Goals of Financial Management

by Sophia

WHAT'S COVERED

In this lesson, you will learn about concepts associated with valuation and market value in financial management. Specifically, this lesson will cover:

1. Valuation

Financial management focuses on the practical significance of financial numbers. It asks: what do the figures mean? Sound financial management creates value and organizational agility through the allocation of scarce resources among competing business opportunities. It is an aid to the implementation and monitoring of business strategies and helps achieve business objectives. There are several goals of financial management, one of which is valuation.

In finance, **valuation** is the process of estimating what something is worth. Valuation often relies on **fundamental analysis** of the **financial statements** of the project, business, or firm, and using tools such as discounted cash flow or net present value. As such, an accurate valuation, especially of privately owned companies, largely depends on the reliability of the firm's historic financial information. Items that are usually valued are a financial asset or liability.

Valuations can be done on:

- *Assets:* investments in marketable securities (stocks, options, business enterprises) or intangible assets (patents and trademarks)
- *Liabilities:* bonds issued by a company

Valuation is used to determine the price financial market participants are willing to pay or receive to buy or sell a business. In addition to estimating the selling price of a business, the same valuation tools are often used by business appraisers to resolve disputes related to estate and gift taxation, and divorce litigation; to allocate business purchase price among business assets; to establish a formula for estimating the value of partners' ownership interest for buy-sell agreements; and many other business and legal purposes. Therefore, not only do managers want to keep reliable financial statements so that they can know the value of their own businesses, but they also want to manage finances well to enhance the value of their businesses to potential buyers, creditors, or investors.

TERMS TO KNOW

Valuation

The process of estimating the market value of a financial asset or liability.

Fundamental Analysis

An analysis of a business with the goal of financial projections in terms of income statement, financial statements and health, management and competitive advantages, and competitors and markets.

Financial Statements

A formal record of all relevant financial information of a business, person, or other entity, presented in a structured and standardized manner to allow easy understanding.

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2. Maximizing Shareholder and Market Value

The idea of maximizing **shareholder** value comes from interpretations of the role of corporate governance. Corporate governance involves regulatory and market mechanisms and the roles and relationships between a company's management, its board, its shareholders, other stakeholders, and the goals by which the corporation is governed.

In large firms where there is a separation of ownership and management and no controlling shareholder, the principal–agent issue arises between upper-management (the "agent") and shareholders (the "principals"). The danger arises that, rather than overseeing management on behalf of shareholders, the board of directors may become insulated from shareholders and beholden to management.

Thus, one interpretation of proper financial management is that the agents are oriented toward the benefit of the principals – shareholders – in increasing their wealth by paying dividends and/or causing the stock price or market value to increase.

The idea of maximizing **market value** is related to the idea of maximizing shareholder value, as market value is the price at which an asset would trade in a competitive auction setting.

↪ EXAMPLE For instance, returning value to the shareholders if they decide to sell shares or if the firm decides to sell.

TERMS TO KNOW

Shareholder

One who owns shares of stock.

Market Value

The total value of the company as traded in the market. Calculated by multiplying the number of shares outstanding by the price per share.

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3. Maximizing Value Without Harming Stakeholders

The stakeholder concept is associated with the concept of corporate governance. As mentioned above, corporate governance involves regulatory and market mechanisms and the relationships that exist between a company's management, its board, its shareholders, other stakeholders, and the goals for which the corporation is governed.

Stakeholders are those who are affected by an organization's activities. The stakeholders can be:

- Internal (owners or employees)
- External (customers, suppliers, the government, local communities, and the environment)

Some stakeholders are involved directly in economic transactions with the business. Others are either affected by, or able to affect, an organization's actions without directly engaging in an economic exchange with the business (for example, trade unions, communities, activist groups, etc.). Because of the breadth of the term stakeholder, there are different views as to who should be included in stakeholder considerations.
In the field of corporate governance and corporate responsibility, a major debate is currently occurring about whether a firm or company should make decisions chiefly to maximize value for shareholders, or if a company has obligations to other types of stakeholders. This increased after the financial crisis of the late 2000s, when concerns deepened about the potential of companies to lower the welfare of other stakeholders while maximizing their shareholder value.

IN CONTEXT

While the Anglo-American (US and UK) business "model" tends to emphasize the interests of shareholders over other implicated parties, some European countries formally recognize other stakeholders in corporate governance decisions.

Some people who argue that businesses should consider other stakeholders, like the government or the environment, argue that an attention to these types of stakeholders is intimately entwined with market value. They also argue that a holistic view can enhance general outcomes for all the stakeholders that are involved. Still others argue that stakeholders, even if they are not considered in business decisions, should at the very least not suffer harm, and that businesses should maximize value only if they can do so without generating harm.

TERM TO KNOW

Stakeholder
A person or organization with a legitimate interest in a given situation, action or enterprise.

SUMMARY

In this lesson, you learned that **valuation**, or estimating the market value of an asset, liability, or business entity, is a key goal of financial management. Corporations want to **maximize shareholder and market value** by ensuring proper financial management. There is some debate as to whether companies and their financial managers have an additional responsibility to **maximize value without harming other stakeholders** beyond their shareholders, particularly since the financial crisis of the late 2000s.

Best of luck in your learning!

TERMS TO KNOW

Financial Statement

A formal record of all relevant financial information of a business, person, or other entity, presented in a structured and standardized manner to allow easy understanding.

Fundamental Analysis

An analysis of a business with the goal of financial projections in terms of income statement, financial statements and health, management and competitive advantages, and competitors and markets.

Market Value

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Shareholder

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Stakeholder

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Valuation

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