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Part 1

Introduction to Financial Management

1 The Role of Financial Management

Contents

Objectives

After studying Chapter 1, you should be able to:

- Explain why the role of the financial manager today is so important.
- Describe "financial management" in terms of the three major decision areas that confront the financial manager.
- Identify the goal of the firm and understand why shareholders' wealth maximization is preferred over other goals.
- Understand the potential problems arising when management of the corporation and ownership are separated (i.e., agency problems).
- Demonstrate an understanding of corporate governance.
- Discuss the issues underlying social responsibility of the firm.
- Understand the basic responsibilities of financial managers and the differences between a "treasurer" and a "controller."

Increasing shareholder value over time is the bottom line of every move we make.

—ROBERTO GOIZUETA
Former CEO, The Coca-Cola Company

Introduction

The financial manager plays a dynamic role in a modern company's development. This has not always been the case. Until around the first half of the 1900s financial managers primarily raised funds and managed their firms' cash positions – and that was pretty much it. In the 1950s, the increasing acceptance of present value concepts encouraged financial managers to expand their responsibilities and to become concerned with the selection of capital investment projects.

Today, external factors have an increasing impact on the financial manager. Heightened corporate competition, technological change, volatility in inflation and interest rates, worldwide economic uncertainty, fluctuating exchange rates, tax law changes, and ethical concerns over certain financial dealings must be dealt with almost daily. As a result, finance is required to play an ever more vital strategic role within the corporation. The financial manager has emerged as a team player in the overall effort of a company to create value. The "old ways of doing things" simply are not good enough in a world where old ways quickly become obsolete. Thus today's financial manager must have the flexibility to adapt to the changing external environment if his or her firm is to survive.

The successful financial manager of tomorrow will need to supplement the traditional metrics of performance with new methods that encourage a greater role for uncertainty and multiple assumptions. These new methods will seek to value the flexibility inherent in initiatives – that is, the way in which taking one step offers you the option to stop or continue down one or more paths. In short, a correct decision may involve doing something today that in itself has small value, but gives you the option to do something of greater value in the future.

If you become a financial manager, your ability to adapt to change, raise funds, invest in assets, and manage wisely will affect the success of your firm and, ultimately, the overall economy as well. To the extent that funds are misallocated, the growth of the economy will be slowed. When economic wants are unfulfilled, this misallocation of funds may work to the detriment of society. In an economy, efficient allocation of resources is vital to optimal growth in that economy; it is also vital to ensuring that individuals obtain satisfaction of their highest levels of personal wants. Thus, through efficiently acquiring, financing, and managing assets, the financial manager contributes to the firm and to the vitality and growth of the economy as a whole.

What Is Financial Management?

Financial management Concerns the acquisition, financing, and management of assets with some overall goal in mind.

Financial management is concerned with the acquisition, financing, and management of assets with some overall goal in mind. Thus the decision function of financial management can be broken down into three major areas: the investment, financing, and asset management decisions.

Investment Decision

The investment decision is the most important of the firm's three major decisions when it comes to value creation. It begins with a determination of the total amount of assets needed to be held by the firm. Picture the firm's balance sheet in your mind for a moment. Imagine liabilities and owners' equity being listed on the right side of the balance sheet and its assets on the left. The financial manager needs to determine the dollar amount that appears above the double lines on the left-hand side of the balance sheet – that is, the size of the firm. Even when this number is known, the composition of the assets must still be decided. For example, how much of the firm's total assets should be devoted to cash or to inventory? Also, the flip side of investment – disinvestment – must not be ignored. Assets that can no longer be economically justified may need to be reduced, eliminated, or replaced.

Financing Decision

The second major decision of the firm is the financing decision. Here the financial manager is concerned with the makeup of the right-hand side of the balance sheet. If you look at the mix of financing for firms across industries, you will see marked differences. Some firms have relatively large amounts of debt, whereas others are almost debt free. Does the type of financing employed make a difference? If so, why? And, in some sense, can a certain mix of financing be thought of as best?

