Introduction to Financial Management

Introduction:

If a person wants to start a new business what so ever, he has to look upon certain things like capital investments to be made, where, when, how, how much, money to be raised for these capital investments, handling day to day activities, paying dividend etc. While these are not the only concerns of financial management but they are some of the most important ones.

Financial Management is a managerial activity which is mainly connected with the planning and controlling of firm's financial resources. Financial management is dependent on economics for its theoretical clarity as it was a branch of economics till 1980. As a subject, Financial Management is a developing area as many of its areas have controversies and there is no unanimous solutions achieved. It is one of the most interested subjects to study as it is relates to firm's one of the most important decisions which are related to money (finance).

Financial management is dynamic, in the making of day- to-day financial decisions in a business of any size. The old concept of finance as treasurer-ship has broadened to include the new, meaningful concept of controllership. While the treasurer keeps track of the money, the controller's duties extend to planning analysis and the improvement of every phase of the company's operations, which are measured with a financial yardstick.

Financial management is thus an integrated and composite subject. It welds together much of the material that is found in Accounting, Economics, Mathematics, Systems analysis and Behavioral sciences, and uses other disciplines as its tool. For a long time, finance has been considered as a rather sterile function concerned with a certain necessary recording of activities alone. Financial management makes a significant contribution to the management revolution that is taking place.

Financial management's central role is concerned with the same objectives as those of the management; with the way in which the resources of the business are employed and how the business is financed. Financial management has been divided into three main areas - decisions on the capital structure; allocation of available funds to specific uses and analysis and appraisal of problems. Financial management includes planning or finance, cash budgets and source of finance.

Financial management refers to the management of finance. It includes the efficient and effective use of available financial resources. Financial management is a managerial activity which creates balance among financial planning, procure
administration and sources of funds.

Definitions: Financial management is defined as follows:

"Financial management is concerned with the efficient use of an important economic resource, namely, capital funds". - **Soloman**

"Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations". - **Joseph and Massie.**

"Financial management is an area of financial decision-making, harmonizing individual motives and enterprise goals**".** - **Weston and Brigham.**

"Financial management is the area of business management devoted to a judicious used of capital and a careful selection of sources of capital in order to enable a business firm to move in the direction of reaching its goals".- **J.F.Bradley.**

Scope and Evolution of Financial Management:

Financial activities of a firm are always related with other activities of a firm and they cannot be separated. Certain firms produce goods while some others provide services to customers. They raise funds to acquire production and other facilities. The scope of financial management includes mainly three activities namely Production, Marketing and Finance. A firm gets or acquires capital and employs it through financing activities and generates return on this invested capital through production and marketing activities.

The evolution of financial management is divided into three faces i.e. the traditional phase, the transitional phase, and the modern phase.

Traditional Phase: Main features of the traditional phase are as follows.

- The role of financial manager was limited to rising of funds.
- Main focus was mainly on the events like formation, expansion, mergers & acquisitions etc.
- The approach of the management was institutional.
- Decisions of the firm were made from the view point of investors.
- Day to day activities of financial management were ignored.

Transitional Phase: The transitional phase period was from 1940s to 1950s where the basic approach of the management was same as the traditional phase but a heavy emphasis was put on day to day activities like planning, control etc. The focus of the management was shifted.

Modern Phase: This phase of financial has both prospective I.e. theoretical concepts and analytical methods which have shown the following features.

- Wealth maximization of all share holders became the main concerned objective.
- Focus was not only on rising of funds but also on use of funds
- The approach has become more analytical and quantitative.
- Quantitative tools are used by modern managers such as ca
  programming, option pricing theory, agency theory etc.

Functions of Financial Management:

As already discussed, finance activities cannot be separated from production, marketing and other activities but functions of financial management are uniquely identified. There are main four functions of finance management which are discussed as follows. All functions of finance management have risk-return implications. In the following section, we will discuss all these functions and their implications.

