Unit 1 Introduction to Financial Management

<u>Goals of Firm:</u>

QN1 What is Firm value or equity holders' wealth maximization? Discuss the factors affecting the firm's stock price in the market?

Maximizing wealth means maximizing the purchasing power. The way in which an enterprise enables its owners to indulge in the pleasure of purchasing and consumption is by paying them in dividend or by positive change in stock price in the market.

Firm value or wealth is defined as the net present value or present worth of the firm. Wealth maximization means maximizing the net present value of course of actions. Net present value is difference between the present value of firm's benefits and costs. Net present value may be expressed as:

$$NPV = \frac{CF_1}{(1+k)^1} + \frac{CF_2}{(1+k)^2} + \ldots + \frac{CF_n}{(1+k)^n} - NCO$$

Where, CF_n=Expected Cash flow generated by firm's actions for n^{th} year, K= discount factor, NCO= Present value of cost.

To maximize value of firm, a financial action resulting in positive NPV should be accepted and negative NPV should be rejected. This objective appropriate for managerial decision; considers the risk and timing associated with expected earnings per share in order to maximize the price of stock in the market.

Shareholders market value of wealth maximization means the maximizing market price per share (MPS). It is broadly affected by two aspects:

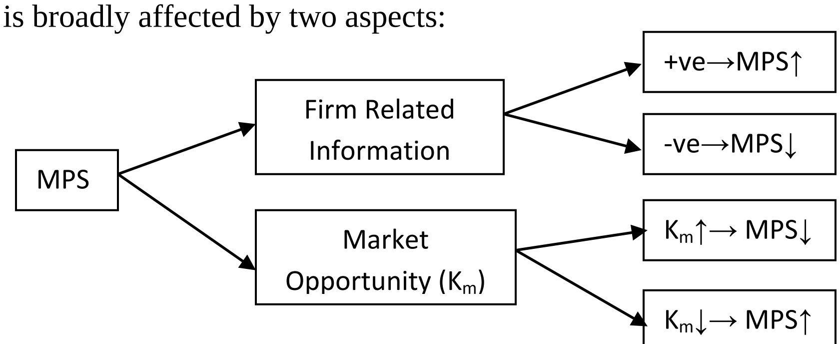


Fig: Factors Affecting MPS.

Positive firm related information regarding future earnings and dividend goes in the market increase the demand of firm's stock and thus increases the stock price and vice-versa. Firm related information that affects the stock prices are:

i) **Projected earnings per shares**: Higher the expected EPS increases the stock price and vice-versa.

ii) **Timing of realization of earnings:** Earlier the realization of earning higher will be the stock price.

iii) **Riskiness of realization of earnings**: Higher fluctuation on earnings creates the higher risk and lowered the value of stock. Consistency on earnings creates the lower risk and increases the value of stock.

iv) **Amount of debt used:** Higher amount of debt in firm increases risk of firm and lower the value of stock. But low rate debt with higher rate opportunity inside firm increases the price of stock.

v) **Dividend policy:** is decision regard to distribution or retention of earnings to shareholders. Retention for reinvestment on projects having greater return than market opportunity increases the value of stock and vice-versa.

Market opportunity is market interest rate which is determined by demand and supply of capital in the market. An increase in interest rate means to be lower supply of capital in the market and thus decreases the demand of capital instruments like stock, bond that decreases the firm's stock price and vice-versa.

QN2 What is profit maximization? What are the arguments in favor of, and shortcoming of it?

Profit maximization simply means the maximizing the income of the firm. Traditionally, a business firm is regarded as an economic entity whose fundamental objective is the maximizing of profit. Profit can be maximized by maximizing the different between total revenue and cost of firm. A firm earning sound profit is considered that it is achieving its goal.

Arguments in favor of profit maximization:

a. **Understandable:** It is simple and straightforward.
b. **Decision Criteria**: Decision inside firm is taken on the basis of whether firm is having positive difference between revenue and cost.
c. **Incentives to work:** Profit is considered as incentives to work. Some corporations are practicing gain sharing between manager, staffs and shareholders on the basis of profit.
d. **Measurement of efficiency:** Firm is earning profit means; it has managed its input resources efficiently, so that goods or services produced by it are low cost or qualitative in compare to its competitors.

