

Financial managers do not operate in a vacuum; they depend on long-term funds from the capital market, which acts as an intermediary for the allocation of investors' capital through debt and equity (see Figure 1.1). Investors may be individuals or institutions acting on their behalf. Again a financial manager needs to understand the functioning of the capital market and its participants to aid decision making. Finance comes from the capital market and is invested in the firm, which produces profit that may be returned to its capital providers in the market as distributions or retained within the firm for future investment. The ability to sustain and increase operating capability through a continual search for investment opportunities should then attract further investment, so that the company grows.

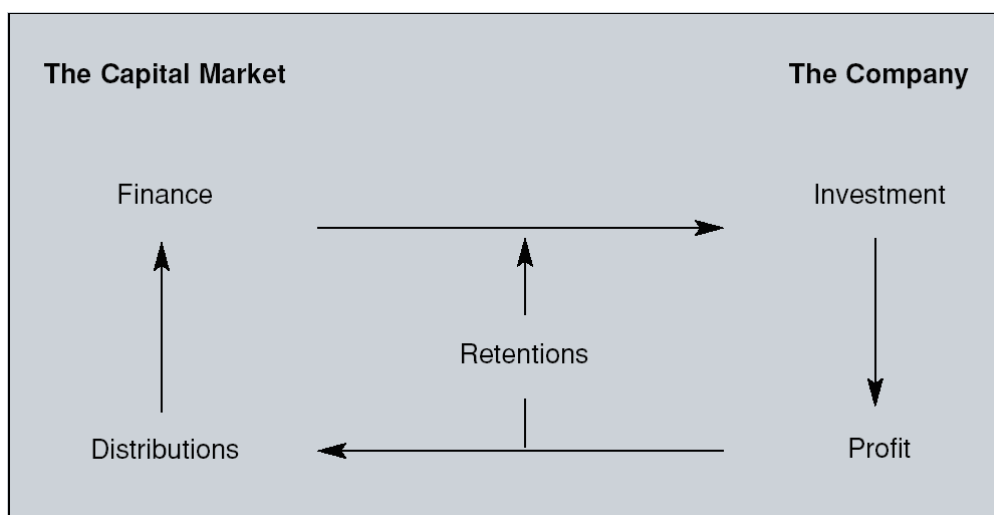


Figure 1.1: The capital market

Q ACTIVITY 1: QUESTION

From your previous accounting studies, identify the main functions of a capital market.

A ACTIVITY 1: ANSWER

Capital markets perform two functions: they balance the supply and demand of funds between organisations offering finance and those seeking finance; and they provide a forum where investors can buy or sell securities.

SHARE PRICE AND SHAREHOLDER WEALTH

The share price is obviously critical in the maximisation of shareholder wealth and in reflecting the company's value. We will put share price into context as the module develops. If the capital market regards the share price as an indicator of a company's financial health, the questions we must ask are:

With maximisation of shareholder wealth, what happens to other classes of investor, such as debenture holders, when the company is making financial returns? How does a financial manager protect the disparate interests of individual shareholders?

OBJECTIVES OF FINANCIAL MANAGEMENT

We develop the over-arching objective of financial management in terms of two distinct but related functions, summarised in Figure 1.2:

- **The investment function**, which identifies and selects investment opportunities that maximise profit.
- **The finance function**, which identifies potential fund sources required to sustain these investments, evaluates the return expected by each, then selects the optimum mix that minimises the overall cost of capital.

Financial managers operate at the interface between the capital markets that supply finance and the internal business operations that require finance. The task is to supply the right finance at the right cost at the right time, and to make judgements about the risk involved with all options. As such, financial managers need to understand the workings of the capital market, the behaviour of individual investors, the value of their own firm and all its individual current and potential projects. No small task! In this module, we start by looking at some ideal conditions and develop some simple models that give us a basis for dealing with the problems that financial managers encounter in the real world.