In addition, dividend policy must be viewed as an integral part of the firm's financing decision. The **dividend-payout ratio** determines the amount of earnings that can be retained in the firm. Retaining a greater amount of current earnings in the firm means that fewer dollars will be available for current dividend payments. The value of the dividends paid to stockholders must therefore be balanced against the opportunity cost of retained earnings lost as a means of equity financing.

Dividend-payout ratio Annual cash dividends divided by annual earnings; or, alternatively, dividends per share divided by earnings per share. The ratio indicates the percentage of a company's earnings that is paid out to shareholders in cash.

Once the mix of financing has been decided, the financial manager must still determine how best to physically acquire the needed funds. The mechanics of getting a short-term loan, entering into a long-term lease arrangement, or negotiating a sale of bonds or stock must be understood.

Asset Management Decision

The third important decision of the firm is the asset management decision. Once assets have been acquired and appropriate financing provided, these assets must still be managed efficiently. The financial manager is charged with varying degrees of operating responsibility over existing assets. These responsibilities require that the financial manager be more concerned with the management of current assets than with that of fixed assets. A large share of the responsibility for the management of fixed assets would reside with the operating managers who employ these assets.

The Goal of the Firm

Efficient financial management requires the existence of some objective or goal, because judgment as to whether or not a financial decision is efficient must be made in light of some standard. Although various objectives are possible, we assume in this book that the goal of the firm is to maximize the wealth of the firm's present owners.

Shares of common stock give evidence of ownership in a corporation. Shareholder wealth is represented by the market price per share of the firm's common stock, which, in turn, is a reflection of the firm's investment, financing, and asset management decisions. The idea is that the success of a business decision should be judged by the effect that it ultimately has on share price.

Value Creation

Frequently, **profit maximization** is offered as the proper objective of the firm. However, under this goal a manager could continue to show profit increases by merely issuing stock and using the proceeds to invest in Treasury bills. For most firms, this would result in a decrease in each owner's share of profits – that is, **earnings per share** would fall. Maximizing earnings per share, therefore, is often advocated as an improved version of profit maximization. However, maximization of earnings per share is not a fully appropriate goal because it does

Profit maximization Maximizing a firm's earnings after taxes (EAT).

Earnings per share (EPS) Earnings after taxes (EAT) divided by the number of common shares outstanding.

What Companies Say About Their Corporate Goal

"We aim to maximise long-term shareholder value."
Source: ABM AMRO Annual Report 2002.

"Cadbury Schweppes' governing objective is growth in shareowner value."
Source: Cadbury Schweppes Report & Accounts and Form 20-F 2002.

"The Board and Senior Management recognise their responsibility to represent the interests of the shareholders and to maximise shareholder value."
Source: CLP Holdings Limited, The parent company of the China Light & Power Group, Annual Report 2002.

"Our overall objectives are to achieve high customer satisfaction, maximize shareholder value and be an employer of choice for talented individuals."
Source: Credit Suisse Group, Annual Report 2002.

"Our ultimate objective remains what it has always been: to maximize long-term shareholder value."
Source: The Dow Chemical Company, 2002 Annual Report.

"ExxonMobil's overarching objective is to create long-term, sustainable shareholder value."
Source: ExxonMobil 2002 Summary Annual Report.

not specify the timing or duration of expected returns. Is the investment project that will produce a \$100,000 return five years from now more valuable than the project that will produce annual returns of \$15,000 in each of the next five years? An answer to this question depends on the time value of money to the firm and to investors at the margin. Few existing stockholders would think favorably of a project that promised its first return in 100 years, no matter how large this return. Therefore our analysis must take into account the time pattern of returns.

Another shortcoming of the objective of maximizing earnings per share – a shortcoming shared by other traditional return measures, such as return on investment – is that risk is not considered. Some investment projects are far more risky than others. As a result, the prospective stream of earnings per share would be more risky if these projects were undertaken. In addition, a company will be more or less risky depending on the amount of debt in relation to equity in its capital structure. This financial risk also contributes to the overall risk to the investor. Two companies may have the same expected earnings per share, but if the earnings stream of one is subject to considerably more risk than the earnings stream of the other, the market price per share of its stock may well be less.

