

FINANCIAL THEORY EVOLUTION

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ABSTRACT

This paper discusses the evolution of the financial theory from the early 20th to the early 21st century. The text deals with the financial implications of ethics, the impacts of social responsibility on corporate value, and the contributions of psychology and neuroscience to financial decisions. This paper seeks to contribute to a more in-depth understanding of the dynamics of the financial management and of its connection to economic cycles and financial crisis.

KEYWORDS: Financial theory, evolution of the literature, maximization of company value.

1 INTRODUCTION

The present study discusses the changing role of the financial management function in order to contribute to a more in-depth understanding of its dynamics and its relation to economic cycles. Discussion of this nature requires great care, lest one fails to consider that currently concepts are the result of built-up prior knowledge and experience.

A review of the state of the art is therefore required, and, according to Brennan (1995), one is advised to recognize the influence of the limitations of the paradigms of each period. In order for this to be understood, Weston (1975) proposes the acceptance of three assumptions:

- The first states that the evolution of economic thought reflects the most pressing problems of each period (*op. cit.*, p. 37). Analogously, this concept may be applied to study of the financial management function, as new solutions are developed in response to workaday challenges;
- The second explains that advances in the field of finance are related to the development of theories and instruments in correlated fields (*op. cit.*, p. 37), so that mounting knowledge and technical evolution in correlated areas is a key factor for innovation in the financial management function; and
- The third mentions that, in the development of financial theory, the constant transformation of economic and managerial circumstances allowed certain aspects of its content to be given little attention in certain periods, and taken into due consideration during others (*op. cit.*, p. 38).

We thus begin the present study with a review of the literature on the evolution of the financial management function, from the early 20th to the early 21st century, relating it to historical facts that characterized each period. We then discuss the changing role of the financial management function, including the influences of ethical debate. This is followed by our final considerations, in which we mention some trends of finance studies as to measurement of the impact of social and environmental responsibility to the company's value to shareholders, as well as the application of psychology and neuroscience concepts to finance.

2 THE FINANCIAL THEORY EVOLUTION

2.1 OVERVIEW

The analytical approach adopted for this article is based upon the work of Archer and D'Ambrosio (1969), Weston (1975), Smith (1984), and Famá and Galdão (1996). Contributions by other authors are mentioned in the text as relevant. Table 1, below, summarizes the developments of this portion of the study.

Table 1: A Summary of the Evolution of the Financial Management Function

Approach		Period	Events	Financial Theory
Archer and D'Ambrosio	Smith (Clifford)			
Traditional	Normative	Early 20th century	Movement toward corporate consolidation	Focus on capital structure and key financial episodes
		1920s –1960s	Expansion of new industries Merger process	Concern with financial structure Liquidity considerations Incipient discussion on planning and control
			1929 crash	Importance to solvency/liquidity and financial recovery of companies
			World War II	Relevance of funding raising
Managerial	Positive	Fear of post-war recession	Emphasis on cash flow versus profitability Internal financial controls (accounts receivable and payable, inventory)	
Economic		Technological development (computing) Growth of international trade	Modigliani and Miller (1958) and the irrelevance of dividends and capital structure Capital costs analysis to determine obstacles to development Development of policies adequate to the internationalization process	
		1970s	Technological development (computing) Collapse of the Bretton Woods Agreements 1974 U.S. stock market crash U.S. oil and inflation increasing.	Interest in the theories of Markowitz, Tobin, and Sharpe, as well as market efficiency Use of the CAPM and the concepts of systematic and non-systematic risk
		1980s	External debt crisis: developing countries declare debt moratorium, financial crisis Financial disintermediation and M&A activity Basel Accord I (1988)	Greater interest in the Black-Scholes option pricing formula Development of complex derivatives strategies for risk limitation

