

Introduction to Financial Management

CHAPTER 1

An Overview of Financial Management

- **Goals and Functions of Finance**
- **Responsibility of Finance Staff**
- **Trends**
- **Forms of Business Organization**
- **Goals of the Corporation**
- **Agency Relationships**

Goals and Functions of Finance

Main goal of finance or Finance Management in a company is to create value for the company via an optimal combination of:

- **Investing Decision (most important)** -

Risk and return

- **Financing Decision**

- **Dividend Decision**

Responsibilities of the Finance Staff

The broad main duties of a finance manager are 1) Investment in assets and new products and determining the best mix of financing and 2) dividends in relation to company's overall valuation. These include:

- **Forecasting and planning**
- **Investment and financing decisions**
- **Coordination and control**
- **Transactions in the financial markets**
- **Managing risk**

Financial Management Trends

- **Use of computers and electronic transfers of information**
- **The globalization of business**



Forms of Business Organization

- **Sole proprietorship**
- **Partnership**
- **Corporation**

Sole Proprietorship

■ Advantages:

- Ease of formation
- Subject to few regulations
- No corporate income taxes

■ Disadvantages:

- Limited life
- Unlimited liability
- Difficult to raise capital

Partnership

- A partnership has roughly the same advantages and disadvantages as a sole proprietorship.



Corporation

■ Advantages:

- Unlimited life
- Easy transfer of ownership
- Limited liability
- Ease of raising capital

■ Disadvantages:

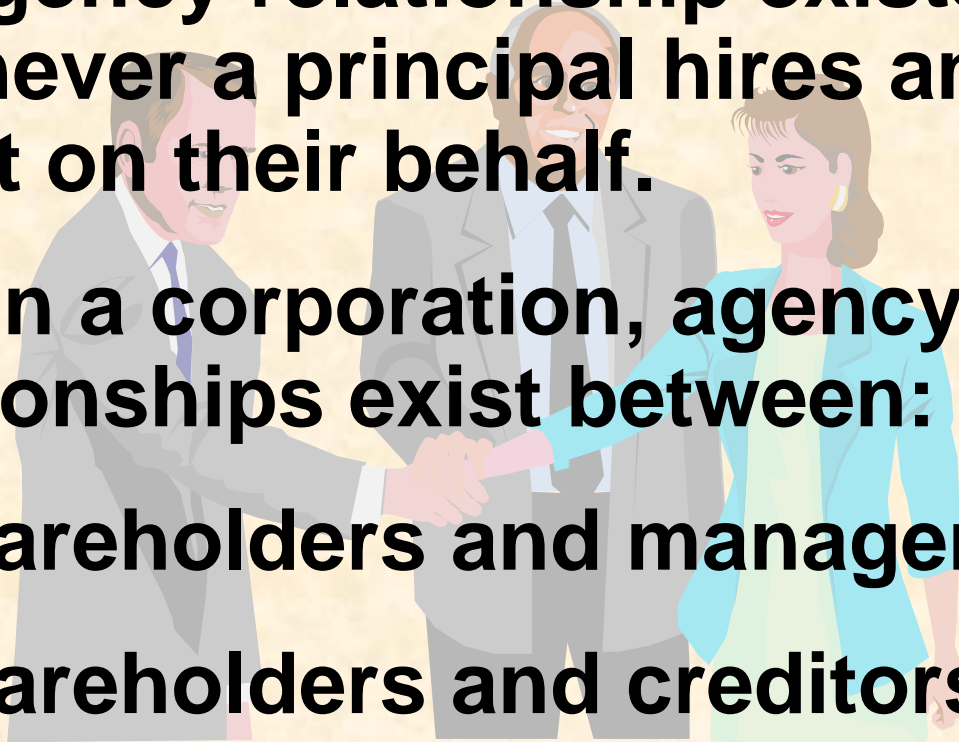
- Double taxation
- Cost of set-up and report filing

Goals of the Corporation

- **The primary goal is shareholder wealth maximization, which translates to maximizing stock price.**
 - **Do firms have any responsibilities to society at large?**
 - **Is stock price maximization good or bad for society?**
 - **Should firms behave ethically?**

Agency Relationships

- **An agency relationship exists whenever a principal hires an agent to act on their behalf.**
- **Within a corporation, agency relationships exist between:**
 - **Shareholders and managers**
 - **Shareholders and creditors**



Shareholders versus Managers

- **Managers are naturally inclined to act in their own best interests.**
- **But the following factors affect managerial behaviour:**
 - **Managerial compensation plans**
 - **Direct intervention by shareholders**
 - **The threat of firing**
 - **The threat of takeover**