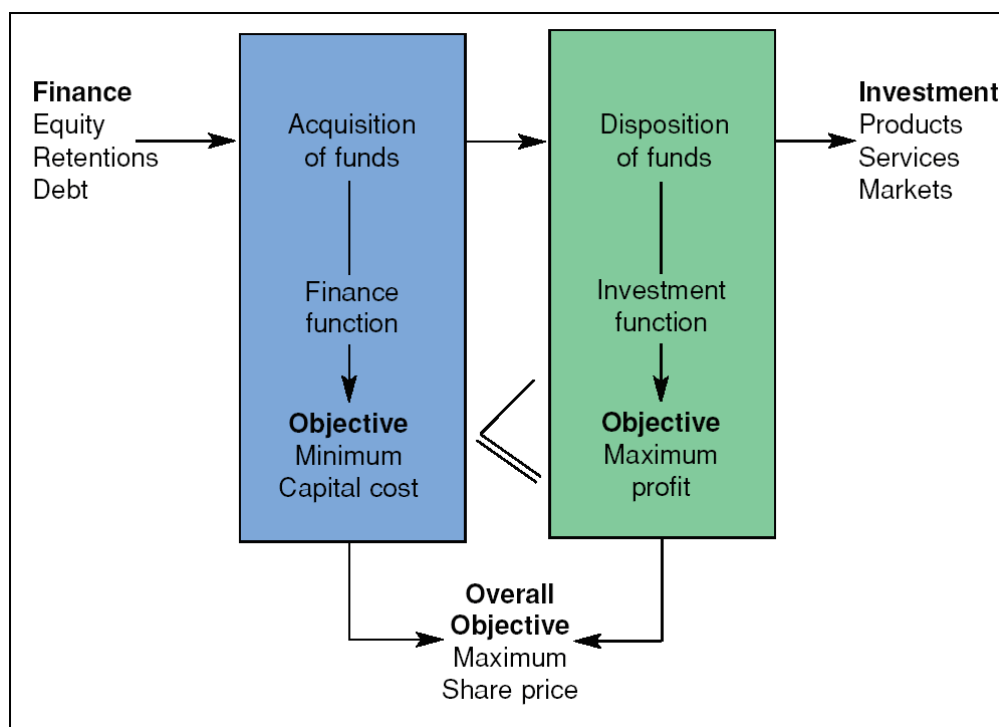


Figure 1.2: Objectives of financial management

In meeting the finance function, firms use a variety of long- and short-term funds. These may also have implicit or opportunity costs (what the money could have been used for instead) that need to be included in the cost of capital calculations.

We begin each unit with a theoretical look at a simple financial decision. We then move into the world of managerial practice. We try not to lose sight of the overall objective of financial management, so wherever possible we question even the most complex investment and financial strategies in terms of shareholder wealth, although we sometimes find we have no straightforward answers.

➤ Objectives

By the end of this course, you should be able to:

- Understand what contemporary finance theory can offer the key functions of modern financial management
- Understand how practising financial managers can combine theory and empirical research with informed judgement to make corporate investment and financial decisions for the mutual benefit of all parties.

➤ Outline of the Course

The contemporary role of financial management is best understood by following the historical development of financial theory. How key issues were addressed and whether or not the subject has changed over time can provide a financial manager with a different approach to traditional practices. The module is divided into four parts:

- Part I: The investment decision
- Part II: The dividend decision
- Part III: The finance decision
- Part IV: The portfolio decision.

PART I: THE INVESTMENT DECISION

We begin by looking at how individuals borrow and lend in a simple world of certainty and perfect markets, based on the work of Irving Fisher. We consider the capital budgeting decisions that a firm faces and how the financial manager evaluates proposed investment opportunities (Unit 1). We move from a world of certainty to one of uncertainty, where a company faces the risk of unexpected gains and losses. We examine various strategies for dealing with risk against our criterion of wealth maximisation. We discover which models work (for example, mean-variance analysis based on the concept of investor utility) and also those which management prefers to use.

Despite the divergence between theory and practice, we demonstrate that the correct approach to investment under conditions of uncertainty is the maximisation of the expected net present value (NPV) of all a company's capital projects (Unit 2). This is also consistent with our objective of shareholder wealth maximisation.

We can divide investment decisions into two broad categories: long term (strategic or tactical capital budgeting) and short term (operational working capital). We are concerned with short-term working capital management of assets and liabilities to maintain liquidity in Unit 3. Strategic decisions tend to be unique, involve significant capital expenditure and have uncertain future gains. Without sophisticated forecasts and without allowing for risk, penalties for error can be severe and can even lead to insolvency. Operational decisions tend to be repetitious and funds may be acquired piecemeal. Costs and returns are usually calculable from existing data, with any weaknesses in forecasting requirements relatively easily remedied. The decision itself may also be reversible without any significant losses. If resources are to be allocated efficiently and wealth is to be maximised, a financial manager should strive to minimise current assets and maximise current liabilities compatible with debt-paying ability, regardless of where the funds have come from.