Shortcomings of goal of profit maximization:

a. **Vague and ambiguous**: Profit maximization conveys different meaning to different people. Profit may be long-term or short-term, after tax or before tax, rate of return on capital employed or assets or equity. Which profit is to be maximized is not clear.
b. **Ignore the time value of money:** It ignores the timing of earning. Earlier realization is greater valuable than later realization of earnings.

c. **Ignore the risk elements:** It ignores the consistency of earning pattern. Fluctuation on firm earning creates more risk. It assumes same sizes of profits with different size of risks are equal.

d. **Incomplete**: Due to the ignoring of time value of money and risk this objective is incomplete.

QN3 What are the differences between Profit maximization and Firm Value maximization of goal of firm?

The difference between the stock price maximization and profit maximization are:

Profit maximization		**Wealth maximization**	
1	Profit maximization represents large amount of profits.	1	Wealth maximization represents highest market value of common stock.
2	Easy to determine the link between financial decisions and profits.	2	Offers no clear relationship between financial decision and stock price.
3	Emphasis on short term.	3	Emphasis on long term.
4	Ignores risk or uncertainty.	4	Recognizes risk or uncertainty.
5	Ignores the timing of returns.	5	Recognizes the timing of returns.
6	Does not consider stockholders' return.	6	Considers stockholders' return.
7	Quantitative.	7	Qualitative.
8	Is not concerned with the welfare of investors, creditors, government, society etc.	8	Is concerned with the welfare of investors, creditors, government, society etc.

QN4 Which goal would you like to recommend to a firm stock price maximization or profit maximization? Discuss.

There are two goals of the firm: stock price maximization and profit maximization. Stock price maximization is recommended due to the following reasons:

Reasons for recommendations:

1. **The meaning of stock price maximization is clear stock price or wealth:** maximization means the maximizing the net present value of a course of action. The net present value of a course of action is the difference between the present value of its benefits and the present value of costs. A financial action resulting in positive net present value should be accepted and negative present value should be rejected. If net present value maximize, then wealth will be maximized and then stock price.
2. **It considers time value of money:** maximizing value takes the time value of money into account. For example, if we could choose between the following two alternatives, we might be indifferent if our emphasis were solely on maximizing earnings.

	Earnings per share		
	Period one	Period two	Total
Alternative A	Rs. 2	Rs. 4	Rs. 6
Alternative B	Rs. 5	Rs. 1	Rs.6

Both investments would provide Rs. 6 in total earnings, but Alternative B is clearly superior because the larger benefits occur earlier. We could reinvest the difference in earnings for Alternative B one period sooner.

3. **It considers the risk element:** Funds that are received this year have more value than funds that may be received five years from now. It considers the riskiness of the income stream. For example, the rate of return required on riskless government securities would be lower than rate of return required on an investment in starting a new business. The quality and timing of expected future cash flow may vary.

<u>Finance and its Functions:</u>

QN5 What is Financial Management? What are the functions of Finance or Corporate Finance Manager?

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. (*Van Horne*)

Most financial management decisions will involve choices risk return trade off. One must be able to weigh these tradeoffs and obtain an acceptable return while, at the same time, protecting the firms' assets from unnecessary risks.

In a summary a primary goal of financial management is to determine:

1. What investments to make;
2. How to finance the investments; and
3. How to manage existing resources in a way that will accomplish the given financial objectives.

The functions of financial management can be studied as:

1. Executive Finance Functions

Executive Finance Functions are functions that require administrative skills in their planning, execution and control. The basic executive finance functions are as under:

- **Investment decision**

Investment decisions most commonly known as capital budgeting decision or long-term assets mix decisions. Capital investment is the allocation of capital to investment proposal whose benefits are to be realized in future. Because the future benefits are not known with certainty, investment proposal necessarily involves risk. The essence of investment decisions is that return from the investment in proposals would exceed the firms required rate of return on capital.

- **Financing decision**

Financial manager must decide when, where and how to acquire funds to meet the firm's investment needs. He must to find the best financing mix or optimum capital structure for his firm, which maximizes the market value of share.

- **Dividend decision**

The financial manager must decide whether the firm should distribute all profits, retain them, or distribute a portion and retain the balance. The financial manager must determine the optimum dividend payout ratio, which maximizes the firm's value.

- **Working capital decision (Liquidity decision)**

Current assets should be managed efficiently for safeguarding the firm against the dangers of illiquidity and insolvency. Therefore the financial manager estimate firm's needs for current assets and make sure that funds would be made available when needed.

