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Chapter 1 – The Financial Manager and the Company

The Role of the Financial Manager

The financial manager is responsible for making decisions that are in the best interests of the business's owners – decisions that maximize the value of the owner's shares

Stakeholders

- A *stakeholder* is someone other than an owner who has a claim on the cash flows of a company, including employees, suppliers, creditors and the government
- Stakeholders may have interests that differ from those of the owners and may exert pressure on management to make decisions that benefit them

It's all about cash flows

- *Productive assets* can be tangible assets, such as equipment, machinery or manufacturing facility, or intangible assets, such as patents, trademarks, technical expertise or other types of intellectual capital
- The decision-making process through which the company purchases long-term productive assets is called *capital budgeting*, and it is one of the most important decision processes in a company
- A firm generates cash flows by selling the goods and services produced by its productive assets and human capital
- A company is successful when the cash inflows exceed the cash outflows needed to pay operating expenses, creditors and tax.
- The firm can pay the remaining cash, called *residual cash flows*, to the owners as a cash dividend, or reinvest the cash in the business
- A company is unprofitable when it fails to generate sufficient cash flows – firms that are unprofitable over time will be forced into bankruptcy by their creditors
- In bankruptcy, the company will either be reorganized, or the company's assets will be liquidated

Three fundamental decisions in financial management

- *Capital budgeting decisions:* identifying the productive assets the company should buy
    - Financial managers should invest in a capital project only if the value of its future cash flows exceeds the cost of the project (benefits > cost) – such investments increase the value of the company and thus increase shareholder's wealth
- *Financing decisions:* determining how the company should finance or pay for assets
    - How a company is financed with debt and equity affects the value of the company
    - A major advantage of debt financing is debt payments are tax deductible for many companies. However, debt financing increases a company's risk because it creates a contractual obligation to make periodic payments and, at maturity, to repay the amount that is borrowed

    - Equity has no maturity, and there are no guaranteed payments to equity investors.
    - *Capital structure* is the mix of debt and equity that is used to finance a company
    - *Capital markets* are financial markets where equity and debt instruments with maturities greater than 1 year are traded.
- *Working capital management decisions:* determining how day-to-day financial matters should be managed so that the company can pay its bills, and how surplus cash should be invested
    - Management must decide how to manage the company's current assets, such as cash, inventory and accounts receivable, and its current liabilities, such as trade credit and accounts payable.
    - *Net working capital* is the dollar difference between current assets and current liabilities
    - The mismanagement of working capital can cause a company to default on its debt and become insolvent even though, over the long term, the company may be profitable

Forms of Business Organisation

The owners of a business usually choose the organisational form that will help management to maximize the value of the company

Sole traders

- A *sole trader* is a business owned by a single individual
- It is the simplest type of business to start, and it is the least regulated
- Sole traders keep all the profits from the business and do not have to share decision-making authority
- All company income is taxed as personal income
- A sole trader has unlimited liability for all business debts and other obligations of the company
- The amount of equity capital that can be invested in the business is limited to the owner's personal wealth, which may restrict the possibilities for growth

Partnerships

- A *partnership* consists of two or more owners who have joined together legally to manage a business and share in its profits
- It is recommended that a formal partnership agreement is drawn up on the roles and authority of each partner
- Partnerships have access to more capital, and the pooling of knowledge, experience and skills
- The key drawbacks of partnership are possible disputes among the partners over profit sharing, administration and business development
- When a transfer of ownership takes place the partnership is terminated, and a new partnership is formed
- The problem of unlimited liability can be avoided in a limited partnership

Companies

- A *company* is an independent legal entity able to do business in its own right; in a legal sense, it is a ‘person’ distinct from its owners
- Companies can sue, be sued, enter into contracts, issue debt, borrow money and own assets
- The owners of a company are its shareholders
- All companies are registered with and regulated by the Australian Securities and Investments Commission (ASIC)
- A major advantage of a company form of business is that shareholders have limited liability
- A company can list on the stock exchange, such as Australian Securities Exchange (ASX), as a *public company* to attract investors.

Managing the Financial Function

A *chief financial officer (CFO)* is the most senior financial manager in a company and holds one of the top executive positions.

Organisation structure

- The top management position in the company is the *chief executive officer (CEO)*, who has the final decision-making authority among all the company’s executives.
    - Most important responsibilities are to set the strategic direction of the company and see that the management team executes the strategic plan.
    - Reports directly to the board of directors, which is accountable to the company’s shareholders
- *Chief financial officer (CFO)*
    - Reports directly to the CEO and focuses on managing all aspects of the company’s financial side, as well as working closely with the CEO on strategic issues
    - Interacts with other functional areas regularly because all senior executives are involved in financial decisions that affect the company and their areas of responsibility.

The Goal of the Company

What should management maximise?

- Minimising risk or maximising profits without regard to the other is not a successful strategy
- A goal that looks at a company’s cash flows and considers both their timing and their riskiness is a more successful measure; the market value of the company’s shares

Why not maximise profits?

- One problem with profit maximization is that it is hard to pin down what is meant by ‘profit’
- Under creative accounting, a decision that increases profits under one set of accounting rules can reduce it under another.