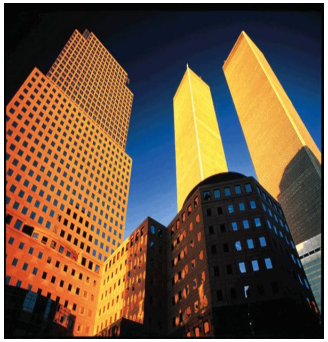
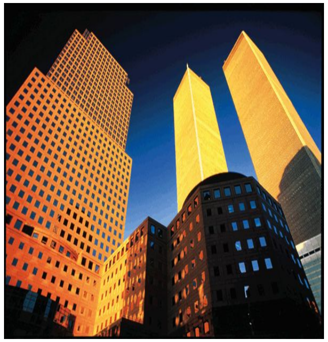


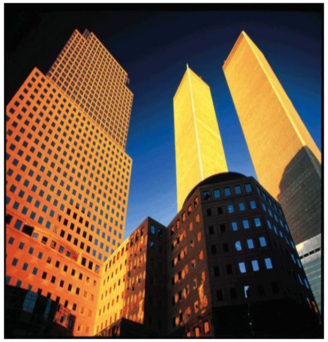
Chapter 1

The Role of Financial Management



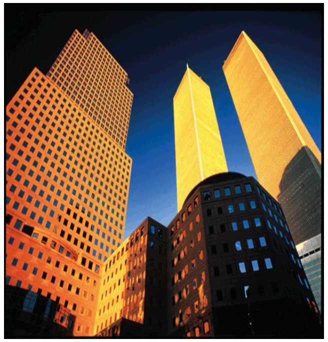
After studying Chapter 1, you should be able to:

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. Understand the basic responsibilities of financial managers and the differences between a "treasurer" and a "controller."



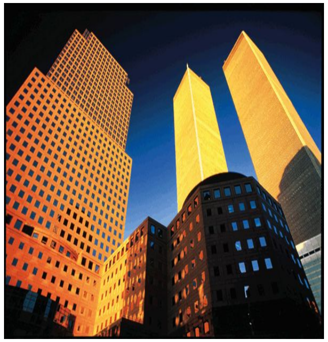
Historical Perspective

- **In early 1900, financial managers had the responsibility to raise funds and manage cash position of the firm**
- **In 1950's, they were also involved in capital budgeting techniques**
- **Now, they are more dynamic in responding to changing economic conditions, managing volatilities, and other challenges.**



What is Financial Management?

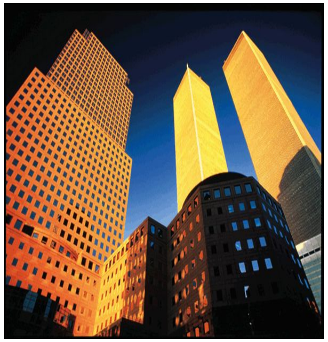
Concerns the acquisition, financing, and management of assets with some overall goal in mind.



Investment Decisions

Most important of the three decisions.

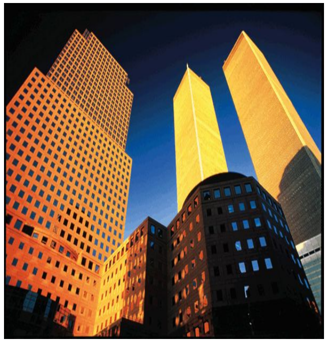
- What is the optimal firm size?
- What specific assets should be acquired?
- What assets (if any) should be reduced or eliminated?



Financing Decisions

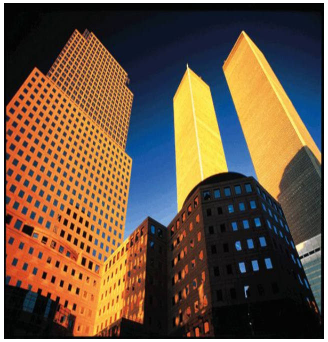
Determine how the assets (LHS of balance sheet) will be financed (RHS of balance sheet).

