CHAPTER 1

The role of financial management

CHAPTER ORIENTATION

The financial manager has a major voice in all aspects of both the raising and allocation of financial capital. This chapter surveys the role of financial management and, in particular, presents a set of ten principles that are recurring themes in financial management and successive chapters of this book.

CHAPTER OUTLINE

1. What is financial management?

This question is answered by portraying financial management as the quest to make financial decisions that create wealth for the firm's owners or shareholders.

(Subsequent sections of the chapter expand on this by outlining 'ten principles' or common themes that recur in financial management, and the chapter's final section lists the successive parts and chapters of the book.)

Why study financial management?

Even those not planning a career in financial management can benefit from including financial management in their studies. Accountants, managers, marketing practitioners and entrepreneurs can all benefit from studying finance. An understanding of financial management can also be valuable for the individual in managing personal finances.

2. Three types of business organisation

NOTE TO THE INSTRUCTOR: Some of the following points go further than the textbook.

Sole proprietorships are characterised as businesses owned by single persons.

(i) This form of business structure has the following advantages:

- easily formed without requiring extensive or expensive legal work to be undertaken
- minimal reporting requirements
- profits do not need to be shared.

(ii) Disadvantages of sole proprietorships include:

- unlimited liability for owner
- losses must be absorbed by the owner personally
- equity capital limited by owner's resources
- termination of business upon death of owner.

Partnerships represent an association of two or more persons carrying on business in common with a view to profit.

(i) This form of business structure has the following advantages:

- minimal organisational requirements however a formal partnership agreement may be desirable
- owners can share individual expertise for mutual benefit.

(ii) Disadvantages of partnerships include:

- each partner is jointly and severally liable for all liabilities incurred by the partnership
- partnership immediately terminated upon death or withdrawal of any partner
- an individual partner's efforts may not always be rewarded by a commensurate share of partnership profits.

The company (or corporation) represents a separate legal entity, separate from its owners, having the power to purchase, sell and own assets and to incur liabilities in its own right.

(i) Advantages of a corporate entity include:

- ownership is formally evidenced by the issue of shares
- owners' liability to the company is generally limited to their investment in the company
- owners can transfer all or part of their ownership in the company by the sale of shares
- perpetual succession is possible for the company, as the death of a shareholder does not affect the existence of the company
- possible to raise capital from the public via a share issue.

(ii) Disadvantages of the company form of business structure include:

- companies must be formally established and registered with statutory bodies such as the ASIC
- relatively expensive to establish and administer on a continuing basis
- may be difficult to maintain control of a company's business affairs arising from the presence of other shareholders.

When comparing organisational forms, the company is the superior legal vehicle for raising funds, largely as a consequence of the shareholders having limited liability. Therefore, the company tends to be the form of legal ownership adopted by larger businesses.

3. The goal of the financial manager

Figure 1.1 contrasts the treasury role in finance with the financial controller's role. Figure 1.2 then portrays the firm's financial manager or CFO (chief financial officer) as an intermediary between the firm and the financial markets. Put simply, the firm raises funds by issuing securities in the financial markets.

These funds are invested in the projects or activities of the firm, and the returns on the investments may be used in three main ways: (i) returning funds to the investors (such as dividends or interest payments), (ii) paying taxes and (iii) retaining profits in the business.

4. Ten principles that form the basis for financial management

In subsequent chapters, the text returns time and again to a set of ten principles that recur in financial management and that act as a unifying theme to bind together the various threads or topics in the book.

This chapter provides introductory and simplified examples of these principles, while subsequent chapters build further on the principles in a wide range of different topics.

Principle 1: *The risk–return trade-off* – we won't take on additional risk unless we expect to be compensated with additional return.

Principle 2: *The time value of money* – a dollar received today is worth more than a dollar received in the future.

Principle 3: *Cash – not profits – is king*.

Principle 4: *Incremental cash flows* – it's only what changes that counts.

Principle 5: *The curse of competitive markets* – why it's hard to find exceptionally profitable projects.

Principle 6: *Efficient capital markets* – the markets are quick and the prices are right.

Principle 7: *The agency problem* – managers won't work for owners unless it's in their best interest.

Principle 8: *Taxes bias business decisions.*

Principle 9: *All risk is not equal* – some risk can be diversified away, and some cannot.

Principle 10: Ethical behaviour is doing the right thing, and ethical dilemmas are everywhere in finance.

