**The Goals and Functions of**

**Financial Management**

**Author's Overview**

The instructor's initial comments should attempt to generate interest in the field of finance. A brief discussion of recent economic and financial developments will provide insight into the problems of financial management. Spending time with the financial pages of a national newspaper or website is invaluable.

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 instructor should highlight the importance of shareholder wealth maximization as a goal and briefly relate it to valuation concepts associated with risk and return. In addition, the role of the financial markets in allocating capital and determining value should be emphasized, as well as the pressures of institutional investors on financial managers. The student should also be directed to the shortfalls of profit maximization as the ultimate goal of the firm. A short discussion of social responsibility, business ethics, corporate governance and their relationship to the financial objectives of the firm, as well as management/ shareholder conflicts is instructive.

**Learning Objectives**

1. Illustrate how finance builds on the disciplines of accounting and economics.
2. Identify the analysis and decision-making nature of finance while considering return and risk.
3. Examine the primary goal of finance as the maximization of shareholder wealth as measured by share price.
4. Debate alternative goals of the firm on the basis of social or management interests.
5. Identify financial manager functions connected to the efficient raising and investing of funds.
6. Outline the role of financial markets in allocating capital, determining value and establishing yields.

**Annotated Outline and Strategy**

1. **Financial management is critical for a firm’s success.**
   1. Changing global economics, technology and consumer demand continually adjust the asset values of the firm.
2. **Finance relies upon the disciplines of economics and accounting.**
   1. Economics provides structure to decision making, value determination and helps us to understand the economic environment in which the financial manager operates.
   2. Accounting provides the financial data needed for financial decision making and value determination.
   3. The demand for financial management skills exists in many sectors of our society, including corporate management, financial institutions and consulting.

***Perspective 1-1: The Finance in Action box, ‘The Foundations’ uses RIM, Teck and the Canadian dollar to highlight changing value and how economics and accounting can assist us in determining value.***

1. **Finance as a field of study has evolved in response to changing business management needs.**
   1. Finance achieved recognition as a separate field of study from economics at the turn of this century.
   2. Initially, finance concentrated on institutional detail, defining stocks, bonds, and institutions such as the markets, with little or no systematic analysis.
   3. With the Depression, emphasis shifted to preservation of capital, maintenance of liquidity, reorganization, and bankruptcy. Government intervention in business financial affairs resulted in:
      1. The development of securities regulation
      2. Published financial data on corporate performance and eventual analysis of that data [**repeated in 2007-08]**
   4. The most significant step in the evolution of financial management began in the mid-1950s. Emphasis was placed on the analytically determined employment of resources within the firm. The decision-making nature of financial management was manifested in the study of:
      1. Capital asset management: capital budgeting
      2. Efficient utilization of current assets
      3. Capital structure composition
      4. Market efficiency and asymmetric information
   5. In the 1960s into the 1980s, these theories migrated to corporate boardrooms with a focus on the risk/return relationship, accompanied by portfolio management theories that led firms to diversification strategies. By the 1990s diversification strategies were challenged in theory and in practice with firms refocusing on core businesses.
   6. The sharpened focus on financial objectives, it has been critically suggested, has left Canadian managers too averse to risk and concentrating too much on the short term.
   7. The derivatives market, developing from theory, has allowed management to reduce financial risks. Technological advances have increased business efficiencies and risks.
   8. E-commerce provides more efficient mechanisms to manage corporate assets.
2. **The goals of the** **financial management.**

***Perspective 1-2: 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 can not be matched in the other functional areas such as marketing or management.*** [***http://nobelprize.org***](http://nobelprize.org)

