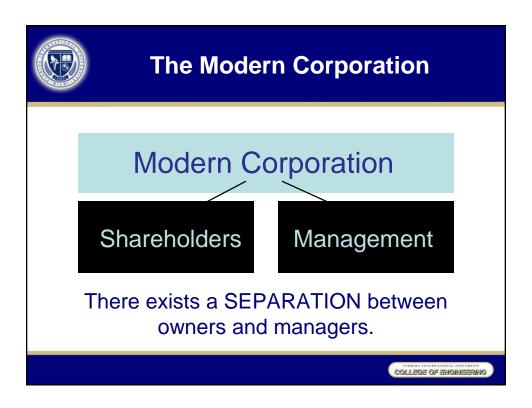
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# What companies say about their corporate goal\*

- <u>Associated Banc-Corp</u>: "Creating superior shareholder value is our top priority"
- <u>FedEx</u>: "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"
- <u>Philips</u>: "The desire to increase shareholder value is what drives our actions"

\*Refer to text for additional details





## **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.
  - <u>Agency Theory</u> 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.





### **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 <u>shareholder</u> <u>wealth maximization</u> remains the appropriate goal in governing the firm. (stakeholders)



# 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.

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### **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**

- <u>Sarbanes-Oxley Act of 2002</u> (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