			<p>Globalization of the economy and intensification of transaction volume;</p> <p>Increased interdependence among economies</p> <p>The Bank for International Settlements (BIS) creates the Committee on Payment and Settlement Systems (CPSS).</p> <p>Mexican financial crisis (1994–1995)</p> <p>Asian financial crisis (1997–1998)</p> <p>Russian financial crisis (1998)</p> <p>Reformulation of the Basel Accord (Basel II) (1998)</p> <p>Cases: Metallgesellschaft, Barings Bank and Long Term Capital Management</p> <p>Argentine financial crisis (2001–2002)</p> <p>U.S. accounting scandals (Enron, Tyco, WorldCom, etc.)</p> <p>U.S. subprime mortgage crisis</p>	<p>Greater importance of option- and futures-based hedging strategies. Risk management gains relevance.</p> <p>Concern with reduction of systematic risk and focus on mitigation of clearing risk and credit risk.</p> <p>Greater attention to value creation.</p>
<p>Economic and Behavioral (*)</p>		<p>1990s – 21st century</p>		<p>Greater importance of Corporate Governance and information transparency.</p> <p>Increased concern with social and environmental responsibility, which is important to the relationship with other stakeholders</p> <p>Discussion of corporate ethics as applied to finance</p> <p>Behavioral finance and the contributions of Minsky (1982) move into the spotlight</p>

Source: based on Archer and D’Ambrosio (1969), Weston (1975), Famá and Galdão (1996), Smith (1984), Duarte Jr. (2003), and Garcia (2003). (*) This approach is not mentioned by Archer and D’Ambrosio (1969), and was conceived by the authors of the present work.

2.2 THE EARLY 20TH CENTURY

The financial management in the early 20th century was characterized by the traditional approach, focusing on the main events of corporate financial life, rather than routine management problems (Archer and D' Ambrosio, 1969, p. 20).

During this phase, development of the financial management function occurred as the result of the corporate consolidation and U.S. domestic market growth brought about by the construction of major railway networks in the late 1880s.

Furthermore, as large industrial conglomerates requiring voluminous financial resources to fund their operations appeared, manager's concerns turned to capital structure-related decisions (Weston, 1975)

Dewing (1914) concluded that the focus of financial managers was to protect the company from bankruptcy and promote its financial restructuring.

2.3 FROM THE 1920s TO THE 1960s

The 1920s and 1930s saw the development of new industries and an intensification of merger activity. Although this was a period of growth, price fluctuations and a scarcity of resources reinforced the relevance of managing the capital structure, and studies on liquidity, budgeting techniques, and financial recovery stood out, particularly after the effects of the 1929 crash (Weston, 1975).

This so-called traditional approach would remain the predominant one until the end of World War II, manifest as an interest in matters concerning capital structure and the funding process (Archer and d' Ambrosio, 1969).

In this sense, emphasis was placed on sources of resources. However, the early 1950s brought rapid economic expansion, pushing internal controls for accounts receivable, accounts payable, and inventory into the spotlight (Weston, 1975).

The post-war period therefore saw a change of focus in finance studies, which began to feature the dominance of internal routines and the concern with organizational structure that characterize the administrative approach, according to Archer and D'Ambrosio (1969).

In addition to the raising of resources, the management of cyclic assets gained importance during this economic phase that required firms to improve their organizational performance, and financial management was forced to evolve in this aspect.

Between the late 1950s and the early 1960s, corporate profitability was reduced, and the appearance of new companies meant that resources became scarce for traditional firms. The study of capital

costs with a view to analyzing the feasibility of investments also gained importance, as did trying to deepen understanding of the international economy; it was a time to search for new markets (Weston, 1975).

Project viability analysis and internationalization, the latter as a means of seeking out new investment opportunities, brought the financial management function closer to the concepts of economic theory.

It bears stressing that, until the 1950s, the study of the financial management function was normative, in that it focused on defining improved investment and funding policies; there was no emphasis on the effect of these policies on company value. Only after the 1950s did a change in focus occur in the finance literature, towards a positive approach, when scholars sought to understand the consequences of these decisions on company value (Smith, 1984). This advancement represented the understanding of the relationship between funding and investment decisions.

2.4 THE MODERN FINANCE

In the beginning of 1950s, two mainstreams formed the foundations of modern finance. The first one – called Corporate Finance – was set forth by Modigliani and Miller (1958). The other, which focuses on portfolio and risk and return studies, was introduced by Markowitz (1952), and has followers in authors such as Tobin (1958) and Sharpe (1964), but its importance was not recognized until the 1970s.

2.4.1 THE CORPORATE FINANCE AND CONTRIBUTION OF MODIGLIANI AND MILLER

Modigliani and Miller (1958) introduced a new mainstream on the subject, which was previously characterized by two polarized beliefs: one maintained that the distribution of dividends maximized the value of the company to its stockholders, while the other understood that distributing dividends prevented the company from investing in profitable projects, thus impeding value maximization.

