Ten Principles of Financial Management

“It is necessary to understand these principles in order to understand finance.”

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Principle 1: The Risk-Return Trade-off

- **We won't take on additional risk unless we expect to be compensated with additional return.**
- **Investment choices have different amounts of risk and expected returns.**
- **The more risk an investment has, the higher its expected return will be.**

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Principle 2: The Time Value of Money

- A dollar received today is worth more than a dollar received in the future.
- Because we can earn interest on money received today, it is better to receive money earlier rather than later.

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Principle 3: Cash—Not Profits—Is King

- Cash Flow, not accounting profit, is used as our measurement tool.
- Cash flows, not profits, are actually can be reinvested.

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Principle 4: Incremental Cash Flows

- **The incremental cash flow is the difference between the projected cash flows if the project is selected, versus what they will be, if the project is not selected.**

Principle 5: The Curse of Competitive Markets

- It is hard to find exceptionally profitable projects
- If an industry is generating large profits, new entrants are usually attracted. The additional competition and added capacity can result in profits being driven down to the required rate of return.
- Product Differentiation, Service and Quality can separate products from competition

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Principle 6: Efficient Capital Markets

- The markets are quick and the prices are right.
- The values of all assets and securities at any instant in time fully reflect all available information.

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Principle 7: The Agency Problem

- Managers won't work for the owners unless it is in their best interest
- A agency problem resulting from conflicts of interest between the manager/agent and the stockholder/owners.
  - Managers may make decisions that are not in line with the goal of maximization of shareholder wealth.

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Principle 8: Taxes Bias Business Decisions

- **The cash flows we consider are the after-tax incremental cash flows to the firm as a whole.**

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Principle 9: All Risk is Not Equal

- Some risk can be diversified away, and some cannot
- The process of diversification can reduce risk, and as a result, measuring a project's or an asset's risk is very difficult.

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Principle 10: Ethical Behavior is Doing the Right Thing, and Ethical Dilemmas Are Everywhere in Finance

- **Each person has his or her own set of values, which forms the basis for personal judgments about what is the right thing**