Finally, this objective does not allow for the effect of dividend policy on the market price of the stock. If the only objective were to maximize earnings per share, the firm would never pay a dividend. It could always improve earnings per share by retaining earnings and investing them at any positive rate of return, however small. To the extent that the payment of dividends can affect the value of the stock, the maximization of earnings per share will not be a satisfactory objective by itself.

For the reasons just given, an objective of maximizing earnings per share may not be the same as maximizing market price per share. The market price of a firm's stock represents the focal judgment of all market participants as to the value of the particular firm. It takes into account present and expected future earnings per share; the timing, duration, and risk of these earnings; the dividend policy of the firm; and other factors that bear on the market price of the stock. The market price serves as a barometer for business performance; it indicates how well management is doing on behalf of its shareholders.

Management is under continuous review. Shareholders who are dissatisfied with management performance may sell their shares and invest in another company. This action, if taken by other dissatisfied shareholders, will put downward pressure on market price per share. Thus management must focus on creating value for shareholders. This requires management to judge alternative investment, financing, and asset management strategies in terms of their effect on shareholder value (share price). In addition, management should pursue product-market strategies, such as building market share or increasing customer satisfaction, only if they too will increase shareholder value.

A Manager's Real Responsibility

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The corporation is a wonderful institution. But it contains inherent drawbacks, at the core of which are conflicts of interest. Control over the company's resources is vested in the hands of top managers who may rationally pursue their interests at the expense of all others. Economists call this the "principal-agent" problem. In the modern economy, where shares are held by fund managers, there is not just one set of principal-agent relations but a long chain of them.

The principal-agent problem is exacerbated by two others: asymmetric information and obstacles to collective action. Corporate managers know more about what is going on in the business than anybody else and have an interest in keeping at least some of this information to themselves. Equally, dispersed shareholders have a weak incentive to act, because they would share the gains with others but bear much of the cost themselves.

The upshot is the chronic vulnerability of the corporation to managerial incompetence, self-seeking, deceit or downright malfeasance. In practice, there are five (interconnected) ways of reducing these risks.

The first is market discipline, since failure will ultimately find managers out. The second is internal checks, with independent directors or requirements for voting by institutional shareholders. The third is regulation covering the composition of boards, structure of businesses and reporting requirements. The fourth is transparency, including accounting standards and independent audits. The last is simply values of honest dealing.

Economists are very uncomfortable with the notion of morality. Yet it seems to have rather a clear meaning in the business context. It consists of acting honestly even when the opposite may be to one's advantage. Such morality is essential for all trustee relationships. Without it, costs of supervision and control become exorbitant. At the limit, a range of transactions and long-term relationships becomes impossible and society remains impoverished.

Corporate managers are trustees. So are fund managers. The more they view themselves (and are viewed) as such, the less they are likely to exploit opportunities created by the conflicts of interest within the business.

Source: Adapted from Martin Wolf, "A manager's real responsibility," *Financial Times* (January 30, 2002), p. 13. (www.ft.com)

Agency Problems

It has long been recognized that the separation of ownership and control in the modern corporation results in potential conflicts between owners and managers. In particular, the objectives of management may differ from those of the firm's shareholders. In a large corporation, stock may be so widely held that shareholders cannot even make known their objectives, much less control or influence management. Thus this separation of ownership from management creates a situation in which management may act in its own best interests rather than those of the shareholders.

Agent(s) Individual(s) authorized by another person, called the principal, to act on the latter's behalf.

Agency (theory) A branch of economics relating to the behavior of principals (such as owners) and their agents (such as managers).

