

The Goals and Activities of Financial Management



Chapter Overview

The major thrust of this chapter is to establish the objectives of financial management and the importance of the financial manager to the organization. The introduction focuses on the financial decisions that a company like Louis Vuitton makes and allows the instructor to bring the real world into the classroom immediately. Likely, some of the questions that Louis Vuitton and other companies must answer will be questions that students had never pondered when considering how the financial side of a business works. The instructor can use this to encourage intrigue surrounding the complexity of financial management. Forms of organization and some major pieces of legislation related to corporate management are introduced. The instructor should highlight the importance of owner wealth maximization as a goal and briefly relate it to valuation concepts associated with risk and return. The Finance in Action Box “The Purpose of the Corporation” can assist in this discussion. The role and functions of the financial markets in allocating capital should be emphasized as well as the pressures of institutional investors on financial managers. The student should also be invited to consider the shortfalls of profit maximization as the ultimate goal of the firm. A short discussion of social responsibility and its relationship to the financial objectives of the firm can engage students in a discussion of how wealth maximization and social responsibility can co-exist. We end the chapter with a short discussion of the impact of internationalization and information technology on financial markets, before laying out a broad overview of the rest of the text.

Chapter Concepts

- LO 1-1 List some of the concepts that the field of finance covers.
- LO 1-2 Recognize that a firm can have many different forms of organization.
- LO 1-3 Describe how the relationship of risk to return is a central focus of finance.
- LO 1-4 Explain the primary goal of financial managers.
- LO 1-5 Recall that financial managers attempt to achieve wealth maximization through daily activities such as credit and inventory management and through longer-term decisions related to raising funds.

Annotated Outline and Strategy

I. The Field of Finance

- i. Finance is a link between accounting, economics, and other related fields of study. A financial manager must understand the Federal Reserve System, the commercial banking system, and the interrelationships between various sectors of the economy.
- ii. Finance is so closely tied to economics that many of the best-known winners of the Nobel Prize for Economics were financial economists.

Perspective 1-1: This is a good place in the lecture to increase student interest by mentioning finance professors who have won Nobel Prizes for their work on issues related to risk and return, portfolio management and capital market theory. Names like Markowitz, Sharpe and Miller give finance a special place in business that cannot be matched in the other functional areas such as marketing or management.

- iii. The financial manager must know how to interpret and use financial statements in assessing the firm's performance and allocating the firm's financial resources to generate the best return possible in the long run.
- iv. One important difference between accounting and finance is that accounting generally measures the results of a business's past activities, while the field of finance is forward-looking.
- v. Investments vs. Corporate Finance. Corporations like Apple sell stocks and bonds to raise capital for expansion. Investors determine the value of these bonds and stocks and buy them to add to a portfolio of securities of various companies.

A. Investments vs. Corporate Finance

- i. Corporations like Apple sell stocks and bonds to raise capital for expansion.
- ii. Investors determine the value of these bonds and stocks and buy them to add to a portfolio of securities of various companies.

- iii. Financial managers must be familiar with the workings of financial markets where securities are bought and sold and where they raise capital.

B. The Value of Studying Finance

- i. Careers in finance include financial officer, banker, stockbroker, wealth manager, financial analyst, portfolio manager, investment banker, financial consultant or financial planner.
- ii. One thing in common for all these jobs is the management of risk and return tradeoffs. Maximizing return while minimizing risk is a common goal.
- iii. It is estimated that about 20 percent of all chief executive officers (CEOs) of publicly traded companies in the United States and in the United Kingdom were Chief Financial Officers (CFO) before being promoted to CEO.
- iv. You will be faced with financial decisions your whole life. You may buy a house or condominium and borrow money to finance the purchase. You may have to manage your retirement plan or your household budget.

II. Activities of Financial Management.

- i. Some of the responsibilities of a financial manager are addressed every day.
 - a. Monitor cash balances
 - b. Credit management
 - c. Inventory control
 - d. Receipt and disbursement of funds
- ii. Other responsibilities are less routine and are addressed quarterly or annually.
 - a. Negotiations with banks for loans to finance business operations
 - b. Sale of stocks and bonds
 - c. Capital budgeting
 - d. Dividend decisions
- iii. All of a financial manager's responsibilities are carried out while balancing profitability and risk.

PPT	Functions of the Financial Manager (Figure 1-1)
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A. Forms of Organization

- i. The finance function may be carried out within a number of different forms of organizations. The factors that influence the choice are the number of people in the organization, the liability of the owners, and taxation.
- ii. Sole proprietorship
 - a. Single ownership
 - b. Simplicity of decision making
 - c. Low organizational and operating costs
 - d. Unlimited liability
 - e. Earnings are taxed as personal earnings of the individual owner
- iii. Partnership
 - a. Two or more partners
 - b. Usually formed by *articles of partnership* agreement
 - c. Unlimited liability for all partners unless a limited partnership is formed which provides limited liability for one or more partners. At least one partner must be a general partner.
 - d. Earnings are taxed as personal earnings of partners
 - e. In a *limited liability partnership*, some members have unlimited liability and others have liability that is limited only to their initial contribution. The limited partners are normally prohibited from being active in the management of the firm.
- iv. Corporation
 - a. Most important form of business in terms of sales (80% of all sales) and profits (70% of all profits)
 - b. Legal entity
 - c. Formed by *articles of incorporation*
 - d. Stockholders (owners) have limited liability
 - e. Easy divisibility of ownership
 - f. Managed by the board of directors
 - g. Double taxation of earnings: Earnings of the corporation are subject to the corporate income tax; dividends (distributed net income) are subject to personal taxation
 - h. The 2017 Tax Cuts and Jobs Act cut the U.S. corporate tax rate from 35% to 21%.
 - i. *S corporations*, however, avoid the double taxation disadvantage. S corporations are limited to 100 shareholders.
 - j. *Limited Liability Company (LLC)* is a popular for its highly flexible structure that provides limited liability for the owners. It is not technically a corporation and can be taxed in many different ways as elected by the owners.

