

# AN OVERVIEW OF FINANCIAL MANAGEMENT

1. The definition of financial management
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3. The functions of financial management
4. Agency theory
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# The Definition of Financial Management

- A process to regulate the financial activities within an organization, which included activities of planning, analysis and controlling. All these activities are usually done by financial managers.
- All activities related to the firm's attempt to get the funds with minimal cost, to allocate the funds efficiently and to manage the results of the allocation.
- Financial management  $\neq$  accounting

# Major Topics of Financial Management

- Corporate finance, will discuss how to manage the financial aspect of a firm.
- Investment, will focus on the investor side and relate with the financing decision.
- Financial market and intermediaries, will focus on the third party which link the firm and the investors

# The Goal of Financial Management

- The primary financial goal is shareholder wealth maximization, which is the same meaning as firm's value maximization.
- How do we know the value of a company?
  - For the public firms, the value can be seen from the stock price
  - For the private firm, the value can be seen from the selling price as if the firm were sold to investors
- Maximizing stock price  $\neq$  maximizing net income. What are the reasons??

# The Functions of Financial Management

1. Establishing the allocation of funds (*investment decision*)
2. Deciding the alternatives of financing
3. Deciding to distribute or to retain profit (*dividend decision*)

# *Investment Decision*

- Decision taken by the finance manager for allocating funds in the form of investments that can generate profits in the future → associated with capital budgeting (capital budgeting).
- Investment decision can be long-term and short-term.
- This decision will be drawn from the assets of the firm and affect the ratio of current assets to fixed assets

