Chapter 1

The Role of Financial Management

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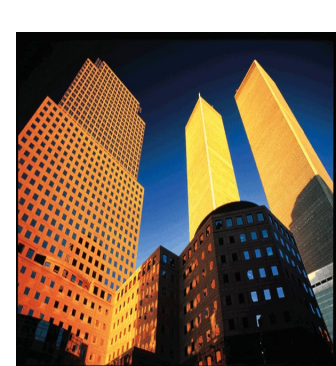**What is Financial Management?**

The Goal of the Firm

Organization of the Financial Management Function

What is Financial Management?

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

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?

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?

How will the funds be physically acquired?

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.
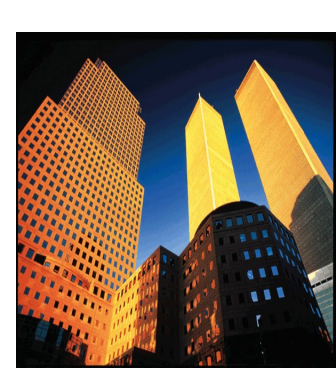
Ignores changes in the risk level of the firm.

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, share price serves as a barometer for business performance.

The Modern Corporation

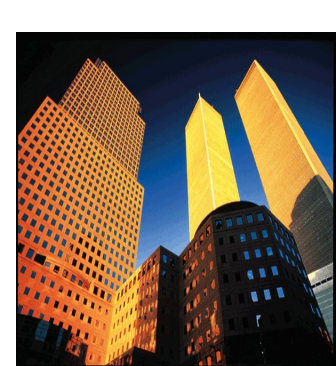**Modern Corporation**

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

Jensen and Meckling developed a theory of the firm based on *agency theory*.

***Agency Theory* is a branch of economics relating to the behavior of principals and their agents.**

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.
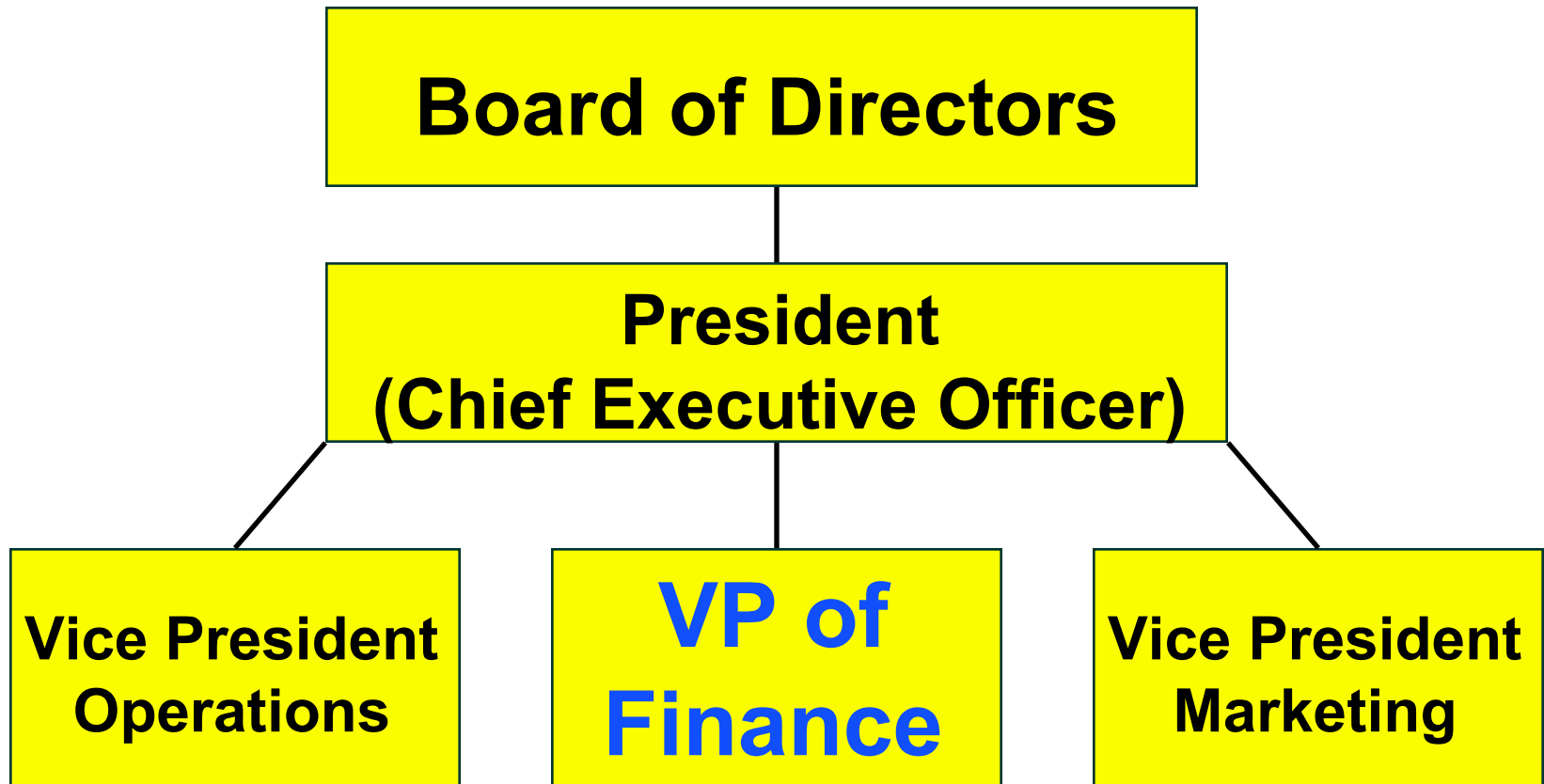
Social Responsibility

