Financial Management: An Organic Approach

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ABSTRACT

Although textbooks present corporate finance using a topical approach, good financial management requires an organic approach that integrates the various assignments financial managers confront every day. Breaking the tasks into meaningful subcategories, the current article offers one approach.

Keywords: Financial Management; Capital Budgeting; Capital Structure; Dividend Policy; Working Capital; Financial Analysis

INTRODUCTION

A series of articles published in the *American Journal of Business Education* (Laux, 2010 – 2012) applies a rubric to the managerial finance course that reviews the typical topics through a stockholder wealth maximization/risk-return/agency conflicts lens. The final article in that series refers to a number of empirical works that investigate the interrelationships among working capital management (the final topic), capital budgeting, and dividend policy. However, all assignments are part of a greater whole; that is, the financial manager must treat the various aspects of his or her job with the knowledge that they are interconnected. Because this "organic" nature of financial management cannot be overlooked, the current article highlights some of the connections among the various elements of financial management and, as a summary, offers financial managers a set of recommendations for tackling this very difficult job on a daily basis. It revisits the design of the series, describes a structure within which to investigate the interrelationships among the charges given to the financial manager, and recaps with a list of directives to aid the financial manager in making the decisions most likely to achieve stockholder wealth maximization.

AN OVERVIEW OF THE SERIES

Offered as a collection of essays intended to supplement the basic finance course, the series opened with an introductory chapter outlining stockholder wealth maximization, the risk-return tradeoff as a mechanism for judging managerial and market efficiency, and the principal-agent conflicts that permeate financial management activities. The first article provided sufficient background for selecting among the eight topics covered in subsequent papers:

- Financial analysis
- Leverage
- Valuation
- Capital structure
- Capital budgeting
- Dividend policy
- Mergers & acquisitions
- Working capital management

The series related each to stockholder wealth maximization (SWM), risk-return trade-offs, and agency conflicts and presented some of the most approachable literature in the area. One can see that this approach foreshadows the connected nature of the various aspects of managerial finance. That is, financial managers cannot achieve SWM without maximizing return per unit of risk and minimizing principal-agent problems, and if they focus on a single assignment in isolation, they risk overlooking negative ramifications in another important facet of financial management, potentially sacrificing the "body" as a whole (solid, healthy financial management).

As outlined in the introductory article, we can picture financial management through the balance sheet, with the left-hand side representing decisions related to asset composition and the right side as those related to capital structure. Short-term assets become part of working capital management, while long-term assets represent capital budgeting and operating leverage decisions. Current liabilities also fall under the working capital assignment, while non-current liabilities are determined through capital structure decisions—financial leverage. To summarize the challenge on the asset side:

Essentially, the manager must determine the mix of assets that will offer the most "bang for the buck"—the highest return per unit of risk (or lowest risk per unit of return)… The financial manager… recognizes that the more liquid an asset, the less risky it is, and the risk-return relationship… suggests that lower risk will be coupled with lower return. Thus, the financial manager must attempt to manage assets in such a way that stockholders receive the highest return for a given risk level and that investment in low-returning assets is minimized. If markets are efficient, managers and stockholders will be rewarded with a higher stock price over the long run. [Laux, 2010 (a), p. 17]

For the right-hand side of the balance sheet, in making judgments about capital structure, managers employ strategies with accounts payable and short-term financing that balance cost (return) with risk through working capital decisions; similarly, the risk-return trade-off provides guidance in the financial leverage decisions that determine the appropriate mix of long-term debt and equity financing. The series used a topical approach to unravel how the details of each specific area relate to the overriding assignment, stockholder wealth maximization (which, in turn, requires knowledge of both the risk-return relationship and possible agency conflicts). With this quick overview in mind, we now investigate some of the interrelationships among the topical areas.

THE ORGANIC NATURE OF FINANCIAL MANAGERS' ASSIGNMENTS

In this section, we revisit the various assignments given the financial manager and discuss in more depth the interactions of these activities. To put the financial manager's job into perspective, we can begin with a basic description of valuable firms. Successful firms offer a competitively priced and highly demanded product or service, operate efficiently, motivate and fairly compensate their employees, satisfy their customers, have a strong brand, constantly innovate, pay their creditors on time, act responsibly within their communities, and reward their stockholders. None of this can materialize in the absence of good financial management. Financial managers:

- provide information for selecting projects
- look for profitable growth opportunities in the form of mergers and acquisitions
- find appropriate funding for acceptable projects
- maintain sufficient working capital to sustain operations, fund R&D, and pay suppliers, employees, creditors, and stockholders
- establish sound credit policies that attract and satisfy customers
- minimize the cash-to-cash cycle
- stay abreast of industry averages and provide financial information for benchmarking
- keep good accounting records, uphold high standards, and fully disclose important economic information

The first two duties fall under the capital budgeting category; the third involves decisions about financial structure; the next three represent working capital management; the last two encompass financial analysis and disclosure. In gauging their long-term success, financial managers (and the investing public) look to the value of the firm (both stocks and bonds) in the marketplace. In this regard, financial analysis and valuation become important analytical tools that inform managers and help those external to the firm weigh the firm's inherent risks and returns and offer their assessments in the form of prices. Let us look in more depth at these more general categories.