Financing Decision (Capital Structure Decision): It is considered as one of the most important function which is to be performed by the financial manager where the main concern of the financial manager is to decide when, from where, how much and how to acquire the required funds to meet the firm’s investment needs. The main difficulty for a financial manager is to determine the appropriate ratio of equity and debt. The mixture of equity and debt (debentures) is called the firm’s capital structure or capital mix. The manager always tries to achieve the optimum capital mix for the firm. The capital structure of the firm is considered as optimum where the value of shares is maximized. A proportion of debt in a firm increases the firm’s value and return but along with that there is always a high risk involved with debt (Higher the ratio of debt, higher risk and higher return is involved). Capital structure decision also includes other factors such as loans, legal aspects, flexibility of capital etc.

Investment Decision (Capital Budgeting Decision): When optimum capital structure is acquired, the investment decision takes place. Capital budgeting decision includes capital expenditures and thus involves the decision of allocating the acquired capital to different long-term assets which generates revenues for the firm in the future. While taking the capital budgeting decision the projected (expected) profitability of the new investments are taken into consideration and the expected profitability of new investments are also compared with the existing ones. Capital budgeting includes investment in new projects as well as replacing the new projects with existing ones or older ones. The expected rate of return of the investor by investing money in financial assets or projects is called the opportunity cost of capital. There are various capital budgeting techniques such as NPV, IRR, ARR, PI and Payback Period, on the basis of which investment decisions are made.

Liquidity Decision (Working Capital Decision): Liquidity decision of a firm is known as working capital decision or current asset management decision. Investments in current assets made by the firm affect the firm’s liquidity and profitability. Lack of liquidity leads the firm to insolvency. A proper balance between profitability and liquidity must be achieved. Current assets of a firm must be managed efficiently and effectively in order to protect the firm against the risk of illiquidity. This can be done by using different techniques of current assets management. The finance manager should estimate the requirement of current assets in the firm and must confirm the availability of these funds when needed.

Dividend Decision (Profit allocation decision): The finance r
whether the firm should distribute all its profits to shareholders c
distribute a portion of profits and retain the balance with them. This

dividend function or profit allocation function. The proportion of the profit distributed as dividend as called the dividend pay-out ratio and the retained portion of the profits is called the retention ratio. The finance manager must determine the most optimum dividend policy that maximizes the value of the firm's shares. Bonus shares are issued by the firm to existing share holders without any charge. The financial manager must consider the questions of dividend stability, bonus shares and cash dividends.

Nature of Financial Management:

Financial management is a process which is concerned with acquiring and utilizing of funds of a firm. It also includes policy decisions such as nature of business, size of firm, liquidity requirement of the firm, use of debt etc. These decisions lead to the margin of profits and the risk-return trade off of the firm. Nature of the finance is as follows:

- Financial activities of a firm are centralized.
- Financial activities are performed in all business firms for giving their contribution to the growth of the firm.
- Finance activities are primarily used for decision making.
- Finance activities are always connected with external activities such as production and marketing.
- Finance activities include planning and control functions.
- The central focus of finance activities is on wealth maximisation of its shareholders.

Importance of Financial Management:

Planning and control: Financial management is in the base of all business activities. Business activities determination and their implementation require financial management. All activities of business move around finance and therefore planning and control is important.

Need of a decision: Financial management is a base to all managerial activities which helps the firm in making decisions related to production, marketing, R&D etc.

Analytical and scientific approach: While making decision through financial management, modern techniques of mathematics are used to make decisions. This also includes the analytical approach of understanding the situation through analytical skills, the knowledge to apply them and interpret their results.

Goal of Financial Management:

Share holder's Wealth Maximisation:

It is commonly understood that the objective of a firm is to maximize value and wealth. The value of a firm is represented by the market price of the company's stock. The market price of a firm's stock represents the assessment of all market participants as to what the value of the particular firm is. It takes in to account present and prospective future earnings per share, the timing and risk of these earning, the dividend policy of the firm and many other factors that bear upon the market price of the stock. Market price acts as the performance index or report card of the firm's progress and potential.

