



# The Firm and the Financial Manager

## Lecture 9

Introduction To finance

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# The Firm and the Financial Manager



# *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***

- **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***

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- **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***

- ❑ **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?

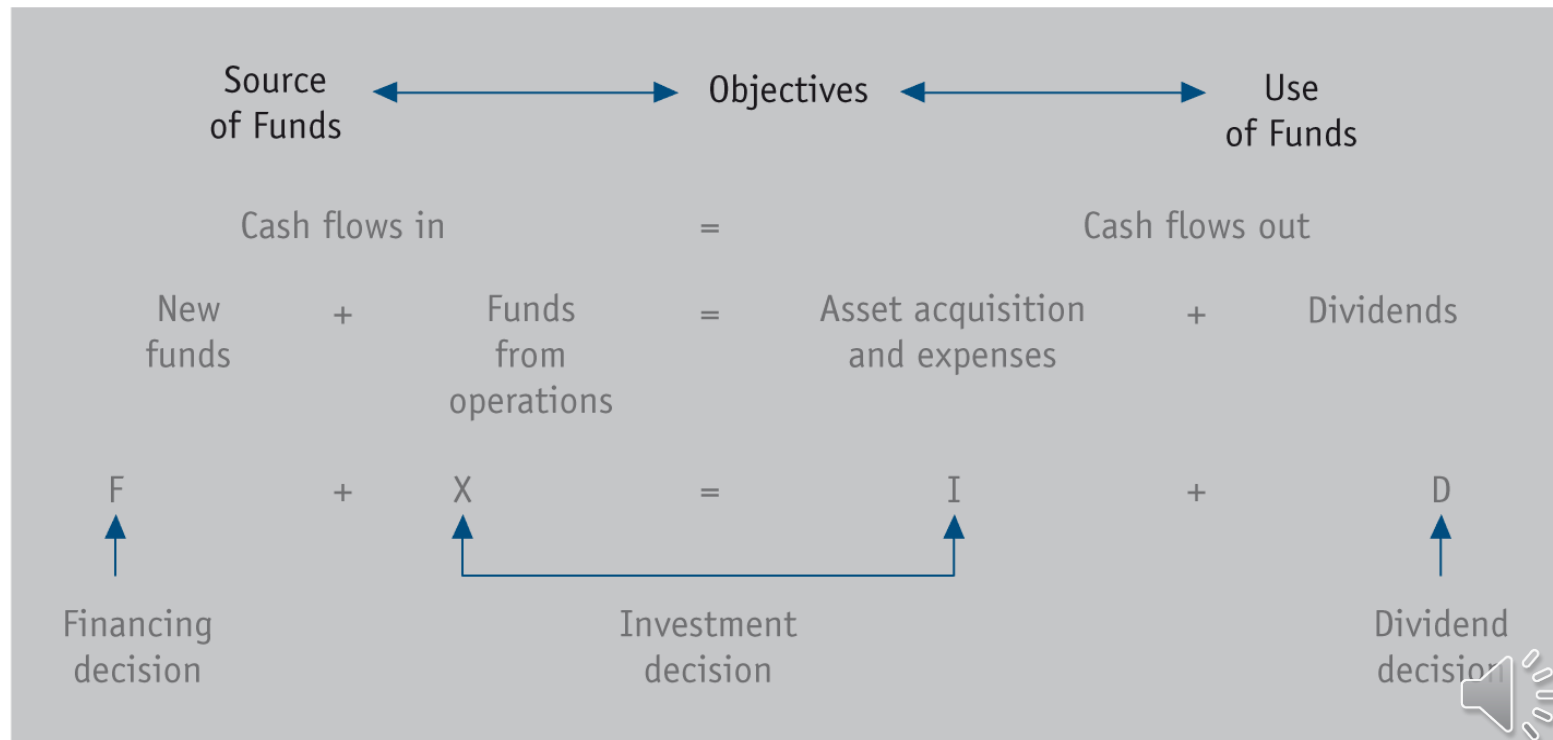


- How do we manage existing assets *efficiently*?
- Financial Manager has varying degrees of operating responsibility over assets.
- Greater emphasis on **current asset management** than **fixed asset management**.