- **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

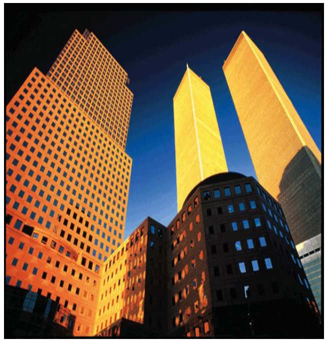
- **How do we manage existing assets *efficiently*?**
- **Financial Manager has varying degrees of operating responsibility over assets.**
- **Greater emphasis on current asset management than fixed asset management.**



What is the Goal of the Firm?

Maximization of Shareholder Wealth!

Value creation occurs when we maximize the share price for current shareholders.



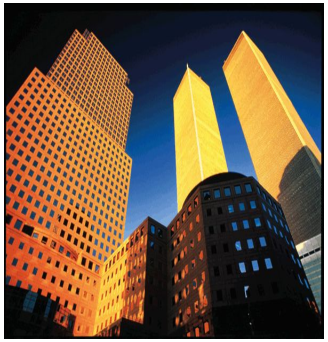
Shortcomings of Alternative Perspectives

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.



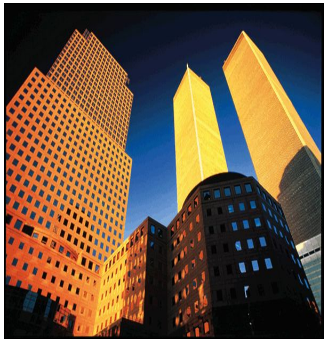
Shortcomings of Alternative Perspectives

Earnings per Share Maximization

- **Maximizing earnings after taxes divided by shares outstanding.**

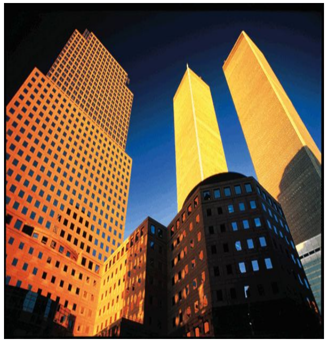
Problems

- **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.**

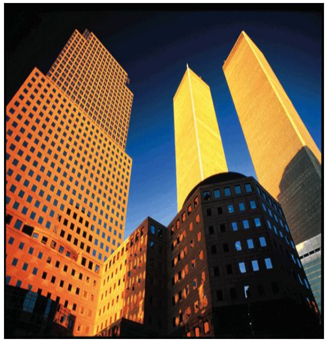


The Modern Corporation

Modern Corporation

Shareholders | **Management**

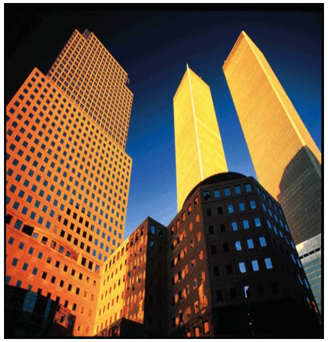
There exists a SEPARATION between owners and managers.



Role of Management

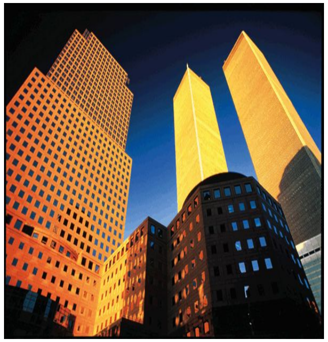
Management acts as an *agent* for the owners (shareholders) of the firm.

- **An *agent* is an individual authorized by another person, called the principal, to act in the latter's behalf.**



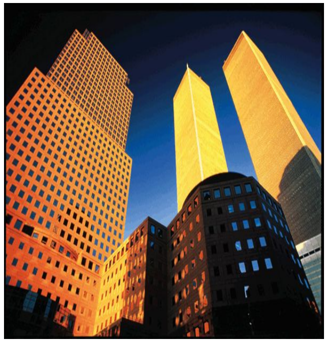
Agency Theory

- 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.



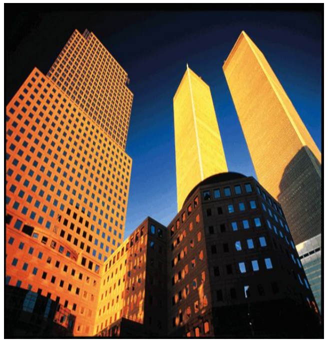
Agency Theory

- Principals must provide *incentives* so that management acts in the principals' best interests and then *monitor* results.
- Incentives include stock options, perquisites, and bonuses.