Finding and Funding the Best Projects—Two Primary Assignments

We begin with capital budgeting, because it constitutes the backbone of the firm's success. The good product must be made; factories, equipment, offices and stores must be built or leased, in the bricks and mortar world, at least. While textbooks will acknowledge just how difficult finding good projects can be, financial managers must gather the data to judge them, and a quick review of some of the questions good financial managers must answer about capital budgeting shows just how interrelated this activity really is:

- *Have we fairly estimated the cash flow projections used in our capital budgeting models?*

  Inevitably, cash flow predictions rely on a basic understanding of demand for the product, degree of operating leverage (which helps determine the cost of the inputs), strength of brand name, and product life cycle. Thus, at a minimum, knowledge of financial forecasting, leverage, and working capital management is critical. If managers use the merger/acquisition approach to invest in long-term property, plant, and equipment, valuation also plays a major role.

- *Have we refused to boost EPS (and associated bonuses) with profitable projects returning less than the weighted average cost of capital?*

  Accounting shenanigans and their associated agency costs must be avoided, with true economic value added as the end pursued. Cost of capital estimation is required (which, in turn, requires an understanding of valuation and the broader subjects, capital structure and capital budgeting), and managers must not take unfair advantage of information asymmetry to skew the key ratios used in financial analysis.

- *Have we considered our dividend policy in tandem with our capital budgeting decisions?*

  In the effort to maximize stockholder wealth, managers must walk a fine line between funding all acceptable projects and providing that "bird in the hand" we call dividends. This, in turn, requires working capital to pay those dividends.

The final capital budgeting questions provide a natural bridge to the second major assignment - capital structure:

- *Are we guilty of capital rationing, failing to accept and fund all projects returning the WACC or above?*
- *Has limited access to capital markets interfered with good capital budgeting decisions?*

  Part of the financial manager's job is to maintain sufficient access to the capital markets to fund all acceptable projects, the financial structure aspect ("funding"). To succeed in this duty requires achieving a track record with both investors and creditors that ensures availability of funding. Capital structure considerations require knowledge of financial leverage and the cost of capital (which, in turn, determines the selection of capital projects—or should—that's part of the first italicized item above). Capital structure also influences working capital management through required interest and dividend payments. Thus, leverage, capital structure, dividend policy, and working capital management play their respective roles.

In short, capital budgeting and capital structure decisions cannot be made in isolation but require investigation of leverage, dividend policy, working capital management, and financial forecasting (including valuation, both in assessing mergers and acquisitions and in determining the cost of capital). These decisions also require introspection about the possible agency conflicts inherent in long-term investment activities and their funding. Now we turn to the third major assignment of the financial manager, working capital management.

Maintaining Sufficient Working Capital

Getting to the long run requires surviving the short run—paying the bills (suppliers, employees, and creditors) and satisfying the stockholders, often through dividends. This is what working capital maintenance is all about. The questions financial managers must ask themselves inform us about the interrelationships between working capital management and other topics we have visited:

- *In general, does our working capital policy maximize returns (or limit costs) per unit of risk?*

  Risk and return, as that relationship applies to working capital management, means being good enough at financial forecasting that managers minimize cash on hand, maximize return from extending credit (which means accepting some bad debts), control inventory costs (and judge success through financial analysis and benchmarking), and stay current on short- and long-term interest rates to ensure that appropriate financing is in place.

- *Have we recognized the interrelationships between maintaining liquidity and funding capital investments but not held more cash than necessary just to avoid the scrutiny of the long-term capital markets?*

  This speaks for itself—capital budgeting, financial structure (the choice between short- and long-term financing), and even dividend policy influence working capital management.

- *Have we abused free cash flow, inappropriately redirecting cash to substandard investments and/or perquisites?*

  Again capital budgeting and awareness of potential agency conflicts/costs relate.

- *Are we being attentive to interest rate fluctuations and maintaining our accessibility to short-term credit? Is our associated financing scheme aggressive (conservative) at the right time(s)?*

  Financial forecasting (including the future direction of interest rates), leverage control (since it can affect access to the markets), and financial analysis (measuring whether or not we are in line with the industry) become paramount. Capital structure also influences both the cost of credit and accessibility to it, as an over-levered firm will find even short-term financing both more expensive and harder to get.

