



ROBERT H. SMITH  
SCHOOL OF BUSINESS

## Financial Management

### *Introduction*

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## Why Study Finance?

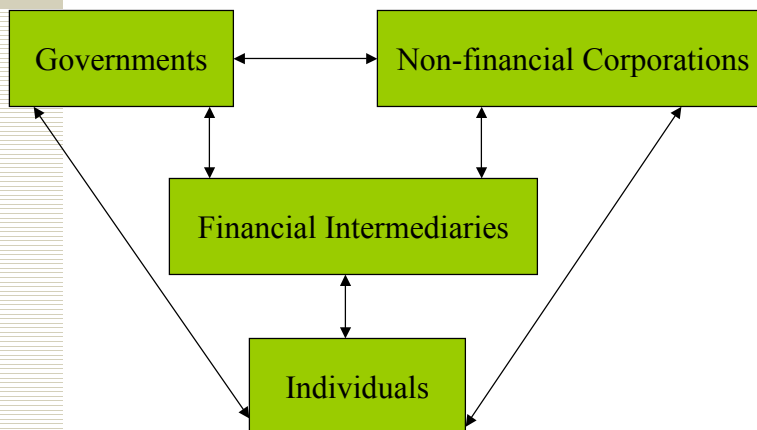
- Corporate life:
  - How does a firm finance its operations?
  - How can a firm use financial techniques to improve decision making (strategy, portfolio planning, manufacturing, etc.)
- Personal life:
  - How should you invest your money?
- What this course provides:
  - a framework to understand the role of finance
  - an understanding of key concepts in finance
  - an introduction to financial instruments
  - exposure to financial techniques

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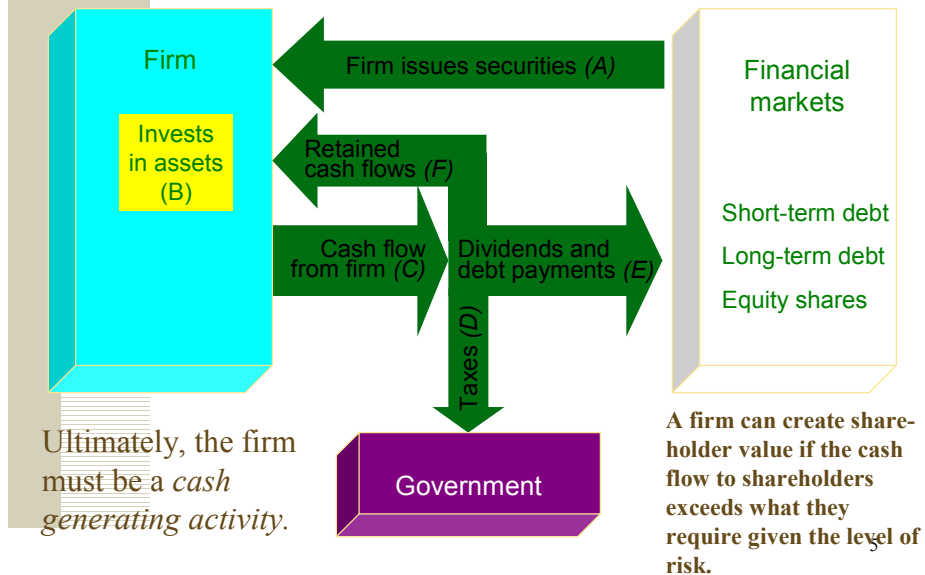
## Functions of a Financial System

- Provide an efficient payment system for the exchange of goods and services.
- Provide mechanisms that allow for the transfer of economic resources
  - Life-cycle allocations (consumption vs. saving)
  - Efficient allocation (specialization)
- Pool funds to undertake large-scale projects
- Manage uncertainty (allocate risk-bearing)

## Structure of a Financial System



## The Firm and Financial Markets



## The Balance Sheet: Finance Perspective

- 1. Liquidity
  - The order of assets on the balance sheet reflects their liquidity. Liability order reflects time to maturity.
  - Liquidity as a continuum reflects an ability to convert an asset to cash with little or no loss of value.
  - Liquidity has an opportunity cost - the more liquid an asset is, the less profitable it usually is.
- 2. Debt vs. Equity
  - Precedence of debt over equity to firm's cash flows.
  - Gains or losses of the business may be magnified for stockholders by financial leverage. The Balance Sheet: Finance Perspective



– 3. Market Value vs. Book Value of Assets and Liabilities

- Irrelevance of book (historical cost) value and importance of market (exchange) value for decision making.
- Some assets and liabilities do not appear on the balance sheet, e.g., talented managers and products that bring lawsuits.



B. THE INCOME STATEMENT

- REALIZATION: Time Line: Generally accepted accounting principles (GAAP) vs. cashflow
- 1. GAAP and the Income Statement
  - Accounting's "realization" principle for revenue, the "matching" principle for costs, and their incongruence with cash flows.
- 2. Non-cash Items
  - For many firms the most important non-cash item is depreciation.
  - NOTE: Do not confuse dollar-denominated amounts with cash. This confusion is particularly evident when discussing retained earnings and non-cash items, such as depreciation. Not every dollar-denominated amount is a pile of money or a check written. In Finance:

## Statement of Cashflows

Remember the

- Based upon the balance sheet identity:  
$$\text{Assets} = \text{Liabilities} + \text{Equity}$$
- Finance version of identity: the cash flow identity:  
$$\text{Cash flow from assets} =$$
  
$$\text{Cash flow to bondholders} + \text{Cash flow to stockholders}$$

## Key Themes in Finance... and in this Course

- Valuation: Topics 2 & 3 on Syllabus
  - firms, securities, and investment projects
- Tradeoff between risk and return: Topics 4 and 5
  - what risk is important? - modern portfolio theory
  - how do financial markets “price” risk?
- Capital structure management: Topic 6
  - creating value through financial strategy
  - consider information asymmetry, transaction costs, liquidity, regulations, and other real-world facts of life
- Risk management: passing on risk to others – Topic 7
  - derivative securities: futures, forwards, and options

## SUMMARY:

### OVERALL THEMES OF LECTURE

- DESIRED GOAL: Maximize market value of the firm!
- FINANCIAL POLICIES: Should be designed to help firm achieve maximize market value.
  - (Not a trivial task, organizations have inertia and individuals may have different agendas inside the firm.)
- In Finance we worry about:
  - Concerned with market value - not book value
  - Cash - not accounting realization of expenses.