2. Incidental/Routine Finance Functions

Clerical types of routine work, which are carried out by junior employees under finance department and which are of regular nature are known as incidental finance functions. Such functions are listed as follows:

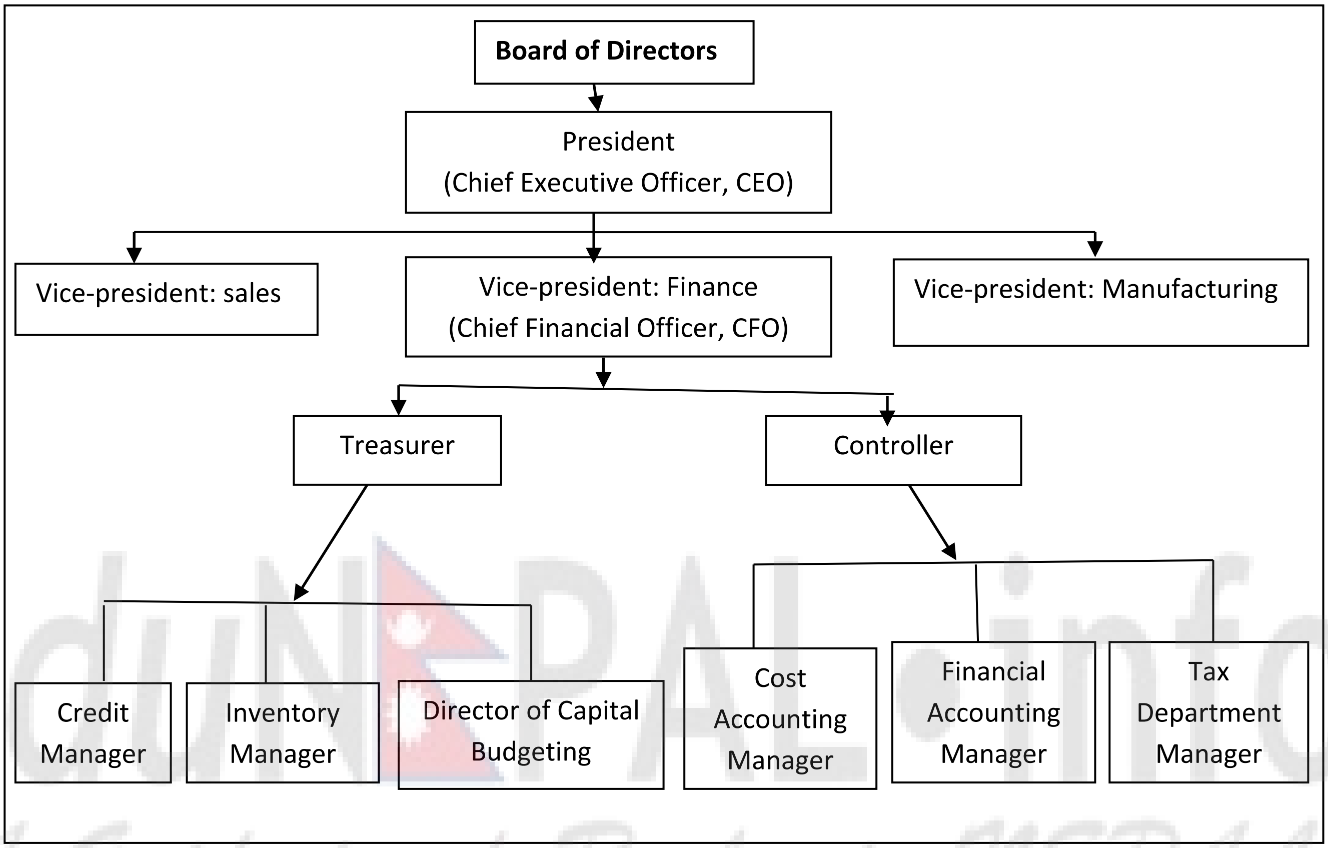
- Supervision of cash receipt and disbursements and the safeguarding of cash balance.
- Custody and safeguarding of securities, insurance policies and other valuable documents.
- Taking care of the mechanical details of financing
- Record keeping and reporting.
- Supervision of fixed and current assets.

<u>Corporate Structure and Finance Department:</u>

QN6 Explain the organization of finance functions with the help of chart.

Shareholders elect board members. The president or chief executive officer (CEO) is also board member, who is highest executive in a corporation. He has number of executives as departmental head. Finance functions typically evolve into separate department linked directly to the CEO through a vice president of finance or chief financial officer (CFO). The lower portion of the organizational chart in the figure below showed the structure of the finance function in a typical medium to large size firm.