# Interrelationship of the decisions made by a Financial Manager

**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.**



# *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.**



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.



- **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.**



- Principals must provide **incentives** so that management acts in the principals' best interests and then **monitor** results.
- Incentives include **stock options**, **perquisites**, and **bonuses**.

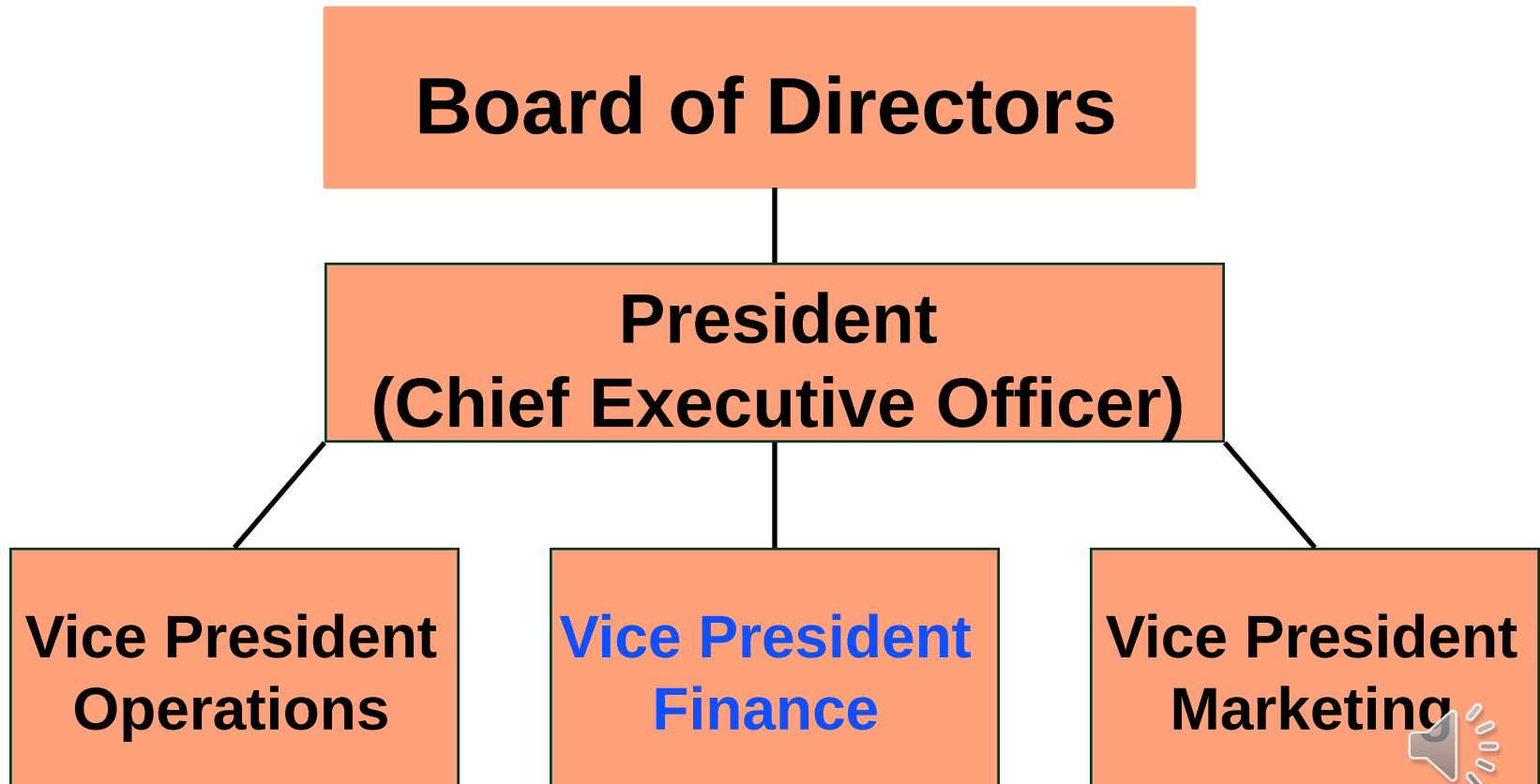


# ***Social Responsibility***

- 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



# ***Challenges of Financial Manager***

**7 challenges faced by finance manager**



## 1. Managing cash flow

**Every business can suddenly fall due to a lack of adequate cash flow, which in turn happens due to poor cash flow management. This is one of the biggest challenges faced by finance managers.**

