

Chapter

10



The Firm and the Financial Manager

Lecture 10

MGM424 Financial Management

Prepared by
Dr. Mohamed Hamouda

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The Firm and the Financial
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Chapter Objectives

- ◆ **What is Financial Management?**
- ◆ **10 principles of financial management.**
- ◆ **What are the Decisions that Financial Manager must be Concern?**
- ◆ **The Goal of the Firm.**
- ◆ **Organization of the Financial Management Function.**
- ◆ **Understand the agency problems.**

What is Financial Management?

Financial Management means **planning**, **organizing**, **directing** and **controlling** the financial activities of the organization.

(الإدارة المالية يعني التخطيط والتنظيم والتوجيه والسيطرة على الأنشطة المالية للمنظمة)

It refers the efficient and effective **management** of money (funds) in such a manner as to achieve the goals of the organization.

Ten Principles of Financial Management

“It is necessary to understand these principles in order to understand finance.”

Principle 1: The Risk-Return Trade-off

- ◆ **We won't take on additional risk unless we expect to be compensated with additional return.**
- ◆ **Investment choices have different amounts of risk and expected returns.**
- ◆ **The more risk an investment has, the higher its expected return will be.**

Principle 2: The Time Value of Money

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- ◆ **A dollar received today is worth more than a dollar received in the future.**
- ◆ **Because we can earn interest on money received today, it is better to receive money earlier rather than later.**

Principle 3: Cash— Not Profits—Is King

- ◆ **Cash Flow, not accounting profit, is used as our measurement tool.**
- ◆ **Cash flows, not profits, are actually can be reinvested.**

Principle 4: Incremental Cash Flows

- ◆ **The incremental cash flow is the difference between the projected cash flows if the project is selected, versus what they will be, if the project is not selected.**

Principle 5: The Curse of Competitive Markets

- ◆ It is hard to find exceptionally profitable projects
- ◆ If an industry is generating large profits, new entrants are usually attracted. The additional competition and added capacity can result in profits being driven down to the required rate of return.
- ◆ Product Differentiation, Service and Quality can separate products from competition

Principle 6: Efficient Capital Markets

- ◆ **The markets are quick and the prices are right.**
- ◆ **The values of all assets and securities at any instant in time fully reflect all available information.**

Principle 7: The Agency Problem

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- ◆ **Managers won't work for the owners unless it is in their best interest**
- ◆ **A agency problem resulting from conflicts of interest between the manager/agent and the stockholder/owners.**
 - ◆ **Managers may make decisions that are not in line with the goal of maximization of shareholder wealth.**

Principle 8: Taxes Bias Business Decisions

- ◆ **The cash flows we consider are the after-tax incremental cash flows to the firm as a whole.**

Principle 9: All Risk is Not Equal

- ◆ **Some risk can be diversified away, and some cannot**
- ◆ **The process of diversification can reduce risk, and as a result, measuring a project's or an asset's risk is very difficult.**

Principle 10: Ethical Behavior is Doing the Right Thing, and Ethical Dilemmas Are Everywhere in Finance

- ◆ **Each person has his or her own set of values, which forms the basis for personal judgments about what is the right thing**

◆ Investment Decisions (*Capital Budgeting*)

(*Investment decisions* revolve around how to best allocate money to maximize their value.)

◆ Financing Decisions (*Capital Structure*)

(*Financing decisions* revolve around how to pay for investments and expenses)

◆ Asset Management Decisions (*Working Capital Management Decisions*)

Investment Decisions

- ◆ **how, when, where and how much money will be spent on investment opportunities.**
- ◆ **A firm has many options to invest their funds but firm has to select the most appropriate assets for investment which will bring maximum benefit for the firm.**
- ◆ **What specific assets should be acquired?**
- ◆ **What assets (if any) should be reduced or eliminated?**

Investment Decisions

- ◆ **What specific assets should be acquired?**
- ◆ **What assets (if any) should be reduced or eliminated?**

Financing Decisions

Determine how the assets will be financed.

- ◆ A company can raise finance from various sources such as by issue of shares, debentures or by taking loan and advances. These sources of finance can be divided into two categories: owners fund (no risk involve) and borrowers fund (risk involve).
- ◆ Find the least expensive sources of fund.