5. Financial management and the new multinational firm

Globalisation of business means that just about all businesses have some international dimension. This includes not only the traditional areas of export/import and foreign investment, but it also increasingly includes the 'outsourcing' of goods and services to overseas producers. Financing, too, is made more complex by the firm raising and investing funds in foreign markets and currencies. Most of the later chapters in the book include material that illustrates international aspects of the relevant topics.

6. Global Financial Crisis (GFC)

This recent crisis is acknowledged as the most significant worldwide economic catastrophe since the Great Depression of 1929. Chapter 1 briefly discusses the causes, immediate effects and ongoing ramifications of the crisis. Many chapters of the textbook include snapshots of the GFC, which provide further support for the *10 principles of finance* which were introduced as a unifying theme for the book.

7. Overview of the book

The book is divided into six main parts as outlined in the table of contents.

Part 1 is aimed at providing background knowledge and skills that are used throughout the book, including knowledge of the tax environment (Chapter 2), Australian financial markets (Chapter 3) and developing skills in using financial mathematics (Chapter 4).

Subsequently, Parts 2 to 5 present a sequence of topics dealing in turn with financial planning and analysis and the management of working capital; valuation and management of long-term investments; financial structure and dividend policy; and long-term financing. Part 6 covers special topics in finance: international business finance; corporate risk management; and mergers and acquisitions.

SOLUTIONS TO REVIEW QUESTIONS

1-1 What long-term investments should the firm undertake?

The starting point for financial decision making involves identifying investments that will increase the value of the firm and therefore the wealth of shareholders. Companies typically have a range of possible investments to choose from and use *capital budgeting* to choose between them. In the case of Apple, the company perceived that there would be sufficient demand for a new tablet computer – the iPad. This decision involved projecting future cash flows from sales and performing a cost-benefit analysis to determine whether the project would increase the value of the company.

How should the firm raise money to fund those investments?

Companies usually have a range of options in terms of raising capital. These include borrowing money from banks, issuing debt securities and issuing shares. The development and production of a major new product such as the iPad requires significant up-front investment, and Apple used a variety of sources to raise the necessary capital.

How can the firm best manage its cash flows as they arise in its day-to-day operations?

Once the product was launched, there would have been significant cash inflows from sales, along with continuing outflows of cash from ongoing development and marketing expenses. Working-capital management involves making sure there is sufficient cash and inventory for day-to-day operations, and projecting and managing cash flows so that obligations can be met in a timely fashion and surplus cash is invested productively.

1-2 The main advantages of a company as the dominant form of business organisation are limited liability of owners, and division of ownership into shares, allowing ease of transfer of ownership. These advantages have enabled companies to pool the funds of large numbers of individual investors. Companies are more easily able to raise additional funding from external investors (or lenders) in the capital markets.

1-3 The goal of the financial manager is to maximise shareholder wealth by maximising the value of ordinary shares. The market value of the firm's shares reflects the value of the firm as seen by its owners. The shareholders are the legal owners of the firm and the financial manager is engaged as their agent to manage the firm's finances in their interest. Maximising share price and hence shareholder wealth is not only in their interest, but also provides the most productive use of society's resources.

One of the difficulties of achieving this goal is that share prices frequently fluctuate, and often for no apparent reason. The solution is to make financial decisions which should, all else being equal and in the long run, maximise share price.

Another difficulty is the 'agency' problem, whereby managers sometimes have a conflict of interest. Sometimes financial decisions might benefit the manager and not shareholders. An example is focusing on short-term profit at the expense of long-term value. One way to combat this problem is by designing remuneration packages for managers which tend to align their interests with those of shareholders, such as bonuses based on long-term share price.

1-4 Almost any financial decision that involves cash flows at different points in time implicitly involves the time value of money. Making an investment such as buying shares, purchasing a major asset such as a house or a car, or deciding to spend money on a university education involves a short-term cash outflow that will hopefully result in future cash inflows. The concept of the time value of money requires us to compare the value of the cash inflows with the value of the outflows, and because the cash flows occur at different points in time, adjustments need to be made for the time value of money in order to make a valid comparison.

1-5 Principle 1 suggests that you should only invest money in a risky investment if the *expected* return on the investment is greater than for a less risky investment. The amount of additional expected return should be proportional to the extra risk being taken on.

1-6 Principle 4 suggests the costs and benefits of any financial decision must be weighed up in terms of incremental cash flows. The decision to reduce your working hours has cost $10,000 per annum. The value of the decision is based on the *extra* cash flow that will be received in the future as a result of enhanced career and job promotion prospects. The decision will be a good one in financial terms if those extra cash flows exceed $10,000 per year.