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.

Organization of the Financial Management Function

Board of Directors

President (Chief Executive Officer)

Vice President Operations

VP of Finance

Vice President 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 Mngmt
Tax Analysis/Planning

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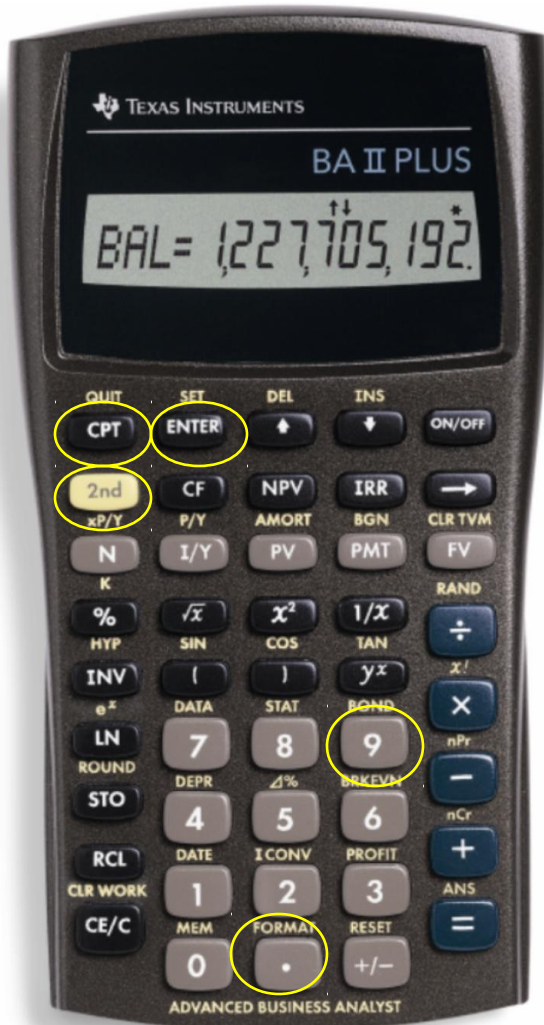**Preparing Forecasts**