Financing Decisions

◆ **What is the best type of financing?**

Mix type financing.

◆ **What is the best financing mix?**

Mixer debt and equity.

◆ **What is the best dividend policy?**

Paying a consistent percentage of net earnings.

◆ **How will the funds be physically acquired?**

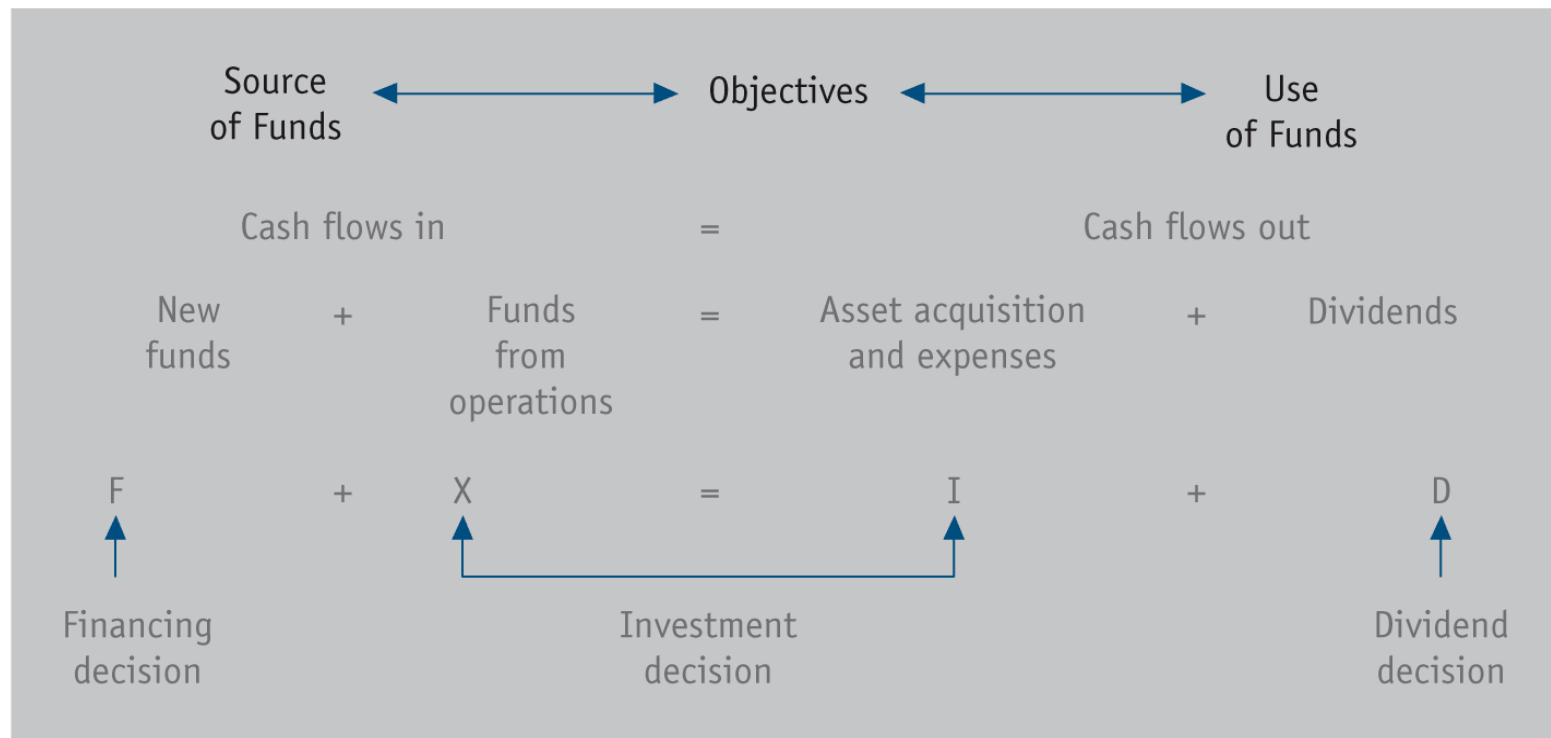
- ◆ How do we manage existing assets *efficiently*?
- ◆ Financial Manager has varying degrees of operating responsibility over assets.
- ◆ Greater emphasis on **current asset management** than **fixed asset management**.