We may think of management as the **agents** of the owners. Shareholders, hoping that the agents will act in the shareholders' best interests, delegate decision-making authority to them. Jensen and Meckling were the first to develop a comprehensive theory of the firm under **agency** arrangements.[1] They showed that the principals, in our case the shareholders, can assure themselves that the agents (management) will make optimal decisions only if appropriate incentives are given and only if the agents are monitored. Incentives include stock options, bonuses, and perquisites ("perks," such as company automobiles and expensive offices), and these must be directly related to how close management decisions come to the interests of the shareholders. Monitoring is done by bonding the agent, systematically

[1]Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3 (October 1976), 305–360.

reviewing management perquisites, auditing financial statements, and limiting management decisions. These monitoring activities necessarily involve costs, an inevitable result of the separation of ownership and control of a corporation. The less the ownership percentage of the managers, the less the likelihood that they will behave in a manner consistent with maximizing shareholder wealth and the greater the need for outside shareholders to monitor their activities.

Some people suggest that the primary monitoring of managers comes not from the owners but from the managerial labor market. They argue that efficient capital markets provide signals about the value of a company's securities, and thus about the performance of its managers. Managers with good performance records should have an easier time finding other employment (if they need to) than managers with poor performance records. Thus, if the managerial labor market is competitive both within and outside the firm, it will tend to discipline managers. In that situation, the signals given by changes in the total market value of the firm's securities become very important.

Social Responsibility

Stakeholders All constituencies with a stake in the fortunes of the company. They include shareholders, creditors, customers, employees, suppliers, and local communities.

Maximizing shareholder wealth does not mean that management should ignore social responsibility, such as protecting the consumer, paying fair wages to employees, maintaining fair hiring practices and safe working conditions, supporting education, and becoming involved in such environmental issues as clean air and water. It is appropriate for management to consider the interests of **stakeholders** other than shareholders. These stakeholders include creditors, employees, customers, suppliers, communities in which a company operates, and others. Only through attention to the legitimate concerns of the firm's various stakeholders can the firm attain its ultimate goal of maximizing shareholder wealth.

Being a Responsible Corporate Citizen

EXEC

As stories of corporate irresponsibility continue to headline the news, organizations are finding ways to establish corporate citizenship as a business essential.

"Corporate citizenship is the relationship between business and society," explains Bradley Googins, Ph.D., professor and executive director of the Center for Corporate Citizenship at Boston College (Boston). Googins points to two emerging trends in corporate citizenship.

The first is the increase in the amount of social and environmental reporting. "Companies are producing reports that say, 'Here's what we're doing and here's how we plan to improve our social and environmental efforts,'" Googins says. Organizations reveal such information in annual reports or in separate corporate responsibility documents.

The second is the recognition that corporate citizenship has traditionally existed in a narrow function within the business. Today, companies are developing integrated strategies, Googins explains, to ensure that all business units are working together to create a corporatewide strategy for citizenship.

A corporatewide strategy can mean business success for astute organizations, observes Googins. "Corporate citizenship speaks to the core values of who you are as a company," he says. "And stakeholders compare your behavior to what you say your core values are. Profitability is dependent on stakeholder trust."

Also, by investing in community and economic development in countries that have emerging economies, for example, companies open themselves to those new markets.

"You can use social and economic values both to create benefits for society and to generate profits for the company," adds Googins. "It can be a win-win situation."

Source: "Being a Responsible Corporate Citizen," *Exec*, Vol. 25:1 (2003), p. 5. (www.unisys.com/execmag/)

Many people feel that a firm has no choice but to act in socially responsible ways. They argue that shareholder wealth and, perhaps, the corporation's very existence depend on its being socially responsible. Because the criteria for social responsibility are not clearly defined, however, formulating consistent policies is difficult. When society, acting through various representative bodies, establishes the rules governing the trade-off between social goals and economic efficiency, the task for the corporation is clearer. We can then view the company as producing both private and social goods, and the maximization of shareholder wealth remains a viable corporate objective.

Corporate Governance

Corporate governance The system by which corporations are managed and controlled. It encompasses the relationships among a company's shareholders, board of directors, and senior management.