They devised the concept that the value of a company is independent of its capital structure. In light of the innovative character of this proposal, Chew (1993) considers Modigliani and Miller to be the founders of modern finance.

Although the assumptions that underlie the original proposal of Modigliani and Miller (1958) – such as the absence of taxes – cannot be wholly ratified in real-world situations, they do allow study of the factors capable of affecting the definition of an adequate corporate capital structure (Amaro de Matos, 2001).

2.4.2 MARKOWITZ'S PORTFOLIO THEORY

Markowitz (1952) spread the notion that investors should build their portfolios on the basis of expected returns (desirable) and returns variance (undesirable), in order to maximize the former and minimize the latter, by diversifying assets with reduced covariance.

Markowitz (1952) rejected the idea that investors should base their portfolios solely on the greatest expected return, because adopting this criterion may lead to two assets with similar returns being allocated to the investment portfolio with no analysis of their contribution to its risk. He also explained that a portfolio with the maximum expected return is not necessarily that with the least risk, and stresses that a naively diversified portfolio, which does not account for the relationship between assets (stocks) and considers only their amount, does not necessarily mitigate risk.

To Markowitz (1952), although diversification allows reduction of portfolio risk, it does not eliminate the variance in a portfolio, that is, diversification does not lead to complete extinction of the risk present in an investment portfolio. One may state that Markowitz (1952) implicitly contributed to our understanding of the concepts of systematic (non-diversifiable) and non-systematic (diversifiable) risk, which were later explicitly explored by Sharpe (1964).

The Markowitz model (1952) was therefore important because it allowed propagation of the understanding that diversifying a portfolio – by holding assets with a reduced level of correlation (covariance) – is important for mitigating portfolio variance in relation to its expected return (risk).

In his article, Markowitz (1952) explained that combining all assets and all risks allows the portfolios with the greatest level of return for a given amount of risk to be identified out of a set containing all possible portfolios. This was named the efficient frontier.

2.4.3 THE TOBIN SEPARATION THEOREM

Tobin (1958) contributed to the expansion of the concepts introduced by Markowitz (1952). Using Keynesian Theory as a starting point, Tobin (1958) argued that investors choose situations that fall between a state of total liquidity and a point of total investment in high-risk assets.

In his work, Tobin (1958) noted that investors prefer liquidity, due to two aspects: one concerns individual inelasticity towards the expected interest rate, and the other, uncertainty as to the future of interest rates. In other words, investors are inclined to avoid the risk of losing the wealth of their capital as a consequence of unpredictable asset price fluctuations (market risk).

Additionally, Tobin (1958) developed the observation that investors make their decisions by combining a risk-free asset with the portfolio located at the Efficient Frontier introduced by Markowitz (1952), leading to the Separation Theorem, which states that the two investment decisions made by individuals are independent and separate. These decisions consist of:

- Determining the most efficient risky asset portfolio;
- Defining the proportion of resources to be allocated to risk-free assets and risky assets.

The Separation Theory that bears his name was Tobin's greatest contribution showing that the most efficient portfolio of risk-bearing investments is independent of personal preferences regarding risk – the difference between an investor with higher risk tolerance and one with lower risk tolerance is the proportion of risk-free assets in his or her portfolio (Famá and Galdão, 1996; Elton and Gruber, 1997; Dimson and Mussavian, 1999).

2.4.4 THE CAPITAL ASSET PRICING MODEL – CAPM

The Capital Asset Pricing Model (CAPM), devised in the seminal work of Markowitz (1952) and Tobin (1958) and later simplified by Sharpe (1963; 1964), Lintner (1965; 1969), and Mossin (1966), considers returns expected by resource suppliers to be determined by the risk-free rate, plus the expected market risk premium adjusted by the beta coefficient. This simplification of the Markowitz model allowed observation of the fact that total asset risk is composed of systematic and non-systematic (or diversifiable) risk, broadening understanding of the matter.

The understanding that systematic risk affects assets was extremely important, because, as explained by Assaf Neto (2003), this is one of the most relevant risks, as it cannot be mitigated through asset diversification.

Sharpe (1964) clarified that, in the presence of a single risk-free interest rate for obtaining resources or investing, there exists a point on the efficient frontier whose corresponding portfolio will be held by all investors, regardless of their personal risk profiles.