Prices in the share markets are affected by many factors like general economic outlook, outlook of the particular company, technical factors and even mass psychology. Normally this value is a function of two factors i.e. the anticipated rate of earnings per share of the company and the capitalization rate. The likely rate of earnings per shares depends upon the assessment of how profitable a company may be in the future. The capitalization rate reflects the liking of the investors for the company.

The financial goal of the management should be shareholder's wealth maximization. Shareholder's wealth maximization is theoretically logical and operationally feasible for decision making. Shareholder's wealth maximization means maximizing the Net Present Value of shareholders. NPV is the difference between the present value of its benefits and the present value of its costs. A financial action with a positive NPV is a desirable because it creates wealth for shareholders. A financial decision resulting in negative NPV should be rejected. In case of mutually exclusive projects, a project with higher NPV should be accepted.

The problems of timing and risk of expected profits are handled by selecting an appropriate rate for discounting the expected flow of future benefits. It is important to emphasis that benefits are measured in terms of cash flows. The flow of cash is important in financing decision and not the accounting profits.

Advantages of Wealth Maximization

1) Wealth maximization is a clear term. Here, the present value of cash flow is taken into consideration. The net effect of investment and benefits can be measured clearly. (Quantitatively)

2) It considers the concept of time value of money. The present values of cash inflows and outflow helps the management to achieve the overall objectives of a company.

3) The concept of wealth maximization is universally accepted, because, it takes care of interests of financial institution, owners, employees and society at large.

4) Wealth maximization guides the management in framing consistent strong dividend policy, to earn maximum returns to the equity holders

5) The concept of wealth maximization considers the impact calculating the Net Present Value at a particular discount

made to cover the risk that is associated with the investments.

Criticisms of Wealth Maximization

1) The objective of wealth maximization is not descriptive. The concept of increasing the wealth of the stockholders differs from one business entity to another. It also leads to confusion in and misinterpretation of financial policy because different yardsticks may be used by different interests in a company.

2) As corporations have grown bigger and more powerful, their influence has become more pervasive; they have created an imbalance which is widely believed to have been instrumental in generating a movement to promote more socially conscious business behaviour. Academicians and corporate officers alike have urged the advisability of more socially conscious business management. Financial management will then have to rise equal to the acceptance of social responsibility of business.

3) Financial management should not only maintain the financial health of a business, but should also help to produce a rate of earning which will reward the owners adequately for the use of the capital they have provided. To the creditors, the management must ensure administration, which will keep the business liquid and solvent.

4) Wealth maximization is as important objective as profit maximization. The operating objective for Financial Management is to maximize wealth or the net present worth of a firm. Wealth maximization is an objective which has to be achieved by those who supply loan capital, employees, society and management. The objective finds its place in these segments of the corporate sector, although the immediate objectives of Financial Management may be to maintain liquidity and improve profitability.

5) The wealth of owners of a firm is maximized by raising the price of the common stock. This is achieved when the management of a firm operates efficiently and makes optimal decisions in areas of capital investments, financing, dividends and current assets management. If this is done, the aggregate value of the common stock will be maximized.

Profit Maximisation:

The objective of financial management is the same as the objective of a company which is to earn profit. But profit maximization alone cannot be the sole objective of a company. It is a limited objective. If profits are given undue importance then problems may arise as discussed below. The term profit is vague and it
contradictions. Profit maximization must be attempted with a realiz

A positive relationship exists between risk and profits. So both risk and profit objectives should be balanced.

The goal of profit maximisation implies that a firm either produces maximum output for a given unit of input or uses minimum input for producing a given output. The underlying logic of profit maximisation efficiency which means efficient allocation of resources under the competitive market conditions and profit is considered as the most appropriate measure of a firm's performance.

Profit maximization should serve as the basic criterion for decisions arrived at by financial managers of privately owned and controlled firms. Different alternatives are available to a business enterprise in the process of decisions- making. Each alternative has its own implications. Different courses of actions have to be evaluated on the basis of some analytical framework and for this purpose, commercial strategies of an enterprise have to be taken into consideration. The availability of funds depend upon the kind of commercial strategies adopted by a firm during a particular period of time. Various different theories of financial management provide an analytical framework for an evaluation of courses of action.