Corporate governance refers to the system by which corporations are managed and controlled. It encompasses the relationships among a company's shareholders, board of directors, and senior management. These relationships provide the framework within which corporate objectives are set and performance is monitored. Three categories of individuals are, thus, key to corporate governance success: first, the common shareholders, who elect the board of directors; second, the company's board of directors themselves; and, third, the top executive officers led by the chief executive officer (CEO).

The board of directors – the critical link between shareholders and managers – is potentially the most effective instrument of good governance. The oversight of the company is ultimately their responsibility. The board, when operating properly, is also an independent check on corporate management to ensure that management acts in the shareholders' best interests.

The Role of the Board of Directors

Sarbanes-Oxley Act of 2002 (SOX) Addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information.

The board of directors sets company-wide policy and advises the CEO and other senior executives, who manage the company's day-to-day activities. In fact, one of the board's most important tasks is hiring, firing, and setting of compensation for the CEO.

Boards review and approve strategy, significant investments, and acquisitions. The board also overseas operating plans, capital budgets, and the company's financial reports to common shareholders.

In the United States, boards typically have 10 or 11 members, with the company's CEO often serving as chairman of the board. In Britain, it is common for the roles of chairman and CEO to be kept separate, and this idea is gaining support in the United States.

Sarbanes-Oxley Act of 2002

Public Company Accounting Oversight Board (PCAOB) Private-sector, nonprofit corporation, created by the *Sarbanes-Oxley Act of 2002* to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

There has been renewed interest in corporate governance lately caused by major governance breakdowns, which led to failures to prevent a series of recent corporate scandals involving Enron, WorldCom, Global Crossing, Tyco, and numerous others. Governments and regulatory bodies around the world are getting louder on the issue of corporate governance reform. In the United States, one sign of the seriousness of this concern is that Congress enacted the **Sarbanes-Oxley Act of 2002** (SOX).

Sarbanes-Oxley mandates reforms to combat corporate and accounting fraud, and imposes new penalties for violations of securities laws. It also calls for a variety of higher standards for corporate governance, and establishes the **Public Company Accounting Oversight Board (PCAOB)**. The Securities and Exchange Commission (SEC) appoints the chairman and the members of the PCAOB. The PCAOB has been given the power to adopt auditing, quality control, ethics, and disclosure standards for public companies and their auditors as well as investigate and discipline those involved.

Lessons from the European Boardroom?

There is no such thing as common corporate governance across Europe. Each of the countries that make up the European Union goes its own way. In Germany and the Netherlands, two-tier boards, with the upper tier keeping a close watch on the executives at the lower tier, provide a degree of protection from corporate malfeasance. In Austria, Denmark, Germany, Luxembourg and Sweden, employees have the right to elect some members of their company's supervisory board; whereas in France, employee representatives can even attend (but not vote at) board meetings.

Comprehensive model

Of all the nations of the European Union, it is the UK that has developed the most comprehensive system of governance. This did not happen by accident. The UK has the largest number of publicly quoted companies in Europe, the stock exchange with the highest volume, and an open capitalist model that is more akin to that of the US.

The main difference is that over the last decade the UK has sought to respond to successive business and financial scandals by strengthening both its accounting practice and corporate governance. This follows a series of scandals including the collapse of the media empire controlled by the late tycoon Robert Maxwell, the huge losses at Barings Bank, the Guinness share support operation scandal, and recently building public concern about rewards in the nation's boardrooms.

Corporate self-regulation

An interesting aspect of the UK approach is that until now it has been largely based around self-regulation and governance codes developed by the corporate sector itself. These codes have become part of the "listing requirements" for quoted companies in the UK, but until recently were not captured in company law. The codes drawn up by Sir Adrian Cadbury, formerly of the food group Cadbury Schweppes, Sir Ronnie Hempel of ICI, and Sir Richard Greenbury, formerly of Marks and Spencer, have led to improved corporate practices in the boardroom.

Several key principles have been established. Among these is the separation of power between chairman and chief executive officer, a device designed to prevent absolute domination of proceedings by a single individual.

Another area that is receiving attention is the role of non-executives. Governance reports have placed great emphasis on developing committees of independent directors in the areas of compensation, auditing, and appointments.