1. Shareholders’ wealth maximization, the goal of the firm, is measured by the highest possible market price of the firm’s shares. Other possible goals of the firm should be suggested.
2. Financial decision-making analysis is always predicated on this goal: to increase value to shareholders within a risk-return framework. This is a valuation approach.
3. Shareholders' wealth maximization incorporates:
4. The risk associated with future earnings
5. The timing of benefits
6. Market judgment on accuracy of profit measurement
7. The present value model is useful in establishing asset values
8. Maximizing profits is not the same as maximizing shareholder wealth.
9. The efficiency of the capital market dictates that, with a given level of risk, capital will flow to those firms ‘promising’ the highest return.
10. Management interests and risk perceptions may conflict with the goal of shareholder wealth maximization. This is the agency relationship. Institutional investor’s participation in corporate governance can help align management-shareholder goals.
11. Maximization of shareholder wealth is tempered by social responsibility.
12. Ethics from a finance standpoint is put in the context of market efficiency (chapter 14). Fairness (playing by the rules) and honesty (timely, relevant and reliable disclosure) are key elements.
13. Good corporate governance practices with regulatory changes are outlined and tied to chapter topics of the text (page 10) in the context of value creation.

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| **Finance in Action: Functions of Finance**  Capital budgeting, capital structure and working capital are identified as the key areas of corporate decision making. Corporate governance practices are examined in: Are Executive Salaries Fair?” |

1. **Functions of Financial Management: A financial manager is responsible for financing an efficient level and composition of assets by obtaining financing through the most appropriate means.**

PPT 11 of 22 Functions of the financial manager (Figure 1-1)

1. Daily financial management activities
2. Credit management
3. Inventory control
4. Receipt and disbursement of funds
5. Less-routine activities
6. Sale of stocks and bonds
7. Capital budgeting
8. Dividend decisions
9. Forms of organization: The finance function may be carried out within a number of different forms of organizations.

***Perspective 1-3: The use of Figure 1-1 (covering functions of the financial manager and their relationship to shareholder wealth maximization) is a good way to tie a number of important concepts together.***

1. Sole proprietorship
   1. Single ownership
   2. Simplicity of decision making
   3. Low organizational and operating costs
   4. Unlimited liability
   5. Earnings are taxed as personal earnings of the individual owner
2. Partnership
   1. Two or more partners
   2. Usually formed by articles of partnership agreement
   3. Unlimited liability for all partners. A limited partnership may provide limited liability for one or more partners, except for a general partner.
   4. Earnings are taxed as personal earnings of partners
3. Corporation
   1. Most important form of business in terms of revenue and profits
   2. Legal entity
   3. Formed by articles of incorporation
   4. Shareholders (owners) have limited liability
   5. Easy divisibility of ownership
   6. Managed by the board of directors
   7. Double taxation of earnings: Corporate earnings are subject to corporate income tax; dividends (distributed net income) are subject to personal taxation. The dividend tax credit attempts to reduce double taxation.
4. **The Role of Financial Markets: Wealth maximization depends on the perception and expectations of the market. The market through daily share price changes of each publicly traded company provides managers with a performance report card.**
5. Structure and Functions of the Financial Markets: Money markets (Chapter 7) and Capital markets (Chapter 14) are identified. Students may find that some current examples from the *Globe and Mail* will create a sense of realism about this course.

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| **Finance in Action: The Pricing Mechanism of Financial Markets**  A discussion of noteworthy markets by which capital resources are allocated. |

1. Allocation of Capital. Market price reflects risk and return expectations and a company’s ability to raise funds is influenced by its financial performance and corporate behavior. The markets (primary and secondary) determine value.
2. Risk. Many factors contribute to our collective perceptions of risk including:
   1. Debt: The typical firm makes extensive use of debt financing. The government has been a heavy user of debt markets. Debt versus deficit represents different but related measures.
   2. Interest Rates: The market interest rates are a key to determining required rates of return. Interest rates are volatile.

PPT 21 of 22 Prime rate versus percent change in the CPI (Figure 1-2)

* 1. Global competition: Emphasize the globalization of the capital markets and the worldwide pool of capital available to many companies. The creation of the Euro and impact of the setbacks in the Far East are worth noting.

**Summary Listing of Suggested PowerPoint Slides**

PPT 11 Functions of the financial manager (Figure 1-1)

PPT 21 Prime rate versus percent change in the CPI (Figure 1-2)

**PowerPoint Presentation**

The Chapter 1 PowerPoint Presentation, which covers the same essential points as the annotated outline, consists of 22 frames.