Maximization of profits is often considered to be a goal or an alternative goal of a firm. However, this is somewhat narrow in concept than the goal of maximizing the value of the firm because of the following reasons: **(Limitations of Profit Maximisation)**

1) The maximization of profits, as reflected in the earnings per share, is not an adequate goal in the first place because it does not take into consideration time value of money.
2) The concept of maximization of earnings per share does not include the risk of streams of alternative earnings. A project may have an earning steam that will attain the goal of maximum earnings per share; but when compared with the risk involved in it, it may be totally unacceptable to a stockholder, who is generally hostile to risk-bearing activities.
3) This concept of maximization of earnings per share does not take into account the impact of dividend policy upon market price or value of the firm. Theoretically, a firm would never pay a dividend if the objective is to maximize earnings per share. Rather, it would reinvest all its earnings so as to generate greater earnings in the future.
4) It ignores the timing of returns (Time Value of Money).
5) It ignores the risk factor.
6) It fails to provide an operationally measure for ranking alternative courses of action in terms of their economic efficiency.
7) It is vague as the precise meaning of profit maximisation is unclear.

Other Objectives of Financial Management:

Increase in Profits: A firm should increase its revenues in order
For this purpose, the volume of sales or any other activities should

normal practice for a firm to formulate and implement all possible plans of expansion and take every opportunity to maximize its profits. In theory, profits are maximized when a firm is in equilibrium. At this stage, the average cost is minimum and the marginal cost and marginal revenue are equal. A word of caution, however, should be sounded here. An increase in sales will not necessarily result in a rise in profits unless there is a market for increased supply of goods and unless overhead costs are properly controlled.

Reduction in Cost: Capital and equity funds are factor inputs in production. A firm has to make every effort to reduce cost of capital and launch economy drive in all its operations.

Sources of Funds: A firm has to make a judicious choice of funds so that they maximize its value. The sources of funds are not risk-free. A firm will have to assess risks involved in each source of funds. While issuing equity stock, it will have to increase ownership funds into the corporation. While issuing debentures and preferred stock, it will have to accept fixed and recurring obligauons. The advantages of leverage, too, will have to be weighed properly.

Minimum Risks: Different types of risks confront a firm. "No risk, no gain" - is a common adage. However, in the world of business uncertainties, a corporate manager will have to calculate business risks, financial risks or any other risk that may work to the disadvantage of the firm before embarking on any particular course of action. While keeping the goal of maximization of the value of the firm, the management will have to consider the interest of pure or equity stockholders as the central focus of financial policies.

Long-run Value: The goal of financial management should be to maximize long run value of the firm. It may be worthwhile for a firm to maximize profits by pricing its products high, or by pushing an inferior quality into the market, or by ignoring interests of employees, or, to be precise, by resorting to cheap and "get-rich- quick" methods. Such tactics, however, are bound to affect the prospects of a firm rather adversely over a period of time. For permanent progress and sound reputation, it will have to adopt an approach which is consistent with the goals of financial management in the long-run.

Maximising EPS: The goal of maximising earnings per share does not suffer from the first limitation of profit maximisation but it suffers from other limitations. Maximising EPS fails as a financial objective as it does not provide economic welfare to owners (shareholders).

Status and Duties of Finance Executives (Finance Man

The organisation structure for financial management will differ across different firms. The designation of Chief Financial Officer (CFO) and other finance executives would also differ within different firms.

A finance manager is responsible to carry out the finance functions. The role of finance manager is becoming more pervasive, intensive and significant in solving complex fund management problems. Under the direct supervision of CFO, two more officers are appointed as treasurer and controller.

Functions of Finance Manager:

Chief Financial manager is the top officer of finance department. In America he is known as Vice-president finance and in India he is called Chief Financial Controller. He performs following functions:

(1) Financial Planning: He determines the capital structure and prepares financial plan.

