FINANCIAL MANAGEMENT

LECTURE 2

AN INTRODUCTION

- Financial management provides a set of principles and tools that help managers accumulate and allocate *capital* in a firm.
- A firm's capital is the *money* the firm needs to carry out its full set of business operations.
- The objective that governs financial management decisions is that of *economic value creation*.
- For any business decision, value is created when *the total value of the benefits accrued exceeds the total value of the resources expended*.

ISN'T FINANCIAL MANAGEMENT ONLY HELPFUL TO THOSE WHO INTERACT REGULARLY WITH INVESTORS AND FINANCIAL MARKETS?

- Investors are the most critical stakeholders.
- Investors have ultimate say on all business policy, including the appointment of business management.
- Business managers interact directly or indirectly with investors and financial markets.
- Managers that fail to please their investors, regardless of how well they please other stakeholders, will at some point be removed.
- Financial management provides that investor perspective and shows the role of *value mindedness*.

ISN'T FINANCIAL MANAGEMENT ONLY HELPFUL TO THOSE WHO INTERACT REGULARLY WITH INVESTORS AND FINANCIAL MARKETS?

- Value creation is important to managers not only they want to please investors but also, if they are interested in prudent decision-making.
- For example, strong *cash flow* is vital to the health of any business and financial management helps managers measure and maintain that lifeblood.
- Financial management helps managers understand the sources of value in their business and how to tradeoff inherent business risk.
- Financial management helps managers scrutinize a business proposal and improve decision making.
- A business manager who appreciates the value creation process makes a better manager than on who cannot.
- A strong background in financial management is highly relevant and broadly applicable to business professionals in all sorts of decision-making roles.

ISN'T FINANCIAL MANAGEMENT MOSTLY A NUMBER-CRUNCHING EXERCISE? IF YOU DO THE RIGHT CALCULATIONS, YOU GET THE RIGHT ANSWER.

- Real-world business decisions tend *not* to be straight forward, therefore, the accurate goal of financial management is not to give the *right* answer, rather it is to help managers build the business judgment they need to approach highly nuanced decisions.
- Financial management gives managers the tools that add *rigor* to their judgment.
- It helps managers understand the perspectives and needs of business investors.
- Because of the ambiguity embedded in real-world business problems, there are a lots of right answers, as well as lots of wrong answers. Financial management helps managers distinguish between the two.

ARE BUSINESS MANAGERS ONLY FOOLING THEMSELVES WHEN THEY USE *FINANCIAL FORECASTS* TO MAKE BUSINESS DECISIONS? NOBODY KNOWS THE FUTURE.

- The world is too uncertain to forecast the details of the future with any precision.
- Business managers use financial forecasts to gain important insights into understanding the key bets in any business decision.
- Use of financial forecasts helps the managers understand the interrelationships and drivers of their business economics.
- The process of disciplined forecasting is highly valuable to business managers who constantly make important decisions in a highly uncertain environment.

MANAGERS CAN GET PARALYZED BY THEIR FEARS OF RISK. AREN'T BUSINESS MANAGERS BEST SERVED BY IGNORING THE DOWNSIDE AND FOCUSING ON BUILDING ON GOOD BUSINESS?

- To build businesses, managers make bets (take risks) all the time and their success depends on the outcomes of these bets (risks taken).
- Because of the pervasiveness and impact on business outcomes, the consideration of business risk is naturally of primary concern to business managers.
- Betting helps managers learn about risk, how to measure and think about it.
- Managers understand that some types of risk matter and others don't.
- Through confronting business risk with a full set of tools, managers are better able to think about risk in a healthy way.

DOES THE UP-AND-DOWN DRAMA OF FINANCIAL MARKETS REALLY AFFECT MOST BUSINESS MANAGERS? FINANCIAL MARKETS SEEM LIKE AN IRRELEVANT SIDESHOW TO THE REAL BUSINESS WORLD.

- Managers pay attention to financial markets because these markets generate lots of information that is highly valuable to managers.
- Investors make big money decisions, because of the magnitude of the money at stake, investors pour tons of analysis into these bets.
- If the price of a financial security becomes a little high or a little low, investors swoop in to compete away any such mispricing.
- The concept of information content of market prices is called *market efficiency*.
- Because of the competitive forces to maintain financial market efficiency, financial markets provide an array of highly scrutinized information that is readily available for managers in making business decisions.

ISN'T BUSINESS GROWTH ALWAYS GOOD?

- Financial management claims that some growth creates value and merits funding while some growth destroys value and weakens the business by draining the resources of the company.
- Such *bad growth* can happen with actions that require too much investment or generate returns that don't compensate the company for the risk being taken.
- Financial management assigns different values for money across time, in the receiving money sooner is worth more than receiving money later and that the precise difference in value depends on relevant rates of returns.
- Through all these principles, financial management helps managers distinguish good growth from bad growth.

CAN BUSINESS MANAGERS BENEFIT THEIR BUSINESSES BY FOOLING THEIR INVESTORS?

- Business is filled plenty of smoke-and-mirror activities, features that may dazzle but are void of any true value.
- Principles of financial management provide frameworks for seeing through the smoke-and-mirrors activities and isolating those activities that are truly meaningful.
- A message of financial management is that investors only pay for activities that create real value.
- This message is particularly relevant in financial policy decisions such as appropriate level of borrowing, the appropriate level of cash and the appropriate level of dividends.