Interrelationship of the decisions made by a Financial Manager

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FIGURE 1.3 THE INTERRELATIONSHIP OF THE DECISIONS MADE BY A FINANCIAL MANAGER



What are the Goals of the Firm? (General Goals)

- ◆ **Survival**
 - ◆ **Avoid financial distress and bankruptcy**
 - ◆ **Beat the competition**
 - ◆ **Maximize sales or market share**
 - ◆ **Minimize costs**
 - ◆ **Maximize profits**
 - ◆ **Maintain steady earnings growth.**

Shortcomings of these General Goals

Problems

- ◆ These goals are either associated with increasing profitability or reducing risk.
 - *Could increase current profits while harming firm (e.g., defer maintenance, issue common stock to buy Treasury-bills, etc.).*
 - *Does not specify timing or duration of expected returns.*
 - *Calls for a zero payout dividend policy.*
 - *They are not consistent with the long-term interests of shareholders.*

So it is necessary to find a goal that can encompass both profitability and risk.

The Real Goal of the Firm

Maximization of Shareholder Wealth!

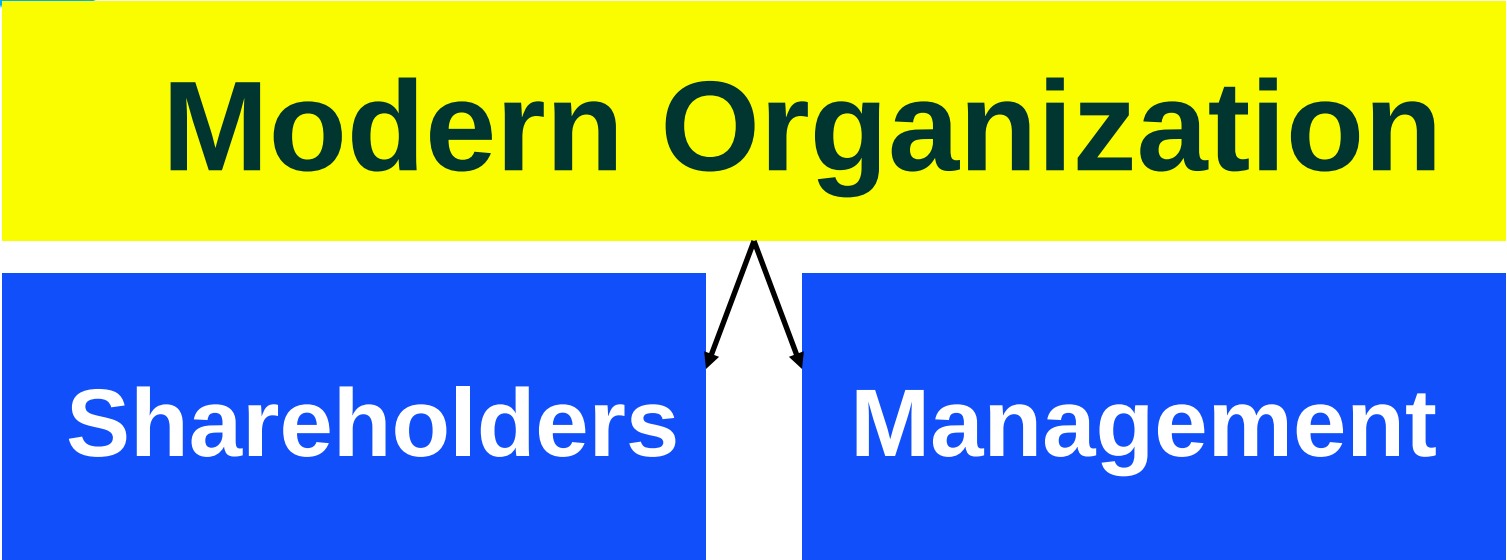
Shareholders' wealth can be measured as the current value per share of existing shares.