(2) Procurement of Funds: Financial manager makes the necessary funds available from different sources.

(3) Co-ordination:- Financial manager establishes co-ordination among the financial needs of various departments. He is a member of finance committee.

(4) Control:- Financial manager examines whether the work is being performed as per pre-determined standards or not. He gets the reports prepared, controls the cost and analyses profits.

(5) Business Forecasting:- Financial manager evaluates the effects of all national, international, economic, social and political events on industry and company.

(6) Miscellaneous Functions:- It includes the management of assets, management of inventory, arrangement of data and management of bank deposits etc.

Fund Raising: The scope of financial management in traditional phase had the limited role of finance manager simply to raise funds. It was during promotion, recoganisation, expansion or diversification of the firm, the financial manager was called upon to raise funds.

Funds Allocation: The function is to decide about the expenditure decision and to determine the demand for capital for these expenditures. The finance manager is concerned with the efficient allocation of funds. The funds should be acquired and allocated as and when needed by the firm.

Profit Planning: Profit planning refers to the decisions in the areas of pricing, costs, volume of output and the selection of production lines by the firm. Profit planning is a prerequisite for optimizing investment and financing decision. Pr
anticipate the relationships between volume, costs and profits and d
face unexpected conditions.

Emerging Role of Finance Manager in India: The performance role of finance manager is changed in many ways from early 1990s.

Following are the different changes occur in the role of finance manager.

- The industrial licensing framework has been substantially relaxed which leads to expansion in other areas.
- The MRTP act has been eventually abolished and the FEMA Act has been substantially liberalized.
- Controller of capital issue was deciding face value of shares but now managers do that.
- The scope of FDI has expanded considerably and a huge significance is given to foreign portfolio management.
- Options and futures were introduced in the markets.

The key challenges for the finance manager appear to be in the following cases.

- Investment Planning
- Financial Structure
- Mergers & Acquisitions
- Working Capital Management
- Performance Management
- Risk Management
- Investor Relations

Functions of Treasurer and Controller:

The finance officer reporting to the CFO has different designation namely controller and treasurer who performs various finance functions. The controller performs functions of an accountant in the company while the treasurer performs the functions of a relationship manager.

Main functions performed by the treasurer and the controller can be described as follows:

Functions of Treasurer

The following are the functions of treasurer.

(1) Provisions of finance: It includes the estimation of funds necessary for procurement preparing programmes and implementing them, establishing relation among various sources of funds, issuing the securities and managing debt etc.

(2) Banking Function: It includes opening bank accour payment of company liabilities, accounting cash rec responsibility for transacting actual assets etc.

(3) Custody:-The treasurer is the custodian of funds and securities.

(4) Management of credit and collection: The treasurer determines credit risk of customers and arranges for collection.

(5) Investments: It involves the investment of surplus funds.

(6) Insurance: The treasurer signs the cheques, agreement and other letters of company forecasts cash receipts and payments, pay property taxes and follows government regulations.

Functions of controller

The controller performs the following functions:-

(1) Planning: The controller prepares plan for controlling the business activities which are the main constituents of management and in which proper arrangement regarding profit planning, capital expenditure planning, sales forecasting and expenditure budgeting is made.

(2) Accounting: Controller determines the accounting system and arrangements for costing and management accounting systems and prepares financial statements.

(3) Auditing: Controller Manages internal auditing.

(4) Reports: Controller prepares financial reports according to various needs and presents them to the managers. He advises the management to correct the deviation between the standard performance and actual performance

(5) Government Reporting :- Controller sends essential information's to the government by obeying the legal requirement.

(6) Tax Administration: Controller prepares statement on tax liability.

(7) Economic Appraisal: He determines and analyses the effect of economic and social factors on business.

Agency Theory:

Recently, finance academics and practitioners have devoted attention to describing and removing one particular barrier to effective shareholder wealth maximization: the differences in motives between a corporation’s stockholders and its professional managers. These insights are summarized under the title, agency theory.