The CAPM explains that the super-efficient portfolio obtained through the combination of risk-free and risky assets is located at the point of tangency between the Capital Market Line (CML) and the efficient frontier. The CML represents a set of combinations of risk-free and risky assets, which will be considered by all investors (homogeneous expectations), and the point where the CML meets the efficient frontier is known as the Market Portfolio. Sharpe (1964) concluded that this super-efficient portfolio is the market itself; according to him, investors cannot obtain above-market returns in a consistent manner, because the market behaves in a manner conducive to its equilibrium, assuming that all investors are subject to the same risk-free rate.

The CAPM introduced the concept of beta, which measures the covariance between the return of an asset and the market, and represents the contribution of systematic (non-diversifiable) asset risk towards the risk of a diversified portfolio. Therefore, unlike Markowitz (1952), the CAPM explicitly mentions the concept of systematic (non-diversifiable) risk.

It is worth mentioning that other models – more robust than the CAPM – have been developed and have gained relevance, such as Arbitrage Pricing Theory (APT), introduced by Ross in 1976, which

offers an alternative to the CAPM in that, in addition to beta, it correlates a “k” quantity of factors with asset return (Copeland, Weston and Shastri, 2005).

Whereas Black *et al.* (1972) and Fama and MacBeth (1973) found evidence consistent with CAPM’s acceptance, Lakonishok and Shapiro (1986) and Fama and French (1992, 1993, 1996, and 2004) have conducted studies favoring a multifactor approach proposed by Ross (1976). However, their findings and results do not permit a consensus on the multifactor model.

Despite of this dilemma, the APT requires more information than the CAPM does, and is thus subject to greater difficulty in obtaining data. This explains the greater applicability of CAPM to professionals who face the challenge of estimating capital costs, despite criticism of its simplicity.

2.5 THE 1970s

The 1970s were characterized by a global recession, brought about by the exhaustion of the post-war model of economic growth.

The grave condition of the U.S. economy led to the downfall of the Bretton Woods Agreements; this did not prevent domestic inflationary pressure from causing ripples at the international level.

To make the situation worse, the worldwide economic scenario was faced with oil crisis in 1973 and 1979, with a considerable increase in oil barrel prices after OPEC member states curtailed their output.

In addition, the New York Stock Exchange crashed in 1974, further adding to the risk and uncertainty of the financial environment.

In this panorama, there was resurgence in the quantitative models created before the 1970s by Markowitz, Tobin, and Sharpe (Famá and Galdão, 1996), which was made easier by their practical nature, which allowed processing of a wide range of economic and financial data.

Fama (1970) introduced his Efficient Market Hypothesis, one of the most important contributions to finance theory of the decade. The hypothesis posits that, in efficient markets, the prices of financial assets reflect the set of available, relevant information.

2.6 THE 1980s

During this period, U.S. economic growth was characterized by budget deficits, widespread imports of European and Japanese products, and adoption of restrictive monetary policies.

This led to an increase in international interest rates, which, coupled with a reduction in commodity prices, made it difficult for developing countries to honor payments on loans made in the 1970s, when excess liquidity in the worldwide financial system – provided by the surpluses of oil-

exporting nations – encouraged international banks to grant expressive funding to developing nations' investment projects.

This period saw the debt moratoria of developing countries – including Brazil, which began defaulting on its payments in 1987 (Fausto, 2006). Oil-exporting nations, in parallel, sought to redeem their investments, and international banks were placed in a distinctly uncomfortable situation.

Thus began a process of market disintermediation, and securitization was an important instrument for turning poorly negotiable debts into assets attractive to the capital market (Famá and Galdão, 1996).

In this context, the study of risk became more relevant, and research involving the futures and options markets stood out.

Merton (1997) notes that, in the 1980s, the use of mathematical models expanded even further. Mathematical modeling was employed by retail and investment banks, as well as institutional investors. Merton considers the Black and Scholes pricing model, introduced in 1973's "The Pricing of Options and Corporate Liabilities", to have been most influential in the 1980s.

In their article, Black and Scholes (according to Famá and Galdão, 1996) developed a formula to evaluate call options, showing that the value of these options is influenced by the strike price, the time to maturity, the spot price, the risk-free interest rate, and the volatility of the stock.