Strengths of Shareholder Wealth Maximization

- ◆ Takes account of: **current and future profits and EPS**; **the timing, duration, and risk of profits**; **dividend policy**; and all other relevant factors.
- ◆ Thus, **share price** serves as a barometer for business performance.

The Modern Organization

Modern Organization



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.

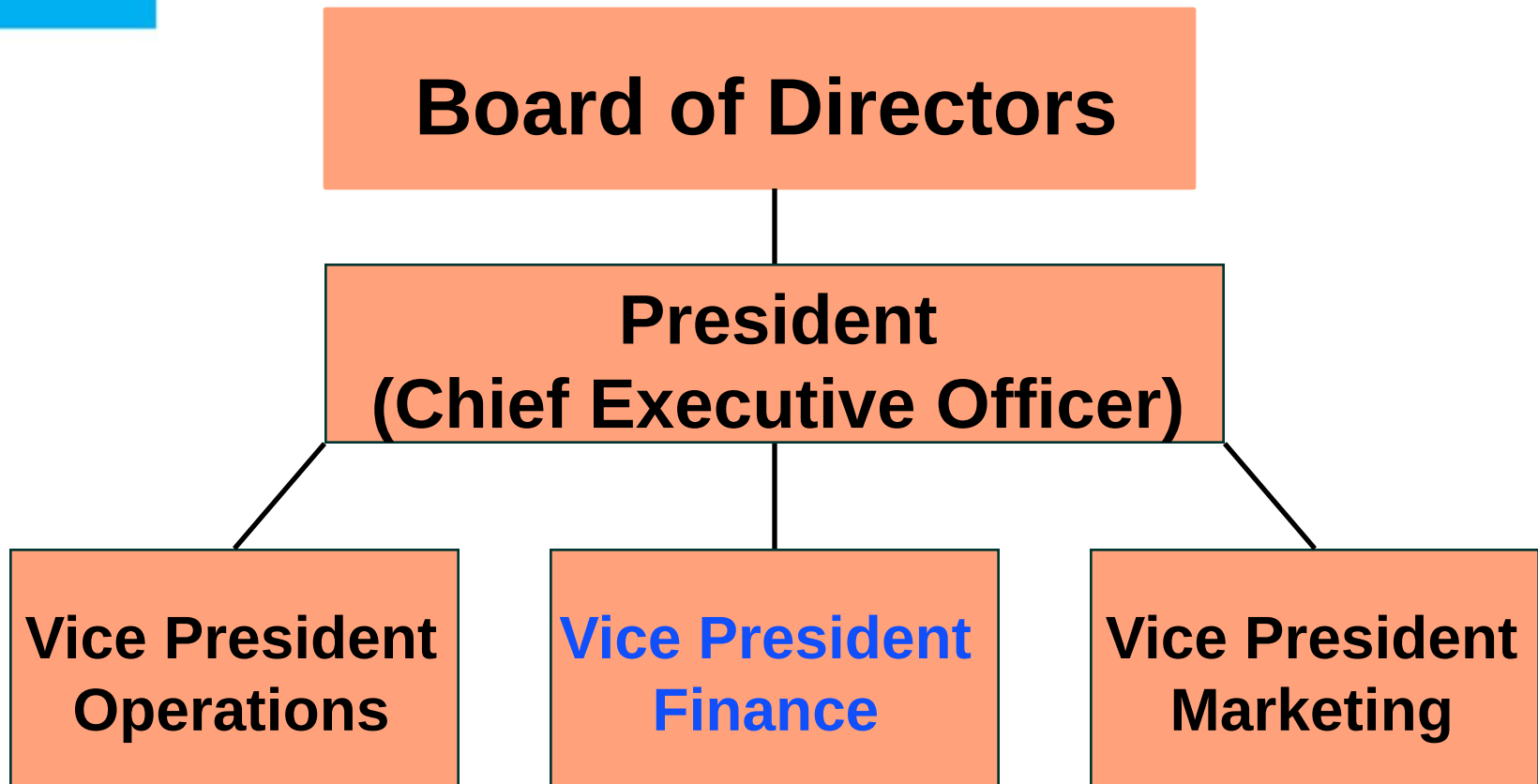
Agency Theory

- ◆ 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 stop 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

Vice President 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