- *Have we focused too intently on one or two aspects of working capital, ignoring the effects on (or abandoning) other elements?*

  For example, managers can jeopardize SWM if they concentrate on extending extra credit but overlook the financial forecasting ramifications, such as the need for more inventory, higher production, and capital budgeting/expansion to support the extra sales that should result.

- *Have we minimized our cash-to-cash cycle while maintaining good relationships with our customers and suppliers?*

  Minimizing the cash-to-cash cycle requires managers to (1) develop and maintain good relationships with the firm's suppliers, (2) establish a sound credit policy with customers, and (3) create dependable sources of short-term liquidity with the firm's bankers (to take advantage of trade discounts, fund inventory build-up, and so forth). Finally, financial analysis can inform managers (through accounts receivable, inventory, and accounts payable turnover ratios, for example) about the degree of success.

So, even something as short-term in nature as working capital management must be considered in tandem with more long-term elements (capital budgeting, dividend policy, capital structure, and leverage), as well as financial forecasting and analysis. In the next subsection, we discuss in more depth the interplay among the various topics and the three major assignments.

Financial Analysis and Valuation

If we can boil the financial manager's job down to just three major activities—capital budgeting, capital structure, and working capital management—what does this imply for offering a better picture of financial management? How does it become "organic," with parts interlinking to ensure sound health? Financial analysis and valuation provide a kind of umbrella, and the other topics really pervade these two activities:

- *Financial Analysis* offers common measures for judging relative risk and return as well as efficiency. Profitability, asset utilization, and market-based ratios help judge the efficacy of capital projects and the efficiency and risk associated with working capital management. For capital structure, debt utilization measures aid in the risk-return assessment.

- *Valuation* establishes a theoretical model for using risk and return to set prices of stocks and bonds (the components of capital structure). In addition to financial analysis, this valuation requires inputs such as the cash flows associated with capital projects (and their variability and timing) as well as the aggressiveness of working capital policy and whether that stance enhances or impedes the market's assessment of the firm's value and its access to capital markets. Leverage (both operating and financial) also influences valuation by highlighting a firm's exposure to risk. Operating leverage results from the capital budgeting decisions, while working capital management determines whether a firm can cope with the amount of leverage (and swings in it), as measured through financial analysis. Also related to capital budgeting, the two remaining topics covered in the series offer inputs for the valuation process. *Mergers and acquisitions* can be viewed as a subset of capital budgeting, because a firm is simply purchasing the long-term assets in one fell swoop by buying another firm. In the residual approach to *dividend policy* (wherein dividends are paid only after all acceptable capital projects have been funded), the dividend decision becomes a subset of capital budgeting, and in the active dividend policy approach (wherein some dividends <u>must</u> be paid), it becomes a working capital topic. Either way, these activities affect valuation.

While the topical approach can help us better understand the details and intricacies of financial management, a broader look can help the financial manager see the day-to-day decisions as a bit more manageable for the average human being! Instead of eight vastly different balls to juggle, it's really three big assignments with myriad aspects playing their supporting roles. Still, the job offers more than enough challenge; there are no dull days for the best financial managers. What words of wisdom can we offer to summarize the work of the financial manager? This constitutes the subject of the following section.

WORDS OF WISDOM OR "ONE-A-DAY KEEPS INVESTORS AT BAY"

In this section, we visit for a final time the various topics and the directives offered to managers for maximizing shareholder wealth, distilling the advice into a set of thirty ("one a day") directives. This daily regimen should satisfy stockholders and bondholders alike, maximizing the value of the firm.

Capital Budgeting (2 Directives)

While financial managers are not the only ones attempting to discover the best investments, they do play a major role in judging projects' potential for improving the firm's future cash flows. In this assignment, financial managers must:

- *Minimize the firm's free cash flows and maximize its economic value added***.** This is the essence of achieving SWM, and it requires consistency in finding good projects.

- *Never accept projects that earn less than the true economic weighted average cost of capital; pay dividends or buy back stock, if necessary*. Yes, financial managers can hide the truth about the profitability and risk associated with capital projects, but they shouldn't.

Capital Structure (including leverage) (15 Directives—remember, the title IS <u>Financial</u> Manager!)

To establish an appropriate capital structure policy, financial managers must begin with an understanding of the decisions associated with leverage, both operating and financial, since investors will consider the degree of combined leverage in setting their desired returns for stocks and bonds. Thus, we offer the following directives for the two categories:

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- *Match capacity with demand*: This requires good forecasting.
- *Balance risk and return*, subordinating personal attitudes towards risk: It's not about the financial manager's safety or bonuses but about the long-run value of the firm.
- *Maximize operating efficiency without accounting games*: Control costs, really.
- *Disclose pertinent information, without jeopardizing competitive advantages*: This reduces risk in the eyes of investors.
- *Avoid agency problems such as "two wrongs don't make a right"* (failing to acknowledge bad investments and passing up the opportunity to correct them, postponing equipment repairs, etc.): Nothing substitutes for sound economic decision making.