New and complex derivatives-based risk mitigations strategies were developed in the 1980s. Furthermore, we must stress the importance of the Basel Committee, which, in 1988, drafted the first Basel Accord (Basel I), which established a regulatory framework for the calculation of a minimum capital that financial institutions must hold. The Basel Accord became a landmark in banking regulation and supervision (Garcia, 2003).

2.6 FROM THE 1990s TO THE EARLY 21TH CENTURY

The globalization process picked up steam in the 1990s, which saw an increase in the international flow of capital, products, and services.

Franco (1996) believes that the "[...] globalization process leads us to relate it to the growth of trade flows – of goods, services, and international investment – at levels consistently superior to the growth of production" (*op. cit.*, p. 3).

Intensification of the international flow of capital, products, and services therefore led to increased interdependence among national economies, and, consequently, an increase in the possibility that the economic collapse of a given country will "infect" other economies; this would later become evident in the Mexican, Asian, Russian, and Argentine crisis that occurred between 1994 and 2001.

These aspects were met with greater concern for risk, and the use of options- and futures-based hedging strategies became more widespread. From 1993 onwards, the concept of *value at risk* (VAR) was also implemented among G-30 nations (Jorion, 2003).

As for the mitigation of systematic risk, the financial sector focused on studies of payment systems. In 1990, the Bank for International Settlements (BIS) created the Committee on Payment and Settlement Systems (CPSS), which comprises the central banks of G-10 nations. The CPSS focuses on conducting studies and publishing recommendations on (mostly) the mitigation of the clearance and credit risks that are characteristic of payment system structures (BIS, 2005).

In 1998, the Basel Committee reformulated the 1988 Accord, perfecting its formula for calculation of regulatory minimum capital and including aspects of market discipline and transparency, as well as explicitly noting the role of banking supervision and financial institutions in establishing minimum capital levels (Garcia, 2003).

Therefore, as stated by Famá and Galdão (1996), the market globalization process led to a greater concern with risk management in the 1990s, which was also influenced by the following cases, mentioned in Duarte Jr. (2003), which demonstrate the need for managing corporate risk:

- *Metallgesellschaft*, a German conglomerate whose subsidiary adopted a hedge strategy based on using short-term oil futures to protect its long-term sales contracts;
- *Barings Bank*, a UK bank that collapsed due to the misguided strategy of one of its main traders, who operated without any backup or operational controls;
- *Long-Term Capital Management*, a U.S. hedge fund that offered no transparency to its investors, was not obligated to provide collateral for the lines of credit it held, and was extremely leveraged while operating with no computational market risk management support, despite having scholars such as Robert Merton and Myron Scholes on its board of directors.

In addition to the importance of risk management, Famá and Galdão (1996) note that, during the 1990s, new costing techniques (such as Activity-Based Costing) played an important role during the restructuring moment companies went through, and explain that the measurement of shareholder value creation became more relevant, leading to the concept of *Economic Value Added* (EVA).

The early 21st century saw several accounting scandals involving widely known U.S. corporations, such as Enron, WorldCom, Xerox, Tyco, Arthur Andersen, and Merck. These scandals shed light on the existence of severe conflicts of interest within organizations, and on the need to expand control mechanisms.

In this context, the concepts of corporate governance and greater transparency in manager–stockholder relations gained prominence. In parallel, in mid-2002, the United States Congress enacted the *Sarbanes-Oxley Act* (SOX), seeking to provide greater investor protection.

Discussions of corporate ethics and transparency also became frequent in relations between the company and other stakeholders. Themes related to corporate governance and social and environmental responsibility influenced the financial management function. The stakeholder theory was emphasized, favoring expansion of the Balanced Scorecard (BSC), developed by Kaplan and Norton in 1990 (Kaplan and Norton, 1997), which allows companies to align their strategies with performance indicators from the standpoints of financial management, clients, internal processes, and learning and knowledge. This makes it possible to meet the demands of shareholders and other stakeholders alike.

Studies that discuss the validity of the CAPM and the Efficient Market Hypothesis began to gain ground in the 1990s. Work by scholars such as Famá and French (1992) – questioning the Sharpe model – and Haugen (1995) – criticizing the notion that markets are efficient – are examples of ideas that have been stirring debate in academia.

Another line of research that has been growing in relevance seeks to relate human behavior with economic concepts, in order to understand the influence of the human factor on financial decisions. This field is known as Behavioral Finance.