1-7 Companies can improve their competitive position through:

Product differentiation: Differentiating your products from those of competitors enables you to charge a premium, because customers no longer base their decisions on price alone. This can be done through quality and service, advertising, patents or product innovation.

Creating a cost advantage: This can be achieved through economies of scale, experience or location advantage, among others. If you can produce at a lower cost than your competitors, you can maintain a competitive advantage.

1-8 Globalisation has resulted in opportunities and challenges. Businesses are more easily able to source labour and materials internationally, often resulting in cost savings. But it also means that businesses in many different industries are faced with low-cost competitors.

1-9 The answer to this question will vary from person to person. Increasing unemployment because of reduced economic growth in Australia (and a recession in most countries) can affect individuals and families when jobs are lost. Many investors in some financial products have lost their investments but, more broadly, anyone with direct share investments or retirement savings which include investments in shares has seen a reduction in the value of their investments. Those close to retirement may see a significant reduction in their standard of living post-retirement because of the reduction in the value of their investments.

SOLUTION TO CASE STUDY

1. A minerals company would be involved in mining projects and the extraction of minerals from ore. This necessarily entails a range of activities, such as exploration and transport of ore and/or processed minerals.

2. Part of this will entail the evaluation of investment projects. This involves projecting future cash flows and using time-value-of-money techniques to value those cash flows and determine whether a project is value enhancing, or to choose between alternative projects. Once investment projects have been selected, other activities will relate to financing those projects, such as through borrowing and the issue of shares. Finally, working-capital management involves the management of cash flows over the life of a project to ensure that the company can meet its obligations and maximise the return on invested capital.

3. All financial decisions should be based on maximising the value of the firm. This is measured by market price of the firm's shares, thus ensuring that maximisation of share price is equivalent to maximising the wealth of shareholders.

4. The firm also has legal, moral and ethical responsibilities to a range of stakeholders, including employees, customers, suppliers, government authorities and the wider community. First and foremost, it must meet its legal obligations, such as Occupational Health and Safety requirements and environmental regulations. Beyond minimum legal requirements, the objective should be to meet moral and ethical requirements (e.g. fair treatment of employees, customers and suppliers, and acting in a way that is not detrimental to the wider community). This is not necessarily inconsistent with long-term profitability and company value. Moral and ethical treatment of employees, customers, suppliers and the community will hopefully result in satisfied and loyal employees, customers and suppliers and favourable regard with the community, and this will generally translate into long-term economic benefits.

SOLUTIONS TO CONCEPT CHECK QUESTIONS

1.1 A sole proprietorship is a business owned by a single individual. The owner maintains title to the assets and is personally responsible, generally without limitation, for the debts incurred and has entitlement to the profits but must also absorb any losses.

A partnership is an association between two or more persons carrying on a business in common for profit. In a partnership each partner is jointly and severally responsible for the liabilities of the partnership, and share profits proportionately in accordance with capital invested by each partner or by other agreement.

The legal concept of a company is that it is an entity that legally functions separately and apart from owners. The company once incorporated has the same rights and responsibilities as a natural person.

1.2 Large and growing firms tend to choose the company form of legal organisation because of limited liability to shareholders, flexibility and the avenues of raising capital that are not available to other legal forms.

1.3 The duties of the Treasurer include handling the firm's financial activities, cash and credit management, making capital expenditure decisions, raising funds, financial planning and managing any foreign currency. The duties of the Financial Controller include managing the firm's accounting duties, preparation of financial statements, cost accounting, paying taxes, and gathering and monitoring the data necessary to oversee the firm's financial well-being.

1.4 Investors demand a minimum return that must be greater than the anticipated rate of inflation, and the return must be commensurate with the risk of the investment.

1.5 As mentioned in Principle 5, in reality it is much easier doing the number crunching than actually finding good investment opportunities. If an industry is generating large profits, new entrants are usually attracted. If an industry is generating low profits, some participants in the market drop out, reducing capacity and competition.

1.6 As mentioned in Principle 10, ethical behaviour is relevant because unethical behaviour eliminates trust and a business can lose the public's confidence in its ethical standards. The ultimate problem for shareholders is that ethical errors are not forgiven in the business world.

1.7 All of this has taken place at a time when information technology has experienced a revolution brought on by the personal computer (PC) and communications have been liberated by the World Wide Web and email. Other reasons are the deregulation of local markets and industries and mobility of capital.

1.8 Complexities and risks of operating internationally include sourcing raw materials, supplies, components, international customers, outsourcing of operations, and raising and investing funds in foreign markets and currencies.