1. Background to Agency Theory

In agrarian societies prior to the Industrial Revolution, business dealings were quite simple. Most transactions were exchanges between farmers, shopkeepers, craftsmen, etc. Transactions were carried out face to face between parties who of- ten knew each other personally. There was little need to be concerned about whether other parties to a transaction would fulfill their obligations.

With the arrival of the Industrial Revolution, much of this changed. To produce new and often complex products, a variety of labor and material resources had to be brought together. Transactions grew more complicated, many involving relationships between persons who did not know each other. Today, the number, variety, and complexity of goods and services demanded by consumers are immense. It is commonplace for a business to be operating in dozens of locations around the world, producing hundreds of different products, requiring thousands of raw materials and tens of thousands of employees. It is no longer possible to rely on personal relationships to ensure that all these transactions occur as de- sired. It would be very costly to engage in and monitor so many independent transactions; rather, a more formal structure of relationships is required.

The world of business in advanced economies is dominated by corporations. Corporations exist because they provide the formal structure necessary to organize complex transactions and, in doing so, reduce the cost of doing business. As Ronald Coase, the winner of the 1991 Nobel Prize in economics, has written5, firms are formed whenever the cost of making individual transactions exceeds the additional costs of operating within a business. Consider what you would do if you had to arrange for the education of a child. You could enter into separate trans- actions with each teacher, with suppliers of instructional materials, with a land- lord for classroom space, with a caterer for lunch, etc.; but you would probably find it easier to contract with a school to provide all the services. Even with all its internal overhead costs, it is cheaper—in terms of money and effort (and headaches!) — To employ the school. As a result, schools exist to deliver educational services. In the same manner, all corporations exist to deliver products and services cheaply and efficiently.

Principal: a person who employs another to act in his/her behalf

Agent: a person who acts on behalf of and by the authority of another

Agency problem: the possibility that an agent will not act in the best interests of his/her principal

2. The Agency Problem

As useful as corporations are, their existence does introduce a new problem into the maximization of owners' wealth. Recall that shareholders employ professional managers to run the business. Borrowing from legal terminology, we can identify shareholders as a corporation's principals and the firm's professional managers as the shareholders' agents. It is quite possible that the goals of the agents, who make the day-to-day decisions about the direction and activities of the firm, might differ from the goals of the principals. If so, the manager-agents might not act in the best interests of the shareholder-principals to maximize owners' wealth. This is the agency problem.

The **agency problem** arises from a variety of sources. The six problems discussed below are frequently cited.

The time horizon problem: Managers spend a relatively short time in any one position, they have a tendency to slight the long term, favoring decisions that pay off during their tenure on the job over those with longer-term pay- off, for which they might receive no recognition. They are motivated to ignore good opportunities that do not produce measurable returns in the short term and to accept poor opportunities that do well in the short term but ultimately reduce owners' wealth. This is especially true if some portion of managers' compensation is based on the current year's profits. The manager-agents look good and receive their raises and promotions, but at the expense of the shareholder-principals.

The compensation problem: Managers typically have considerable influence over their salaries independent of the "fair" value of their compensation. It is not uncommon to hear of executives who vote themselves large bonuses or other forms of compensation that have no connection to their firm's performance. The manager-agents are well paid, but at the expense of the shareholder-principals.

The perquisite problem: Managers often add to their earnings by increasing the nonmonetary forms of their compensation. They arrange for luxurious offices, company cars, and company-paid vacations. They carry company-paid credit cards which permit them to eat well and regularly attend plays, the opera, or the symphony. The manager-agents increase their overall compensation, but at the expense of the shareholder-principals.

The information problem: Managers are insiders, privy to detailed knowledge about all facets of the firm's operations. Shareholders, on the other hand, are dependent on managers for their knowledge of the firm. As a result, man- agers can limit the information received by shareholders. This information asymmetry (Information asymmetry: the condition in which a firm's manager-agents know more about the firm than its shareholder-principals) allows managers to make decisions without having to be fully accountable to the firm's owners. The manager-agents can get away with making decisions that favor their own interests at the expense of the shareholder-principals.

