

**Key terms:**

What is **Financial Management**?

Management has the implied function of planning and control.

Financial management is that part of the total management function which is concerned with the **effective and efficient raising and use of funds**.

1 Goals and Functions of Finance

1.1 The three main goals and functions of finance:

- Investing decision

Within the firm, managers make investment decisions regarding the types of products and services produced, as well as the way goods and services are produced and delivered.

- Financing decision

This decision is concerned with the mix of debt and equity to be used, and what specific types of debt and equity securities should be issued.

- Dividend policy decision

The decision as to how much of current earnings to pay out as dividends rather than to retain for reinvestment in the firm.

2 The Responsibilities of the Financial Staff

2.1 The major activities performed by the Finance Manager/Financial Staff include:

- **Forecasting and planning**
- **Major investment and financing decisions** – e.g. help decide what specific assets to acquire and the best way to finance those assets.
- **Coordination and control** – interact with staff from other departments, including the production function and marketing function.
- **Dealing with the financial markets** – ensure that funds are made available at the right time, at the lowest cost and used in the most effective way.
- **Risk management** – responsible for the firm's overall risk management program, including identifying the risks and minimising the risk, protecting the assets.

2.2 A good financial manager will need a knowledge of other subjects in order to fulfil his or her duties properly. These other subjects include Financial and Management Accounting, Law, Economics, Quantitative Methods and Taxation.

3 Financial Management Trends

3.1 Development of Financial Management: History

Year	Scope/areas focused
1900s	Legal aspects of mergers, formation of new firms and various types of securities available to raise capital.
1930s	Bankruptcy and reorganisation, corporate liquidity and regulation of securities markets.
1940-50s	Finance continued to be taught as a descriptive, institutional subject.
Late 1950s	Focus shifted to managerial decision regarding the choice of assets and liabilities, with the goal of maximising the value of the firm.
Up to 1990s	Value maximisation
1990s-to date	?

3.2 The two most important trends in finance have been the increased globalisation of business and the growing use of computers and information technology.

3.3 Factors that have led to the increased globalisation of businesses:

- Improvements in transportation and communications
- Lower trade barriers
- Joint venture as a way to reduce costs
- Free movement of resources – labour, capital, technology, knowledge, etc

4 Forms of Business Organisation

There are three main forms of business organisation:

- Sole proprietorships
- Partnerships
- Corporations

4.1 Sole proprietorships

Feature: It is an **unincorporated** business owned by one individual. Used primarily for small-business operations.

■ **Advantages:**

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

■ **Disadvantages:**

- **Limited life**
- **Unlimited liability**
- **Difficult to raise capital**

4.2 Partnerships

Feature: It is unincorporated business owned by two or more persons.

■ **Advantages:**

- **Ease of formation**
- **Low cost**
- **No corporate income taxes**

■ **Disadvantages:**

- **Limited life**
- **Unlimited liability**
- **Difficult to raise capital**
- **Difficult to transfer ownership**

4.3 Corporation

Feature: It is a legal entity created by a state, separate and distinct from its owners and managers.

■ **Advantages:**

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

■ **Disadvantages:**

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

5 Goals of the Corporation

5.1 Typical goals of the firm include:

- Stockholder wealth maximization
- Profit maximization
- Managerial reward maximization
- Behavioral goals
- Social responsibility

5.2 The primary goal is shareholder wealth maximization, which translates to maximizing stock price.

5.3 Profit maximization does not consider risk or uncertainty, whereas stockholder wealth maximization does.

5.4 Social responsibility is the concept that businesses should be actively concerned with the welfare of society at large. Firms have an ethical responsibility to provide safe working environment, to avoid polluting the environment and to produce safe products.

6 Agency Relationships

6.1 An agency relationship exists whenever a principal hires an agent to act on their behalf.

6.2 Within a corporation, agency relationships exist between:

- Shareholders and managers
- Shareholders and creditors

6.3 Agency relationships create agency problem.



Key terms:

What is **Agency Problem**?

Agency problem arises because due to a potential conflict of interest between the agent (manager) and the outside stockholders or the creditors/debt holders

6.4 Agency costs associated with agency problem include:

- Monitoring cost
- Bonding cost
- Residual loss

6.5 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

6.6 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.

6.7 Lenders or creditors attempt to protect themselves against stockholders by:

- Placing covenants in debt agreements
- Charging a higher than normal interest rate to compensate for the risk assumed
- Refusing to lend the money

7 Profit Maximization v Stock Price Maximization

7.1 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.

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

7.3 Factors that affect stock price include:

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

7.4 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

8 Career Opportunity in Finance

8.1 Finance consists of three interrelated areas:

- Money and capital markets

Deals with securities markets and financial institutions

- Investments

Focuses on the decisions made by both individual and institutional investors as they choose securities for their investment portfolios

- Financial Management

Making *finance* decisions within firms.

Reading/reference materials:

- Brigham E. F. and J. F. Houston. Fundamentals of Financial Management. 8th edition. The Dryden Press 1998
- Shim J.K. and Siegel J.G. Financial Management. 2nd edition. McGraw-Hill 1998
- Brockington R. Financial Management. 6th edition. DP Publications Ltd. 1993