Shareholders versus Creditors

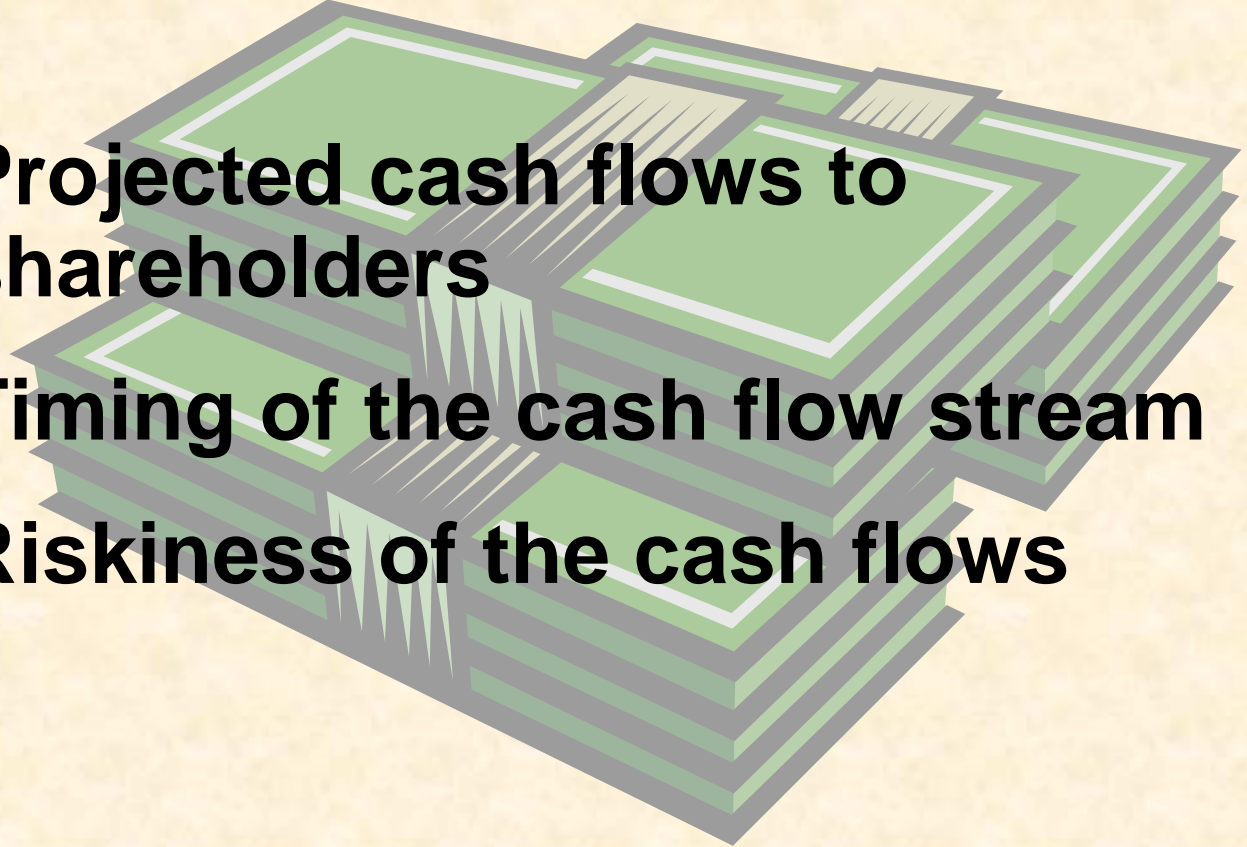
- **Shareholders (through managers) could take risky actions to maximize stock price, but are detrimental to creditors.**
- **In the long run, such actions will raise the cost of debt and ultimately lower stock price.**

Does profit maximization equal stock price maximization?

No, there is generally a high correlation between EPS, cash flow, and stock price, but today's stock price relies not only on current earnings, but future earnings and cash flows.

Some actions may increase earnings, yet cause stock price to decrease (and vice versa).

Factors that Affect Stock Price

- 
- **Projected cash flows to shareholders**
 - **Timing of the cash flow stream**
 - **Riskiness of the cash flows**

Factors that Affect the Level and Riskiness of Cash Flows

- **Decisions made by financial managers:**
 - **Investment decisions**
 - **Financing decisions (the relative use of debt financing)**
 - **Dividend policy decisions**
- **The external environment**

Career Opportunities in Finance

- **Money and capital markets**
- **Investments**
- **Financial management**