The risk-preference problem: Managers' attitudes toward risk may differ from shareholders' attitudes. Managers are often unwilling to take on risky opportunities that have a good chance of benefiting the firm's owners. If the opportunity succeeds, the managers will get little of the benefit; but if the opportunity fails, they may lose their jobs. Or the reverse might be true: a manager might take excessive risks not in the shareholders' best interests in the hope of obtaining a large bonus. The manager-agents make decisions that protect or enrich them- selves at the expense of the shareholder-principals.

Agency cost—the reduction in a principal's wealth when an agent does not act in the principal's best interests

Contract—an agreement between parties specifying each party's role in the relationship.

Nexus of contracts—an interconnection of many contracts

The retained earnings problem: Managers may choose to maintain an excessively high level of cash in the business to provide a cushion against a poor economic environment. In this way they avoid being blamed for any cash shortages that might otherwise develop. They retain a higher degree of the firm's earnings than necessary and pay a lower dividend. The manager-agents protect themselves against poor times, but at the expense of the shareholder-principals.

In each of these cases, the agency problem arises because the managers' best interests are not consistently the same as the owners' best interests. The company's owners suffer an agency cost, a reduction in their wealth. By contrast, the agency problem does not exist in a proprietorship, for in that case the manager is the owner—increased management compensation is simply a change in the form of the owner's wealth. Questionable management decisions may turn out to be mistakes, but they are not mistakes motivated by an agent's opportunity to take advantage of a principal.

3. Viewing Relationships as Contracts

Recently a comprehensive theory of agency has been developed in finance. Each relationship within the firm and between the firm and outsiders is seen as a contract, an agreement covering each party's rights and responsibilities. Some contracts are explicit, such as those between the firm and its suppliers, which are in written form and specify each facet of the relationship. Other contracts are implicit, not in written form but understood through verbal agreement and common business behavior, such as the amount of work per day a non hourly employee owes the firm. Contracts often include terms that specify penalties for non performance, for example, lending agreements that stipulate that the lender can claim some of the firm's assets should the firm default on its promise to pay. Agency theory sees the firm as a nexus of contracts, a series of many such agreements between every party within and outside the business.

One advantage of viewing the firm as a nexus of contracts is that it encourages us to focus on the relationships between the various parties within a business. The concept of a contract provides a framework for delineating each relationship, for discovering whether the parties to that relationship are working together in the best interests of the firm, and for examining what the parties are doing to align their goals.

4. Minimizing Agency Costs—Well- Established Approaches

The shareholder-principals of a corporation will want to minimize agency costs, since each dollar of agency cost saved is one more dollar available to them. In response, two broad methods of controlling agency costs have become well established: incentives (the carrot) and threats (the stick). We identify below three classes of incentives and three threats as well as some limitations of these methods.

Incentives: The most common incentives are those that attempt to connect man- agers' compensation directly to increases in shareholder wealth. There are three variations on the theme.

Salary and bonus plans: These approaches base the agent-managers' compensation on objectives that are negotiated at the beginning of the year. Salary plans tie managers' salaries to their achievements. Bonus plans pay managers a base salary plus a bonus based on the company's financial performance.

Stock-related incentives: These approaches reward managers with company stock to sharpen their focus on shareholder wealth. In the typical plan, a man- ager cannot cash out until some time has passed to maintain the manager 's involvement for the longer term.

Dividend units: This approach gives managers a bonus based on future dividends, tying compensation to the cash benefits shareholders receive.

Threats: A variety of oversight and control techniques exist at various levels in most corporations to prevent manager-agents from acting other than in the share- holders' best interests. These include the following mechanisms.

The firm's internal planning and control systems—Planning makes public what is expected of everyone within the corporation, creating a benchmark against which to measure results. Knowing that their actions are subject to scrutiny by their senior management, managers are more careful about doing what is expected of them.

Corporate governance: A corporation's board of directors exists to monitor and control the company's management. Knowing that their actions are subject to the scrutiny of the board of directors—which has direct responsibility for protecting shareholder interests—managers are more careful about developing and executing plans that will maximize shareholders' wealth.