Indeed, the current economic moment – characterized by growing market volatility and ripples of the Credit Crisis – requires a greater risk management ability of the financial management function, in addition to a more in-depth understanding of the behavioral aspects involved in financial decisions (Wray and Tymoigne, 2008) and of the factors that influence the emergence of market bubbles, thus increasing the relevance of Minsky's contributions (Minsky, 1982).

3 THE FINANCIAL THEORY EVOLUTION ANALYSIS

Financial management function was initially characterized by an emphasis on the main events of a company's financial life and its main purpose was to protect the company by means of funding and capital structure policies.

The use of higher-complexity mathematical models grew in intensity in response to the need for subsidizing managers' analysis of a growing range of information, originating in an environment of increased risk and uncertainty, mostly due to the advance of globalization. Indeed, the very concepts of risk and return have been gaining prominence in the definition of financial strategies; the CAPM's distinction between systematic and non-systematic risk bears noting. Systematic risk can be reduced by building a portfolio of diversified assets with low correlation; as for non-systematic risk, banks have been attempting to mitigate it by undertaking payment system reforms.

A growing concern with risk led to the development of complex options- and futures-based hedging strategies. Risk management in banks and financial institutions also gained importance: in 1998, the Basel Committee reformulated the 1988 Accord, perfecting its formula for calculation of regulatory minimum capital and including aspects of market discipline and transparency, as well as explicitly

noting the role of banking supervision and financial institutions in establishing minimum capital levels (Garcia, 2003).

Cases mentioned by Duarte Jr. (2003), such as Metallgesellschaft, Barings Bank, and Long-Term Capital Management, showed the importance of managing corporate risk in financial institutions.

Several complementary aspects have also been incorporated into the financial management function: budget, results, and cash flow control; an understanding of the influence of investment, funding, and dividend policies on company value; and a questioning of ethics and transparency in the company's relations with its shareholders and stakeholders.

As for transparency and ethical debate, they are becoming increasingly frequent in the relationships between companies, shareholders, and other stakeholders, as each of these groups seeks to protect its interests. Matters related to corporate governance and social responsibility have therefore been standing out.

According to the Organisation for Economic Co-operation and Development (OECD), principles for the adequate practice of corporate governance must promote information transparency and defend the interests of shareholders (including minority shareholders) and all other stakeholders, and must also clearly define the responsibilities of boards of directors (OECD, 2004).

In this context, social pressure – including pressure from organized groups – for greater information transparency and for the implementation of mechanisms to defend shareholder and stockholder interests has been increasing.

This constitutes a challenge for the financial management function, because it implies adoption of social and environmental policies – the impact of which on company value is difficult to measure.

We must stress that social and environmental responsibility, a response to stakeholder demands, engenders discussion on whether the financial management function should maximize shareholder value or try to do so for all stakeholders.

According to Jensen (2001), in attempting to maximize value for all stakeholders by means of the Balanced Scorecard (or similar concepts), the financial management function may actually lead to a destruction of company value, because it is impossible to fully meet the desires of heterogeneous groups whose interests may be divergent and mutually exclusive. Jensen is critical of this concept, alleging that it does not allow clear visualization of the extent to which each decision can affect company value, and also gives managers room to make decisions based on personal preferences or to avoid pressure from interest groups – while this is not necessarily favorable for company value. The potential for agency conflict created by this strategy is readily apparent.

On the other hand, Jensen (2001) concedes that the financial management function must satisfy stakeholders because they matter to the company, but should only do so while respecting its

foremost objective: maximizing shareholder value. In other words, he maintains that a certain corporate policy that satisfies the needs of non-shareholders should only be adopted if it adds shareholder value as well.

In short, the financial management function must maximize shareholder value. This is more consistent with the logic of capitalism, which is based on the existence of risk capital in a competitive environment. Therefore, as shareholders are the agents of investment and take on the highest risk – because their rights are subordinate to those of other stakeholders – the role of the financial management function is to maximize the value of the company for shareholders. Should this not occur, there will be no stimulus to drive new investment – and, consequently, for example, no creation of wealth or jobs. This, in turn, would make the company unable to meet the needs of any other stakeholder.

The financial management function faces the conflict between the “moral of integrity” and “the moral of the partnership”. The former is characterized by virtuous individual behavior accepted as correct by official rules (Srouf, 2003, p. 257), while the latter is guided by the impact of decisions on the company, as well as a strengthening of mutually advantageous bonds between the company and its stakeholders, in order to establish a perennial business (Srouf, 2003).