Directorial value

The most vexed question in the UK, as it has been in the US in recent times, is that of a director's remuneration. The focus in UK governance has been on full disclosure, so company reports now contain pages of information on bonus, share rewards and share option plans.

Source: Adapted from Alex Brummer, "Lessons from the European boardroom?," *The NASDAQ® International Magazine* (September/October 2002), pp. 54–55.

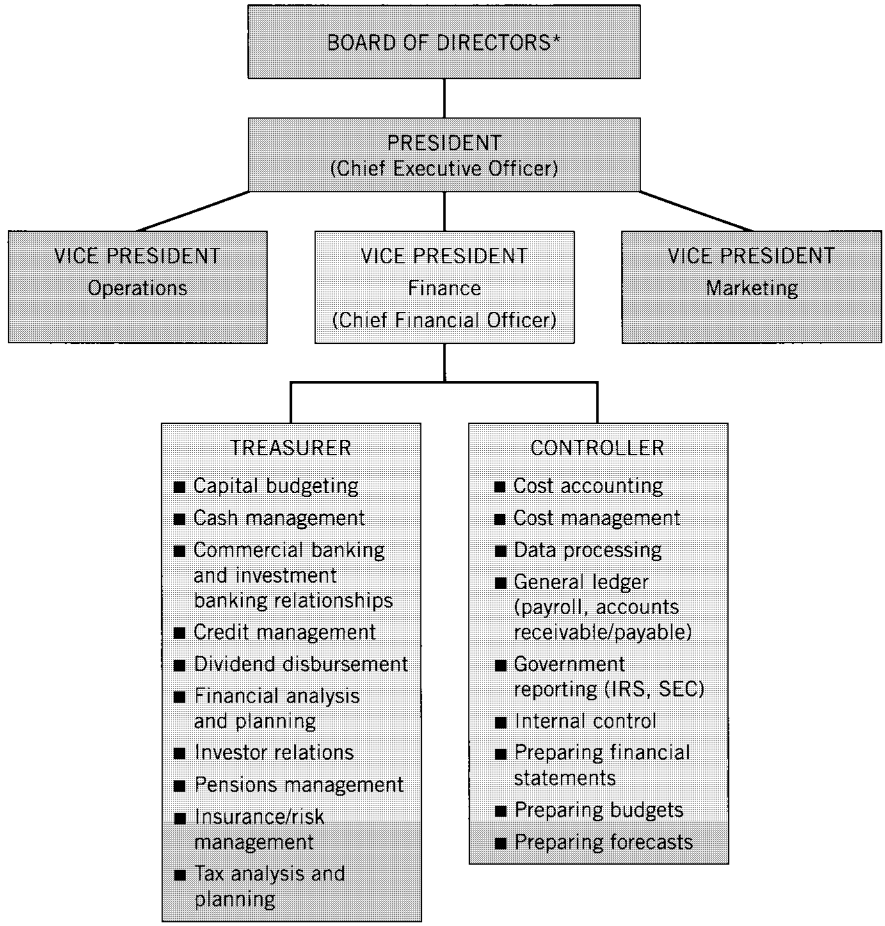
Organization of the Financial Management Function

Whether your business career takes you in the direction of manufacturing, marketing, finance, or accounting, it is important for you to understand the role that financial management plays in the operations of the firm. Figure 1.1 is an organization chart for a typical manufacturing firm that gives special attention to the finance function.

As the head of one of the three major functional areas of the firm, the vice president of finance, or chief financial officer (CFO), generally reports directly to the president, or chief executive officer (CEO). In large firms, the financial operations overseen by the CFO will be split into two branches, with one headed by a treasurer and the other by a controller.

The controller's responsibilities are primarily accounting in nature. Cost accounting, as well as budgets and forecasts, concerns internal consumption. External financial reporting is provided to the IRS, the Securities and Exchange Commission (SEC), and the stockholders.

