1.6: Goals of the Financial Manager

The goal of the Financial Manager is to Maximize the Shareholder Wealth (side note — sometimes this is referred to as Maximizing Firm Value since increasing the value of the firm increases shareholder wealth.)

In order to Maximize Shareholder Wealth, we must concentrate on

- The Magnitude of Expected Cash Flows
- The Timeliness of Expected Cash Flows
- The Riskiness of Expected Cash Flows

The above idea is a central theme that will underlie everything we do this semester!

Key Points regarding the Primary Goal of the Financial Manager

Note that in the 3 factors impacting firm value listed above we use cash flows NOT earnings (net income). While there are many similarities between earnings and cash flows, they are not the same. We should always focus our attention on cash flows instead of earnings. Cash flows are considered more important than earnings for three basic reasons:

- The accrual-based approach of net income accounting can distort the timing of when cash is received or spent. Time value of money recognizes that money spent today is more costly than the same money spread out over years. Therefore, something like depreciation may understate the financial cost of owning assets.
- Generally Accepted Accounting Principles (GAAP) or International Accounting Standards (IAS) allow corporations some flexibility in how they account for revenues and expenses. Firms that choose to aggressively apply GAAP/IAS may mislead shareholders by reporting artificially high earnings. Cash flows are harder to manipulate than net income (earnings).
- Cash is the life-blood of a business. Ultimately, it doesn't matter if the firm is profitable on an EARNINGS basis if it isn't generating enough cash to pay its employees, suppliers, creditors, etc. The firm needs to generate positive cash flows in order to maintain its operations.

The word Expected is a critical component of the three factors. While what has happened in the past is not irrelevant, the relevance is based on how it might impact future cash flows. Investors base their valuation decisions on the future of the firm. When analyzing stock price changes to information, it is always essential to consider what the new information is RELATIVE TO what expectations were. An analogy would be to compare two students in junior high. The first student normally gets As in her classes while the second student normally gets Cs. Both come home with several Bs on their report card. While both received the same grades, one will likely result in disappointment while the other will likely be celebrated. The difference is not the performance, but the performance relative to expectations. With stocks, new information causes investors to revise their expectations for future cash flows to the firm. If the new information is better than previously expected, investors revise cash flow forecasts upward (and the stock price goes up). If the new information is worse than previously expected, investors revise cash flow forecasts downward (and the stock price goes down).

The three key elements (magnitude, timeliness, and riskiness) are not individual goals. Everything else being equal, higher cash flows are preferred to lower cash flows, less risk is preferred to more risk, and earlier receipt (later payment) of cash flows is preferred to later receipt (earlier payment). However, things are rarely equal. Increasing the magnitude of cash flows usually means taking on higher risks. Less risk usually means lower expected cash flows. Thus, we need to keep the primary goal (maximize firm value) in mind and realize that the interaction of risk, magnitude, and timeliness are more important than any one separately.

The concept of maximizing firm value is not specific to finance. The purpose of marketing, internal accounting, personnel decisions, production, etc. is to maximize firm value. When an individual is hired in any field, the rationale for that decision is that the company plans for that person to directly or indirectly increase its value. If you are an employee of a corporation and are not adding value, what reason do the shareholders have to pay your salary?