To the financial management function, this conflict implies choosing between the adoption of policies that maximize value for all stakeholders (“moral of integrity”) or those that maximize shareholder value while satisfying the needs of all interest groups, because they matter to the company, but only if the core objective (shareholder value) is not harmed in any way (the partnership moral). In other words, “the moral of the partnership”, with its characteristically pragmatic stance, is more adequate for the financial management function, and its adoption is paramount to meeting the needs of stakeholders, because the integrity of the company depends above all else on maximizing shareholder value. It is therefore apparent that shareholders and other stakeholders must establish a virtuous long-term relationship.

It bears mentioning that the viewpoint that the role of the financial management function is to maximize shareholder value while seeking a balanced relationship with other stakeholders is a healthy outlook, as it does not relegate the individual element (investors’ free initiative), in detriment of the social element (other stakeholders). In a certain way, it seeks to counterbalance the interests of both groups.

In Romano’s view (as reported to Azevedo, 2006), when the social predominates over the individual, there is a movement towards totalitarian thought and single-mindedness, which leads to destruction of the individual to satisfy the interests of the collective.

This reasoning makes sense if applied to the financial management function, because, after a company is established, it will receive resources from stockholders if it is a value-adding agent, that is, if it maximizes stockholder wealth.

Therefore, if the financial management function attempts to satisfy the needs and desires of all stakeholders indiscriminately, the company's value may be destroyed. Predominance of the social (meeting the interests of all stakeholders without distinction) would thus be responsible for the downfall of the individual (private initiative).

In closing, we must stress that the role of the financial management function reflects the issues and challenges of each time. Over time, it has incorporated several concepts; currently, risk-related aspects are increasingly important, in response to a more volatile environment brought about by the globalization process. Questions regarding transparency in relations with shareholders and other stakeholders, as well as corporate governance and social and environmental responsibility are driven into the spotlight as social pressure increases for these concepts to be seriously and fully realized.

Within this context, the financial management function evolved according to economic cycles and financial crisis. One may state that its role is to maximize shareholder value by means of investment, funding, and dividend policies, with constant evaluation of risk–return factors, capital costs, and balance in the company's relationship with its investors and other stakeholders, within the context of corporate governance and social and environmental responsibility.

4 CONCLUDING REMARKS

The present article discussed the changing concept of the role of the financial management function, which must be viewed with care and due consideration of the aspect that currently predominant concepts are the result of accrued knowledge and prior experience.

We therefore chose to begin with a review of the literature on the evolution of the financial management function, and sought to relate it with historical data, as, according to Brennan (1995), it is important to recognize that concepts are influenced by the limitations of each period's paradigms.

We found that, whereas the financial management function was initially characterized by an emphasis on the key facts of a company's financial life – and its purpose was to protect the company from the possibility of bankruptcy and restructuring through the adoption of correct funding and capital structure policies –, with the passage of time, financial management grew to include concepts of organizational structure and economic theory.

The use of increasingly complex mathematical models was intensified, in light of the need to analyze a growing range of information originating from a riskier and more uncertain environment, mostly due to advances in globalization.

Risk and return concepts gained ground in the devising of financial strategies; the distinction of systematic and non-systematic risk in the CAPM's formula is particularly worthy of note. We must

also stress the importance of systematic risk management, which has been fostered by the BIS, and the relevance of corporate risk management in the current environment.

Several complementary aspects have also been incorporated into the financial management function: budget, results, and cash flow control; an understanding of the influence of investment, funding, and dividend policies on company value; and a questioning of ethics and transparency in the company's relations with its shareholders and stakeholders.

As the result of a historical process, the financial management function has evolved into its current purpose: maximizing shareholder value by means of investment, funding, and dividend policies, with constant evaluation of risk–return factors, capital costs, and balance in the company's relationship with its investors and other stakeholders, within the context of corporate governance and social and environmental responsibility.

We must point out that the financial management function continues to evolve. Research is ongoing and new points of view are being explored. Studies to assess the impacts of social and environmental responsibility on shareholder value will be important. Finally, work that combines tenets of classical economic theory, studies of human psychology, and neuroscience in order to develop new methods to aid the understanding of human behavior will warrant more in-depth investigation. This fact is corroborated by the future developments of the Credit Crisis.

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