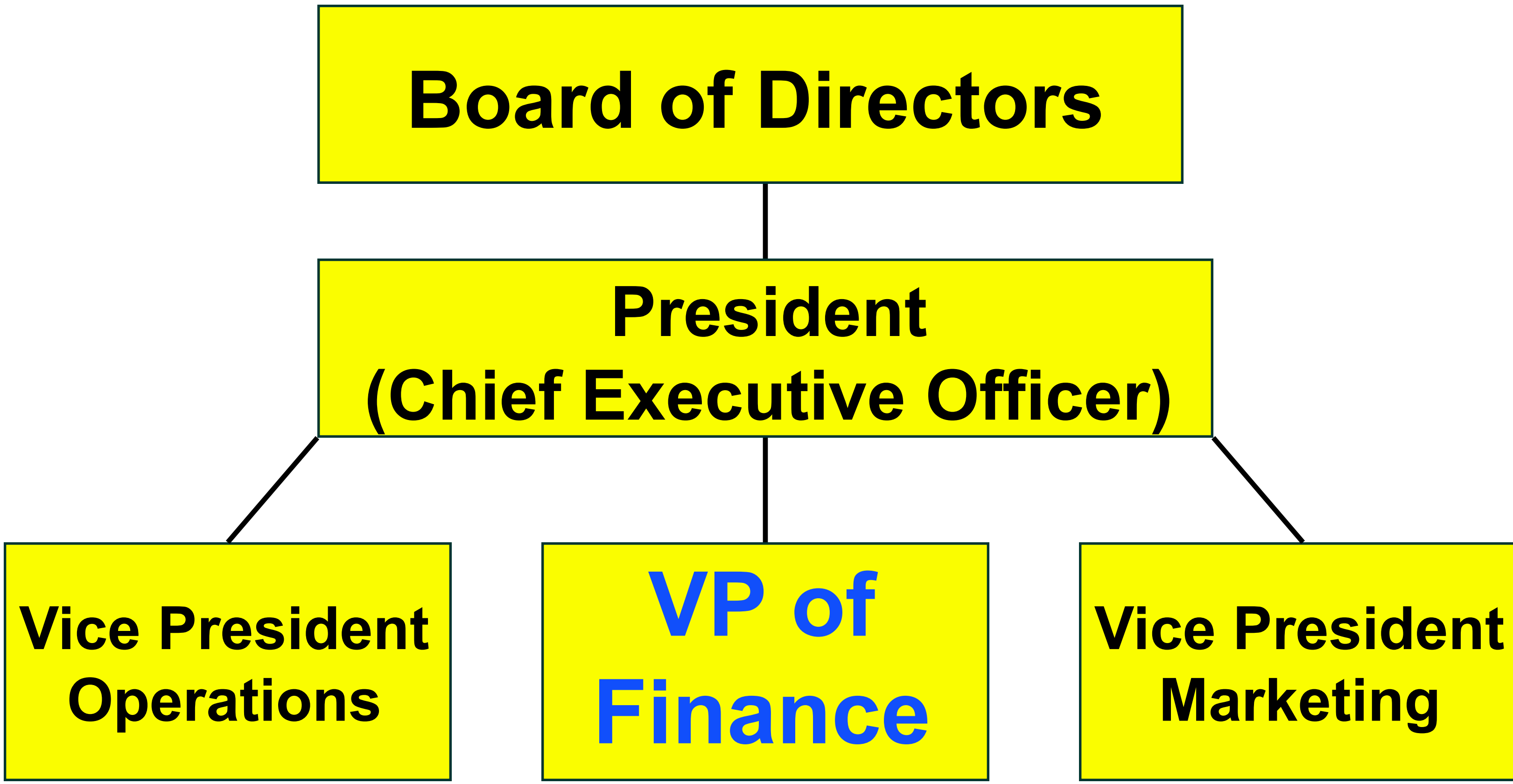


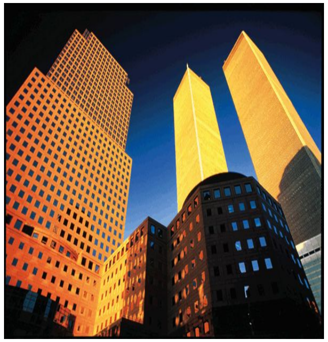
Social Responsibility

- **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





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