Fig: Organizations of finance function



CFO and his team are primarily responsible for strategic issues of finance department like financing decision, investing decision, dividend decision with the coordination of CEO and other functional department. Reporting to the CFO are the treasurer and controller.

Treasurer

The important functions of a treasurer are as follows:

- Financial planning and fund raising
- Making capital structure decisions
- Managing cash and marketable securities
- Managing credit activities
- Managing the pension funds
- Managing foreign exchange

- Short term financing
- Establish relationship with bank and investors

Controller

The important functions of controller are as follows:

- Cost and management accounting
- Tax management and Auditing
- Budgeting, planning, and control
- Financial accounting
- Reporting and interpreting
- Protecting the assets
- Economic appraisal and evaluation
- Reporting to government

Agency Theory:

QN7 What is agency problem? What are the issues in conflict of interest between stockholders and corporate managers? How can they be resolved?

An agency problem is a potential conflict of interests between agent and principal. An agent is a person who acts for and exerts powers of another person or group of persons called principal. In corporate finance, Agency problem or relationship may be defined as a potential conflict of interests between manager and stockholders or the creditors.

Stockholders and Managers

The stockholders as principal hire managers as agents to run the corporation in the stockholders' best interests meaning the maximization of the value of the firm. The agency problem is arises when:

- Managers can option to increase their salaries and perquisites, rather than increase shareholder dividends.
- Managers may engage in empire building by using corporate cash flow to make acquisitions that increase the size of the enterprise in order to enhance their own prestige without commensurately enhancing earnings.
- Managers might use corporate funds to contribute to their favorite charities or political parties to enhance their own reputations at the expense of maximizing shareholder wealth.
- Managers might employ various measures to insulate themselves from investors who are dissatisfied with their performance by recommending persons that are friendly to them for positions on the board of directors.

Mechanisms used to motivate managers to act in share holders' best interest

The best way to minimize the principal agent conflict and encourage managers to act in the best interests of investors is through a properly designed incentive system that rewards good managerial stewardship and punishes performance that does not help optimize investor wealth.

1. Management compensation:

- Basic salary: Under basic salary, annual salary, allowances etc are provided on the basis of qualification and experience.
- Bonus: Bonus can be provided on the basis of performance.
- Executive stock option: It is an option to buy stock at a stated price within a specified time period that is granted to an executive as part of his/her compensation package.
- Performance shares: Performance shares are the stock that is awarded to executives on the basis of the company's performances.

2. Direct intervention by shareholders:

Shareholders can directly intervene in cases where management is underperforming. Institutional investors often have enough knowledge to provide reasonable oversight of managerial actions and decision making processes.

3. The threat of firing:

Management can be ousted and replaced by the new people by the shareholders at the annual general meeting of the firm, if he/she does not work to fulfill the basic objective of the firm.

4. The threat of takeover:

The market prices of the corporation's securities will tend to lag behind the securities prices of rival firms. Takeover specialists may see an opportunity to take control of an underperforming company by offering a premium price for existing shares, replacing the management, changing the way the company is being operated, and increasing the firm's value. This will force the mangers to act for maximizing the stock price.

QN8 What types of agency problem can be seen between stockholders and debt holders inside corporation?

Creditors or debt holders have a claim on part of the company's earnings for the payment of interest and principal on the debt, and they have a claim on the firm's assets in the event of bankruptcy. However, stockholders have control of decisions that affect the riskiness of the firm. Now suppose the stockholders want to take on new ventures that have much greater risk than was anticipated by the creditors. The increased risk will cause the value of the outstanding debts to fall. If the risky ventures turn out to be successful, all of the benefits will go to the stockholders because the creditors only get a fixed return. However, if the venture is unsuccessful, the bondholders will have to share the losses.

Similarly, if the firm increases its use of debt in an effort to boost the return to stockholders, the value of the old debt will decrease, so this will have again “heads I win, tails u lose” situation.

Mechanism to resolve the conflict of Interest between Shareholders and Creditors:

1. **Compensate creditors for increased risk:** If the creditors knew that stockholders are trying to take advantages of them, they may refuse to deal further with firm or they will charge high rate of interest to compensate the increased risk.

2. **Protective terms and conditions for creditors:** Creditors may put restrictions on repurchase of share, restructure of existing capital structure, dividend payment etc. while providing loan to the firm.