III. Corporate Governance

- i. WorldCom, Enron, and Arthur Andersen are discussed as examples of failures of corporate governance.
- ii. The Sarbanes-Oxley Act of 2002 imposed greater accountability on corporate executives and independent auditors. It has also created additional compliance burdens on publicly traded companies.
- iii. The financial crisis of 2007-2009 exposed the inability of corporate boards to understand risk management. In response Congress passed the Dodd-Frank Act, officially known as the Wall Street Reform and Consumer Protection Act of 2010.
- iv. Dodd-Frank was the first major financial regulatory change in the U.S. since the Great Depression. The act assigns regulatory responsibility, actual rulemaking and implementation are charged to different agencies for enforcement.
- v. During the last decade much attention has been devoted to the relationship between the owners of the firm and the managers of the firm. In large corporations, the hired management acts as agents for owners. The study of the relationship between owners and managers as well as other agent relationships is referred to as *agency theory*.
- vi. *Institutional investors* such as pension funds and mutual funds have more and more impact on decisions made by corporate boards of directors because they often own a significant percentage of a company's common stock.

IV. The Time Value of Money

- i. Time value of money is perhaps the most important concept in finance. It is the knowledge that a dollar today is worth more than a dollar received in the future.
- ii. The *future value* (FV) of a dollar is greater than a dollar. Today's dollar value is referred to as the *present value* (PV).
 - a. Future value formula: $FV = PV(1 + i)^n$
 - b. Present value formula: $PV = FV[1 / (1 + i)^n]$
- iii. We cover this topic in greater detail in Chapter 9 where you will learn how to calculate the future value, the present value, the future value of an annuity, and the present value of an annuity.

V. Goals of Financial Management.

- i. The goal of profit maximization has serious drawbacks. First, it does not consider that often higher levels of risk come with higher expected profits. Second, it fails to consider the timing of profits. Finally, accurately measuring profit is difficult, in part because of the various definitions and interpretations of profit.

A. A Valuation Approach

- i. The firm's current overall value is really the present value of all the firm's future cash flows.

B. Maximizing Shareholder Wealth

- i. Shareholders have a *residual claim*, meaning that they can claim everything that is left over after debtholders are paid.
- ii. For the most part, maximizing shareholder wealth means maximizing the firm's stock price, which the financial manager cannot directly control.

C. Management and Stockholder Wealth

- i. While not all managements focus on maximizing shareholder wealth, ignoring wealth maximization for publicly traded firms can result in hostile takeovers or institutional investor pressure on the board of directors.

D. Social Responsibility and Ethical Behavior

- i. The goal of maximizing shareholder wealth cannot ignore corporate responsibility to social issues and cannot operate without ethical standards.
- ii. Socially desirable actions such as pollution control, equitable hiring practices, and firm pricing standards may at times be inconsistent with achieving maximum valuation in the market, absent government mandates.

Finance in Action: The Purpose of the Corporation

In 2019, the Business Roundtable, an organization of over 200 chief executive officers, backtracked on the goal of financial management. They expanded the role of the corporation to include all stakeholders – customers, employees, communities, and shareholders. In other words, they stand behind the idea that you can't maximize value and ignore stakeholders.

- iii. *Insider trading* occurs when someone uses information that is not available to the public to profit from trading in a company's publicly traded securities. This is illegal and protected by the SEC.

Perspective 1-2: Instructors may want to mention recent high-profile examples of insider trading, including possibly Martha Stewart (ImClone Systems, 2004), Raj Rajaratnam (Galleon Group, 2009), or Kenneth Lay (Enron, 2004).

VI. The Role of Financial Markets.

- i. Through daily price changes in the common stock of each publicly traded company, the financial markets provide managers with a performance report card.
- A. Structure and Functions of the Financial Markets
 - i. *Money markets* (dealing with short-term securities with a life of one year or less) and *capital markets* (dealing with securities that have a life of one year or more) are more fully presented in later chapters, chapters 7 and 14 respectively.
- B. Allocation of Capital
 - i. Students need to understand how the market price reflects risk and return expectations and how a company's ability to raise funds is influenced by its financial performance and corporate behavior.
- C. Internationalization of the Financial Markets
 - i. Emphasize the globalization of the capital markets and the worldwide pool of capital available to many companies. Use the international companies highlighted in the text to get across the point that the search for capital is global.

Perspective 1-3: Mention that U.S. and foreign firms often trade on each other's financial markets.

VII. Format of the Text

A. Parts

- i. **Introduction:** This section examines the goals and objectives of financial management with emphasis on decision-making and risk management. Discussion includes an update of significant events influencing the study of finance.
- ii. **Financial Analysis and Planning:** Includes a review the basic principles of accounting, which is required for understanding major financial topics.
- iii. **Working Capital Management:** A discussion of the short-term assets and liabilities of the firm and the related analysis of risk-return issues.
- iv. **The Capital Budgeting Process:** This section begins with a discussion of “time value of money” and continues on to cover the valuation of bonds and stocks, emphasizing the traditional dividend valuation model. The text then covers capital budgeting decisions including the use of risk-return analysis in capital budgeting.
- v. **Long-Term Financing:** This section discusses the U.S. financial markets as they relate to corporate financial management. The student will consider sources and uses of funds, the role of the investment banker, and leasing as a form of debt.
- vi. **Expanding the Perspective of Corporate Finance:** This section addresses corporate mergers and external growth strategies. It describes the growth of international financial markets, the rise of multinational business, and the related effects on corporate financial management.