The market for corporate control: A corporation not acting in the best interests of its shareholders will experience a decline in stock price as investors perceive the firm to have less value. This makes it an inviting target for outsiders or frustrated managers who can buy enough shares to win control of the company, throw out board members and managers unresponsive to shareholder interests, and install new directors and managers more willing to act for the shareholders.

Problems with the Traditional Methods of Minimizing Agency Costs:

The problems of using these well-established methods of reducing agency costs have long been recognized. Three broad problem areas stand out.

Dependence on financial measures: Traditional incentive-oriented methods of dealing with agency costs often use profits or stock price as their measure of performance. Managers are encouraged to improve financial metrics over the time horizon most advantageous to them, which may not be in the best interests of shareholders.

Conflictual premise: Traditional threat-oriented methods of dealing with agency costs emphasize the conflicts described by agency theory. In doing so they ig- nore areas of shared interests between principals and agents and discourage the development of win/win approaches to solving the agency problem.

Reliance on the vertical organizational: Traditional approaches to dealing with the agency problem focus on contracts made between senior managers and their subordinates, following the vertical structure of the firm. However, the work of the organization and the relationships crucial for a firm's success are more likely to be horizontal, crossing departmental and functional lines. Building rewards on vertical relationships may discourage collaboration in horizontal relationships.

Interface between Finance and Other Functions

•Marketing-Finance Interface

The Marketing Manager takes many decisions which have a significant impact on the profitability of the firm. For example, he should have a clear understanding of the impact of the credit extended to the customers on the profits of the company. Otherwise in his eagerness to meet the sales targets he is likely to extend liberal terms of credit which may put the profit plans out of gear. Similarly, he should weigh the benefits of keeping a large inventory of finished goods in anticipation of sales against the costs of maintaining that inventory. Other key decisions of the Marketing Manager which have financial implications are pricing, product promotion and advertisement, choice of product mix and distribution policy.

•Production-Finance Interface

In any manufacturing firm, the Production Manager controls a major part of the investment in the form of equipment, materials and men. He should so organize his department that the equipments under his control are used most productively, the inventory of work-in-process or unfinished goods and stores and spares is optimized and the idle time and work stoppages are minimized. If the production manager can achieve this, he would be holding the cost of the output under control and thereby help in maximizing profits. He has to appreciate the fact that whereas the price at which the output can be sold is largely determined by factors external to the firm like competition, government regulations, etc. the cost of production is more amenable to his control. Similarly, he would have to make decisions regarding make or buy, buy or lease, etc. for which he has to evaluate the financial implications before arriving at a decision.

•Top Management-Finance Interface

The top management, which is interested in ensuring that the firm's long-term goals are met, finds it convenient to use the financial statements as a means for keeping itself informed of the overall effectiveness of the organization. We have so far briefly reviewed the interface of finance with the non-finance functional disciplines like production, marketing, etc. Besides these, the finance function also has a strong linkage with the functions of the top management. Strategic planning and management control are two important functions of the top management. Finance function provides the basic inputs needed to undertake these activities

•Economics - Finance Interface

The field of finance is closely related to economics. Financial managers must understand the economic framework and be alert to the consequences of varying levels of economic activity and changes in economic policy. They must also be able to use economic theories as guidelines for efficient business operation. The primary economic principle used in managerial finance is marginal analysis, the principle that financial decisions should be made and actions taken only when the added benefits exceed the added costs. Nearly all-financial decisions ultimately come down to an assessment of their marginal benefits and marginal costs.

•Accounting - Finance Interface

The firm's finance (treasurer) and accounting (controller) activities are typically within the control of the financial vice president (CFO). These functions are closely related and generally overlap; indeed, managerial finance and accounting are often not easily distinguishable. In small firms the controller often carries out the finance function, and in large firms many accountants are closely involved in various finance activities. However, there are two basic differences between finance and accounting; one relates to the emphasis on cash flows and the other to decision making