**The inflow and outflow of the company money need to be precisely tracked to get the right insight. Most of the traditionally recorded financial statements are intently not meant to give you information regarding the cash flow and its improvement.**

**They are simply statements made for record-keeping, not business management. Automated billing and collection processes and report management can significantly help in improving the cash flow of your business.**

**Without these, cashflow inadequacies will catch up to your business — maybe not now but definitely later, and it's not a pretty picture. The phrase to remember here is “you can’t manage what you can’t measure.”**



## 2. Not having a plan for using the budget

**You cannot run your business by just sitting in your office and thinking that the business bank account has enough to cover all your expenses and pay the bills.**

**It won't be long before your business ends up in a debt cycle and ultimately all the finances go out of your hand. The best business advice to avoid ruining the business finances is to run your company on a budget**

**Create a calculated budget and make sure to stick to it. Developing a budget will not only help you wisely manage your business money but will also prove to be immensely helpful in future financial forecasting and analyzing the directions where the business can grow.**

**Along with this, keep updating the budget regularly according to the changing situations and major business decisions.**



## 3. Not raising enough capital

Not being able to get their expected amount of funding is one of the other challenges faced by finance manager in an organization. However, it is extremely important to have a solid business proposal and growth plan to attract investors to invest in your business.

Without the funding money, your business development would be near impossible. There are five main ways through which you can raise funding:

- Venture funding
- SBA- bank loans
- Private Equity
- Loans from friends and family
- Bank loans



## 4. Too much debt

**There are various reasons why entrepreneurs take loans and sometimes they do max out their options. If the debt is not properly handled and repaid, the business can sink.**

**Whichever way you are trapped, debt can cause short and long-term effects. For example, the business may take time to build profits and even meet the bare minimum. Till that time, the employees and vendors would be on hold and overhead costs would add up.**

**To reduce your debt and pay it back in time, determine the areas where you can effectively reduce costs. Look for creative financing options like crowdfunding and angel investors and group your business loans together to make it into one payment.**



## 5. Not having a proper reporting

**Small businesses are recommended to record all their transactions and it would be even better if is done under the guidance of a financial accounting expert. Records include earnings, expenses, and sales.**

**Private companies are not mandated to disclose their accounting reports publicly. But not keeping a proper report and not keeping track of the financial data leads to major problems.**

**This includes improper tax filing with the wrong revenue estimation, extra interest charges, and many more.**

**On the other hand, public companies are required to disclose their financial reports and inaccurate filing would lead to financial management problems which would take immense firefighting strategies because the records were public.**



## 6. Poor tax compliance

**Managing corporate finance problems is a heavy task, and complicating it with overpaying taxes is not at all a good idea. Almost 85% of small businesses end up overpaying their federal income taxes every year**

**Others are underpaying and moving on the wrong side of the authorities. Both these situations are harmful to any company because it takes intensive effort, time, and money.**

**The most significant issue that all businesses face when it comes to federal taxes is not the payment aspect — it is compliance. This is a heavy burden, especially for small businesses**



## 7. Not paying bills on time

**Everyone who is a part of your business in any way has to be paid. For all the goods and services you use for your business, bills have to be paid on time. Sometimes, a late payment can be overlooked.**

**But if your business becomes one of those which keep repeating the late payment process, you will end up paying loads of money as fines.**

**This can cause damage to your supplier relationship, which ultimately means that the business will be facing a hard time finding the basic raw material.**

**Most companies are still doing their accounts payable process manually which is extremely time-consuming and labor-intensive. It makes the business prone to more errors and maybe even fraud.**



***The End***