The treasurer's responsibilities fall into the decision areas most commonly associated with financial management: investment (capital budgeting, pension management), financing (commercial banking and investment banking relationships, investor relations, dividend



*In response to heightened concern over shareholders' interests, a growing number of companies have placed stockholders in a box above the board of directors on their organization chart.

Figure 1.1

Financial management on the organization chart

disbursement), and asset management (cash management, credit management). The organization chart may give you the false impression that a clear split exists between treasurer and controller responsibilities. In a well-functioning firm, information will flow easily back and forth between both branches. In small firms the treasurer and controller functions may be combined into one position, with a resulting commingling of activities.

Organization of the Book

We began this chapter by offering the warning that today's financial manager must have the flexibility to adapt to the changing external environment if his or her firm is to survive. The recent past has witnessed the production of sophisticated new technology-driven techniques for raising and investing money that offer only a hint of things to come. But take heart. Although the techniques of financial management change, the principles do not.

As we introduce you to the most current techniques of financial management, our focus will be on the underlying principles or fundamentals. In this way, we feel that we can best prepare you to adapt to change over your entire business career.

The Underpinnings

In Part 1, Chapter 1, we define financial management, advocate maximization of shareholder wealth as the goal of the firm, and look at the position that financial management holds on the firm's organization chart. Our next aim is to arm you with certain background material and some of the basic tools of financial analysis. Therefore, in Chapter 2 we examine the

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Total know-how for small business

Dear Alice,

With all the sound and fury going on about our national moral crisis, do you have any words of wisdom and encouragement on the subject of business ethics?

Hopeful in Hawaii

Dear Hopeful,
Glad to hear someone out there still has some faith in the immortality of morality in these troubled times. I don't know why business ethics should be a subset of general, run-of-the-mill ethics, but I'm willing to make a stab at defining how one's ethics can impact one's business.

The way I see it, a business person needs several fundamental ingredients to succeed. These might include skills specific to the trade he or she is in, sufficient capital, a willingness to apply a generous amount of elbow grease, and a whole lot of luck. But even given all of the above, if the ingredient of integrity is absent, true success will elude the enterprise – for what kind of a business can survive without a good reputation? And what is reputation, after all, but ethics and integrity?

To be sure, much morality is imposed externally these days. Laws and regulations tend to make individuals, corporations, and even countries more virtuous than they might otherwise be. Good intentions are fine, but a little external incentive never hurts to get the job done. Yet the true hope for the future of ethics in society stems from the fact that the vast majority of folks have an internal moral compass and would do the right thing even without extraordinary external pressure.

And while these times may indeed appear to be troubled, they are no more so than times gone by. Consider the virtual caste system declaimed by Aristotle, the rampant corruption of the late Roman Empire, the blood and guts of the Middle Ages, not to mention the exploitation of colonialism in more recent times.

If you'd like to see a wonderful example of how the ethical dilemmas of ancient times apply even today, take a look at this very pithy essay on honest business dealings. Here you will find a journal article by Randy Richards of St. Ambrose University titled "Cicero and the Ethics of Honest Business Dealings." (www.stthom.edu/cbes/oje/articles/richards.html) It tells about how Cicero came to write his treatise *On Duties*, in which he addresses what we ought to do when what is right and ethical conflicts with what seems advantageous.

Cicero sent his son off to school in Athens, where Junior proved to be a less-than-stellar pupil. Word got back to Rome about excessive partying and lack of attention to scholarship, and Dad was inspired to write a long letter to his offspring on the subject of doing one's duty. Cicero's examples of problems in doing one's duty, as described by the article's author, are as contemporary as any of the business ethics cases you read about in your daily newspaper. Manipulating earnings and stock values à la Enron and Andersen! Covering up a defect in a product or property à la Firestone! Same race, different rats!

So keep the faith and remain hopeful. Mankind has been struggling with ethical challenges fairly successfully for the two millennia since that wise old Roman fired off a letter to his kid. And as long as the struggle to do the right thing continues, civilization will continue to improve – despite our temporary epidemic of sex, lies and media hype.

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