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Financial Management: An Introduction

While there are many skills that are important for business managers, this note makes the case that financial management is one of the "must have" skills. This note provides an overview of financial management principles and answers to common questions and misconceptions about the topic. In so doing, the note motivates the relevancy of a strong background in financial management.

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. As business managers embrace the principles of financial management they become skilled at appreciating the value implications of their business decisions.

Question 1. Isn't financial management only helpful to those who interact regularly with investors and financial markets?

Through the effect of their actions and decisions, all business managers interact either directly or indirectly with investors and financial markets. Following the norms of standard business governance structure, those who put up the capital for a business (the investors) own that business. As a privilege of ownership, investors have ultimate say on all business policy, including the appointment of business management. Investors are clearly critical stakeholders for any business. In truth, managers that fail to please their investors, regardless of how well they please other stakeholders, will at some point be removed. Because of this reality, it is essential that all business managers, regardless of their functional focus, have an abiding appreciation for what matters to business investors. Financial management provides that investor perspective and shows the role of "value mindedness."

But the principles of value creation matter to managers for reasons other than just because they're required to please investors. The principles of value creation are fundamental to any manager interested in prudent decision making. Strong cash flow is vital to the health of any business. Financial management helps managers measure and maintain that lifeblood. For example, managers of not-for-profit institutions (enterprises that don't have profit-oriented investors) are still motivated to follow standard financial management principles if they are interested in not squandering enterprise capital and maintaining enterprise cash flow. 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 one who cannot. A strong background in financial management is highly relevant and broadly applicable to business professionals in all sorts of decision-making roles.

Question 2. Isn't financial management mostly a number-crunching exercise? If you do the right calculation, you get the right answer.

A striking characteristic of real-world business decisions is that they tend NOT to be straight-forward, black-and-white decisions. Because of the complex nature of such business decisions, the more accurate goal of financial management is not to give the "right" answer, but rather to help managers build the business judgment they need to approach highly nuanced decisions. Financial management decisions tend to be more like a professional basketball coach deciding whether to acquire a particular player for the team than a statistician calculating that player's correct field goal percentage. Financial management gives managers the tools that add rigor to their judgment. It helps managers identify the sources and magnitudes of concern and opportunity for the business. It helps managers appreciate the business risks they face. It helps managers understand the perspectives and needs of business investors. In truth, because of the ambiguity embedded in real-world business problems, there are lots of right answers, as well as lots of wrong answers.[1] Financial management helps managers distinguish between the two.

Suppose Lin, a manager at a major retailer, is deciding which stores her company should selectively upgrade as well as which of a number of proposed sites should be opened. Financial management principles provide Lin with a host of tools and frameworks that she uses to focus her attention on what matters most in this important decision, and how to think about the proposals. In one instance she discovers some concern about the magnitude of the proposed upgrade expenditure. For a new store proposal she is able to tie the viability of the store to a community development that is under discussion. These observations are invaluable to Lin in making the decision, but she does not expect her financial analysis to tell her specifically what to do. Although she gets valuable information from the analysis, the decision to upgrade Store X or open Store Y is still an ambiguous one because there is lots of uncertainty about real-world outcomes.

Question 3. Are business managers only fooling themselves when they use financial forecasts to make business decisions? Nobody knows the future.

Although financial analysts spend a lot of time working on financial forecasts, they appreciate that their forecasts are undoubtedly wrong. The world is too uncertain to forecast the details of the future with any precision. Despite the inevitable failure of the specific details of financial forecasts, business managers use financial forecasts to gain important insights into understanding the key bets in any business decision. As managers use financial forecasts, they understand the interrelationships and drivers of their business economics. In this manner they better establish probable ranges for forecasted outcomes and can use this understanding to improve their understanding of business linkages. The process of disciplined forecasting is highly valuable to business managers who constantly make important decisions in a highly uncertain environment.

Suppose Sandeep is thinking about the long-term prospects of marketing a toothpaste to the elderly. In thinking about this problem, he uses his understanding of trends in the target population, the macro-economy, and the industry dynamics and company strategy to model a base-case forecast of product demand, profit, and investment. He then adjusts the assumptions of his model to identify those elements that are most important and impactful to the forecast. For example, Sandeep discovers that the forecasted cash flow is relatively insensitive to the acquisition of new customers (the gains to attracting new customers more or less offset the costs of all that work). In contrast, the cash flow forecast is highly sensitive to the cannibalization

[1] The characteristic of lots of right and wrong answers is not so dissimilar to other real-world ambiguous problems such as "What should I wear tomorrow?" or "What should I do to make a living?"

of existing company toothpaste brands. Through the analysis, he discovers the strategic importance of digging deeper into understanding the manner and impact of how his toothpaste brands interact.

Question 4. Managers can get paralyzed by their fear of risk. Aren't business managers best served by ignoring the downside and focusing on building a good business?

As business managers seek to build their businesses, they intentionally or unintentionally make big bets all the time. The success of their endeavors depends wholly on the outcomes of these important bets. Because of its pervasiveness and impact on business outcomes, the consideration of business risk is naturally of primary concern to business managers.

But how might a manager think about risk in a healthy way? Investors also make lots of bets. In doing so, investors learn a lot about business risk—how to measure it and how to think about it. They understand how to minimize risk. They appreciate that some types of risk matter and some don't. Investors use their risk assessments to establish benchmark rates of return and provide discipline in their investment policy. In all these ways, managers can learn a lot from investors and what they do in financial markets. This theory and practice provides a foundation for the principles of financial management. Through confronting business risk with a full set of tools, managers are better able to think about risk in a healthy way.