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- *Take advantage of the tax shield associated with the use of some debt, but keep an eye on the degree of combined leverage*: Use some debt and try to issue it in favorable markets without wealth transfers, remembering that it's the long-run after-tax cost of debt that matters.
- *Avoid agency conflicts*, such as levering up the firm in hopes of magnifying personal bonuses or levering down in an effort to avoid the credit markets and their scrutiny (and the possible loss of control associated with debt covenants): Remember whose wealth is to be maximized.
- *Be careful with off-balance sheet financing; allow the investing public to value your firm appropriately, as it will serve the firm well over time*: Be honest, be clear, and be prompt in what you tell your stockholders and creditors; good disclosure is a value-adding activity.

In more general terms, capital structure policy should require financial managers to:

- *Learn about the more esoteric financing instruments, but use them sparingly.*
- *Compare the firm's level of leverage to the industry and benchmark to the lowest cost of capital.*
- *Be mindful to maintain access to capital markets when adjusting the capital structure.*
- *Resist covenants without overprotecting.*
- *Disclose whatever is necessary to allow the investing public to value the firm's debt and equity fairly.*
- *Keep accounting standards up and aggressiveness (earnings management) down.*
- *Avoid the bad decisions associated with entrenchment, including undue optimism and hubris.*

Now we turn to the third assignment - working capital management.

Working Capital Management (4 Directives)

In determining the appropriate composition of current assets and their financing—working capital management—financial managers should adhere to the following directives:

- *Minimize cash but keep enough to pay the bills on time and take advantage of the occasional unexpected value-adding capital investment*. Remember, this asset is low-risk, low-return; hoarding hurts.
- *Institute a credit policy (level of accounts receivable) that equates marginal costs and marginal revenues*. Bad debts expense is not a bad thing; extending credit is an investment decision that results in capturing more market share while boosting overall returns.
- *Control the costs associated with inventory, seeking a level as close as possible to "Just-In-Time" without losing sales*. Minimize the total costs associated with ordering, carrying, and stock-outs.
- *Strike the balance of short- and long-term credit that minimizes costs and maintains good creditor relations.* This requires knowledge of financial markets and expected interest rates (yield curves).

The three major assignments yield 21 directives—a check list for the financial manager that boils down to roughly one per working day each month. Since good financial managers are so dedicated they probably don't take weekends completely "off," nine additional directives are suggested in the following subsections, as we address the other aspects covered in the series.

Financial Analysis (2 Directives)

- *Keep your eye on economic reality*. Refuse to play accounting games to mask that reality, such as changing methods, big bath accounting, accelerating revenue, and understating expenses, such as bad debts. GAAP-accepted decisions that result in smoother earnings are acceptable insofar as economic reality is maintained, but if you manage the true value-adding activities, the numbers will follow. Don't become a slave to the market-based ratios (investors don't always think long-term, but the good financial manager must).
- *Be specific*. Determine an acceptable range for each measure and set targets for improvement over time, permitting judgment about relative success and motivating improvement. Be constantly vigilant about the typical perils: Don't postpone necessary repairs, reduce R&D, or cut the marketing budget just because it will boost short-term earnings.

Dividend Policy (3 Directives)

- *Employ a residual approach, funding all acceptable (and manageable) projects.*
- *Don't use treasury stock transactions to transfer wealth.*
- *Be transparent about the firm's long-run dividend strategy.*

Mergers and Acquisitions (4 Directives)

- *Treat mergers as capital budgeting decisions, judging fairly the potential cash flows and risks.*
- *View potential synergies with skepticism.*
- *Consider an alliance as a more valuable alternative.*
- *Refuse mergers for personal power, compensation, or prestige.*

Of course, the "one-a-day" prescription for financial health is a bit tongue in cheek, resulting in a long list, but not all directives require a "monthly check-up." For example, dividend decisions typically take place quarterly, and once a solid policy is in place, this area requires little added attention. Annual capital budgeting decisions are the norm, and mergers are rarer still. The idea is to keep tabs and stay balanced, recognizing the interplay among assignments and not allowing the details of the job to divert the financial manager from the overriding objective—long-run stockholder wealth maximization.

A PARTING WORD

As an addendum to the "Topics in Finance" series, this article has offered a rubric for synthesizing the myriad aspects of financial management, a way for financial managers to reduce (at least mentally) the number of balls to keep in motion. This summary can also provide professors and students one last picture of the subject and offer a basis for discussing the elements of managerial finance, perhaps discovering for themselves other ways to categorize the duties of the financial manager in a meaningful way. If the series and this parting essay have inspired the reader to enjoy the complexity of financial management, they have met the intended goal.

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