Texas Instruments BAII+
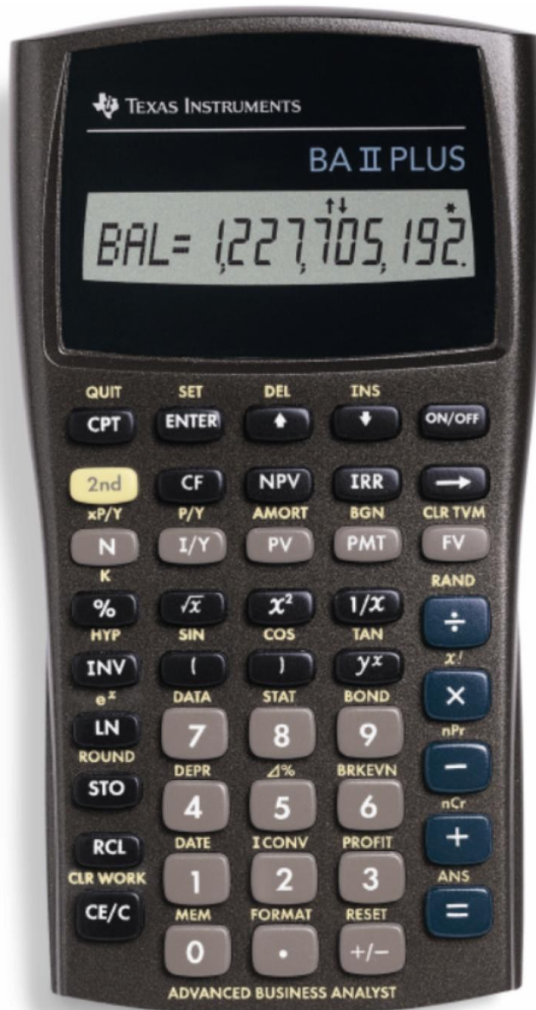
Integrated throughout the chapters

A useful financial tool

Does NOT replace financial understanding

Change Display Setting

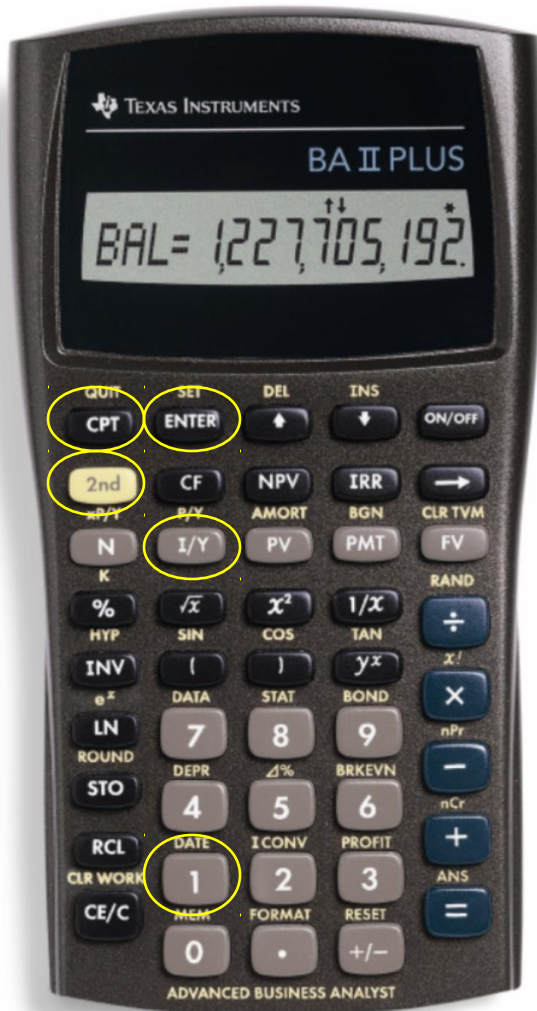**Change the decimal places displayed from "2" to "Floating"**

Press:

2nd	Format
9	ENTER
2nd	QUIT

Change Periods per Year Setting

Change the periods per year from "12" to "1"

Press:

2nd	P/Y
1	ENTER
2nd	QUIT