Suppose that Rodrigo is considering purchasing a new piece of equipment for his manufacturing business. Through improvements in product quality and manufacturing efficiency, he expects that the new equipment will generate an expected 8% return on investment. In Rodrigo's analysis he questions whether 8% is a good return or not. Financial management principles can provide assistance. This is not the first time that investors have seen manufacturing equipment risk. Based on current prices in financial markets, it can be estimated that the rate of return investors demand on investments of comparable risk is about 9%. As such, investors see an 8% expected rate of return as insufficient to justify the manufacturing equipment purchase. By using information from financial markets to benchmark his investment decisions, Rodrigo recognizes that in order to create economic value, he needs to find ways to improve the return on the proposal. He concludes that he needs to think harder about how to leverage the virtues of the equipment and improve the expected returns of the project before he is ready to move forward with the investment.

Question 5. 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.

Investors are important stakeholders in any business. Equity holders, through their elected boards, determine the senior leadership of a company. Through this common governance structure, managers are clearly motivated to stay in touch with investors. But managers have other reasons to pay attention to financial markets. It turns out that financial markets generate lots of information that is highly valuable to managers. Investors make many big money decisions. Because of the magnitude of the money at stake, investors pour tons of analysis into these bets. Through the forces of supply and demand in markets, security prices reflect the combined wisdom of all that analysis across the globe. If the price of a security becomes a little high or a little low, investors swoop in to compete away any such mispricing. The concept of the information content of market prices is called "market efficiency." Because of the competitive forces to maintain financial market efficiency, financial markets provide a remarkable array of highly scrutinized information that is readily available for managers in making business decisions.

Suppose Rodrigo questions the 9% required return figure for his equipment proposal. He appreciates that if it is a good number, it should not come from thin air, but rather that it should be based on prevailing investor expectations in today's financial markets. Rodrigo can use the information provided by financial markets to evaluate the rates of return investors are expecting from investments of similar risk to that of his manufacturing operation. If those rates differ from the 9% figure, he has good reason to reconsider the benchmark in his analysis.

Question 6. 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. Moreover, because business growth proposals generally involve flows of money over multiple years, it is important for managers to know how to think about such prospects. Financial management assigns different values for money across time, in that receiving money sooner is worth more than receiving money later and that the precise difference in value depends on relevant rates of return. Through all these principles, financial management helps managers distinguish good growth from bad growth.

Suppose Jane is considering adding a car wash to the gas station she owns. She expects that the car wash will cost $50,000 to set up and will generate annual net profits of $10,000 for six years. Jane recognizes that six years of making $10,000 adds up to more than the $50,000 investment. So does that simple sum mean that she should jump into the car wash business? Financial management says that it depends on what else Jane might do with the $50,000. Financial markets indicate that she could expect to earn 5.0% over a similar horizon on investments of similar risk. Using the internal rate of return (IRR) tool, Jane calculates that her car wash investment is expected to earn 5.5% over the six years. This 5.5% IRR figure recognizes the value of money over the six-year life of the car wash. If she can earn 5.0% on alternative comparable investments, she is better off going forward with the car wash because the return of 5.5% provides a superior expected return to what investors can get in the market.

Jane recognizes, however, that the decision to proceed with the car wash investment depends strongly on the validity of her annual net profit forecast of $10,000. Financial managers know how to scrutinize profit forecasts. That scrutiny relies on both qualitative assessments of the business and competitive environment, an appreciation of historical financial performance and relationships, and disciplined care to avoid including profits that aren't truly incremental to the decision. Financial management tells managers to focus on business cash flow rather than profit, as cash flow adjusts profits for the important effects of noncash accounting charges and the cash effects of investment. By yielding to the same level of scrutiny, managers can be better informed in their decision making.

Question 7. Can business managers benefit their businesses by fooling their investors?

Business is filled with plenty of smoke-and-mirrors 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 the appropriate level of borrowing, the appropriate level of cash, and the appropriate level of dividends.

Suppose Zeeshan, the CFO at a large software company, is considering initiating a EUR1.00 annual cash dividend. His intent is to boost the company's EUR20.00 stock price by increasing the returns to shareholders. Zeeshan wonders how impressed shareholders will be by the cash they may start receiving. The naïve view is that Zeeshan has just given his shareholders an extra 5% return on their investment (5% = 1.00/20.00) and that investors will bid up the share price as they try to get a piece of this new big dividend. A more sophisticated perspective is that the cash dividend simply takes money out of the coffers of the company to distribute to the owners of the company. In effect, shareholders are no better off because by gaining the EUR1.00 cash dividend, the value of the assets of the company declines by EUR1.00. In effect, the shareholders are no better off because cash has simply moved from the shareholders' stock portfolio to the shareholders' bank account. The overall wealth of a shareholder is no different than it is if she moved a coin from one pocket to another. Zeeshan's cash dividend may be nothing more than a smoke-and-mirrors game. If such is the interpretation of investors, Zeeshan should expect very little in stock price appreciation.

Summary

Financial management contains a simple set of frameworks that provide powerful intuition and judgment for business managers regardless of their functional area. The emphasis is on gaining a set of tools and a mindset that profoundly aids decision making across a wide range of business situations.