Chapter 1

Introduction to Financial Management

Answers to Review Questions

1.1 The main tasks of the finance function are:

- financial planning
- investment project appraisal
- capital market operations
- financial control

1.2 Wealth maximization is considered to be superior to profit maximization for the following reasons:

- The term *profit* is ambiguous. Different measures of profit can lead to different decisions being made.
- Profit maximization in the short term may be at the expense of profit maximization in the long term.
- Profit maximization ignores the issue of risk. This may lead to decisions that result in investments in risky projects in order to gain higher returns. However, this may not meet with shareholders' needs.

Wealth maximization takes both risk and long-run returns into account.

1.3 Survival may be viewed as a necessary objective for the existence of a business. However, shareholders will expect to receive returns from their investment and will not normally be interested in businesses that embrace survival as their primary objective. Nevertheless, there may be periods in the economic cycle when survival becomes the dominant objective. It can be argued, of course, that in a highly competitive economy, a business will have to pursue a wealth maximization objective in order to survive. Under such circumstances, wealth maximization and survival may be seen as different sides of the same coin.

1.4 Various problems are associated with an incentive pay plan that is based on the growth of profits over a period:

- It is a one-way bet. There are no penalties if the managers fail to deliver.
- It fails to take risk into account. One way of increasing profits is to increase the investment risks.
- The profits generated may not be entirely due to the actions of managers. Other factors (for example, general economic conditions) may have an important influence.

1.5 In general, one-dimensional mutual funds tend to underperform unrestricted mutual funds. For example, investors in labour sponsored funds in Ontario currently receive a tax credit on amounts invested (which is being phased out over time), and these funds invest in smaller companies. The government hopes this can stimulate research and development in these companies. These funds have not done very well over time and several have been forced to temporarily freeze redemptions (where investors sell and get back the current market value of their investment).

However, green investment funds may be at the leading edge of the green revolution. If everyone jumps on the green revolution, the performance of green funds may well exceed that of all others. Investors will drive up the share price of those companies perceived to be green friendly, and mutual funds that own shares in these companies will do very well indeed. We have seen that ethical companies have done well for themselves, and to the extent that green investing is perceived as ethical investing, these companies may make good investments.