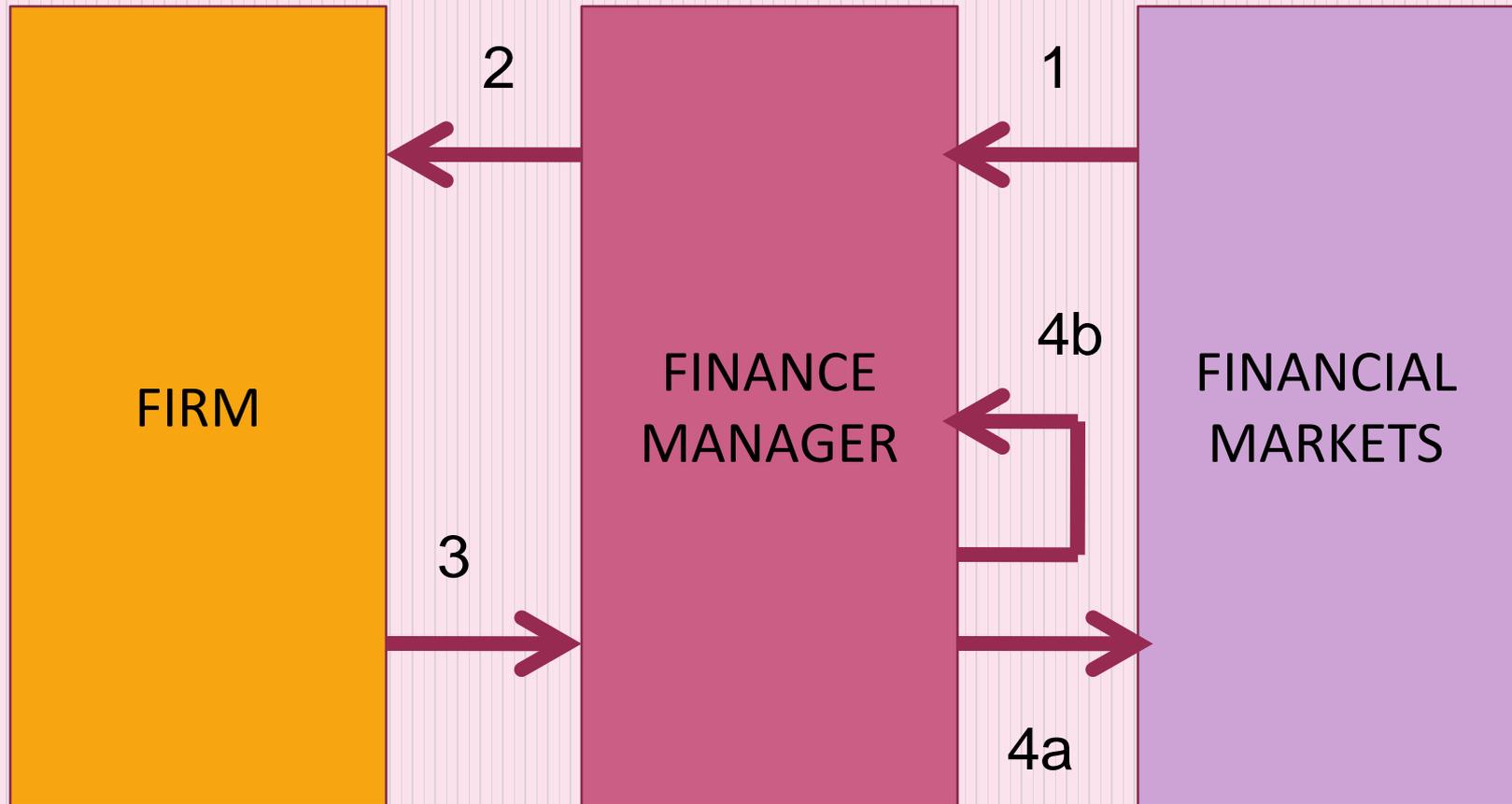
# *Financing Decision*

- The decision of selecting and combining the sources of funds which are the most economical for the firm. This funds are used to support both investment requirements and operational activities of the firm.
- Financing decision can be long-term and short-term
- The financing decision will be reflected in firm's liabilities side.

# *Dividend Decision*

- Dividends are part of a firm's profits paid to shareholders.
- Dividend policy is the firm's decision to determine the proportion of profits to be distributed to the shareholders and the proportion of profits that will be retained in the firm for supporting growth
- This policy will also affect the liabilities side of balance sheet (retained earnings)

# Manager and Financial Market



# *Agency Theory*

- An agency relationship exists whenever a principal hires an agent to act on their behalf.
- Within a corporation, agency relationships exist between:
  - Shareholders and managers
  - Shareholders and creditors

# Shareholders versus Managers

- Managers are naturally inclined to act in their own best interests.
- A potential agency problem arises whenever the manager owns less than 100% of the firm's common stock.
- To reduce the agency conflict, stockholders must incur agency costs, which include all costs borne by shareholders to encourage managers to maximize the stock price rather than act in their own self-interests.

# Shareholders versus Managers

- Three major categories of agency cost:
  1. Expenditures to monitor managerial actions such as audit costs
  2. Expenditures to structure the organization in a way that will limit undesirable managerial behavior
  3. Opportunity costs which are incurred when shareholder-imposed restrictions limit the ability of managers to take timely actions that would enhance shareholder wealth
- Some specific mechanism used to overcome agency conflict:
  1. Managerial compensation plans
  2. Direct intervention by shareholders
  3. The threat of firing
  4. The threat of takeover

# Shareholders versus Creditors

- Creditors have a claim on part of the firm's earning stream for payment of interest and principal on the debt. They even have a claim on the firm's assets in the event of bankruptcy
- Stockholders have control (through the managers) of decisions that affect the riskiness of the firm.
- A potential conflict arises in this situation:
  1. Managers make an investment on risky project
  2. Managers increase the amount of debt
- Mechanism used to reduce the conflict:

Creditors establish restrictive covenants in debt agreements

# *Asymmetric Information Theory*

- *Asymmetric Information* is a situation in which one party in has more or superior information compared to another.
- The level of asymmetric information is various among firms.
- The implications of *asymmetric information* on the manager's behavior:
  1. Managers are usually more motivated to release good information as fast as possible.
  2. Financial decision taken by manager can be used as signal for investors/ outsiders