PART II: THE DIVIDEND DECISION

The selection of any investment opportunity to maximise shareholder wealth requires a financial decision by management. We begin Part II with an explanation of how the price of investment funds is determined by an interaction between the individual lender's preferences and the firm's borrowing requirements (Unit 4). Managerial decisions to invest in productive assets give rise to various claims on company profits (interest as well as dividends). Thus, it is important we establish how different claims are valued by different categories of investor.

This will lead us into a discussion of corporate financial decisions, by which we mean its dividend policy and the complex choice of an appropriate capital structure consisting of debt, equity and retained earnings (Unit 5).

As in Part I, we start to consider risk and gradually relax our perfect market assumptions. We discover that the market price of equity of a company may vary according to the pattern of its dividend stream.

PART III: THE FINANCE DECISION

According to Gordon (1959), the fundamental problem for a financial manager is whether the decision to distribute profits, rather than to retain earnings for reinvestment, has a beneficial impact on the share price. If so then, in an uncertain world, the firm's financial policy, as well as its investment policy, must affect the objective of wealth maximisation. Can a firm have an optimum financial policy, which maximises the value of all its investments? This is a key question in modern financial theory and is a recurring theme throughout the module.

Financial managers obtain funds from sources other than the equity market; each source requires a return and this may be cheaper than equity. In Part III, we consider how firms maximise wealth by securing a flexible inflow of funds (Unit 6).

We consider the impact of financial risk, which is concerned with how the firm's earnings are distributed to its shareholders (or other suppliers of capital), upon the firm's overall cost of capital. In an uncertain world, can management establish an optimal capital structure that minimises financial risk and hence the required rate of return? If so, the firm's overall market value added can be maximised by manipulating its financial policy.

However, based on the work of Modigliani and Miller (MM), we explain why financial policy might not matter. According to MM, in a perfect capital market, corporate value depends solely upon the profitability of a firm's investments and the business risk characteristics of the industry concerned (Unit 7); financial risk is irrelevant. We conclude Part III by relaxing our assumptions of certainty and perfect capital markets with an overview of the empirical evidence.

PART IV: THE PORTFOLIO DECISION

We apply modern portfolio theory (MPT) to the structure of a firm's investment and financial decisions and explain how rational decision makers in a perfect capital market choose an optimum portfolio of investments with different risk-return characteristics (Unit 8). We summarise a number of tests to see whether the model works and if the effects of dividends on share prices and leverage on capital structure (i.e. financial policy) are irrelevant, as MM suggest.

We conclude Part IV with an explanation of why many issues raised throughout the module cannot be resolved by contemporary theory. In a world of certainty and perfect capital markets, the task of financial management is relatively simple, as investment and financing decisions can be determined separately and involve only one transaction. However, this is not the case in practice.

Over the past decade, stock market volatility suggests that information is not only imperfect but also costly. Given the complexity and volatility of capital markets, can we ever achieve our objective of wealth maximisation? The individual shareholder's perception of future returns may differ from the firm's own valuation of its income stream. The capital market may employ a different valuation formula to the firm in assessing its overall financial performance. As a result, security prices may be in a constant state of flux, irrespective of managerial investment and financial policies, leaving the market in a permanent state of disequilibrium.

Introduction to Unit 1

This first unit sets the theoretical stage for the practice of financial management, and we identify key issues that affect the financial manager. You will have less opportunity to practise ideas and reinforce your understanding through activities than in other units, but it is important that you do understand the fundamental concepts clearly and take this understanding into the rest of the module. There will be some mathematics in this and other units; don't be too concerned by this. There is nothing too complicated and we will take you through the steps slowly, but you must have some appreciation of the models and subsequent techniques that are used in financial management.

We start by analysing how individuals borrow and lend in a simple world using a single-period model. We investigate how the investment-consumption behaviour of individuals affects the financial manager and a firm's investment decisions through Fisher's Separation Theorem. Finally, we look at inefficiencies in the perfect capital market through the efficient market hypothesis.

Before we can identify strategies to achieve maximisation of shareholder wealth we need to understand the behaviour of the individual investor under various conditions. We also need to be clear what the share price means not only in an efficient perfect capital market, but in the real complex world.