


Financial Management (University Elective)

Course Instructor: Punita Rajpurohit



Questions



- + Why did you opt for the course financial management?
 - + Will the course contribute to your personal goals, if any?
- 

Course Overview

- +Functional areas of management
- +Operational level – supportive function
- +Managerial level – strategic function
- +Fundamentals of finance management
 - Basic concepts like time value of money, risk, return, NPV etc.
 - Financial decisions

Modules

- +Basics of financial management – introduction to FM and financial system; time value of money; risk and return
- +Financial markets and instruments – banking, insurance
- +Major financial decisions – capital budgeting, cost of capital, leverage, capital structure, sources of finance, dividend decision, working capital management
- +Using spreadsheets in finance – time value of money, capital budgeting

Course Learning Outcomes

- + Understand the significance of financial management to firm performance.
- + Identify the variables important to making financial decisions.
- + Perform primary investment decision analysis.
- + Describe sources of funds and their costs.
- + Perform basic financial analysis using spreadsheets.

Text Book

- + Financial Management (theory and practice) by Prasanna Chandra

Assessment Components and Schedule

- +Quiz 1 (7.5%) – After 8th session
- +Quiz 2 (7.5%) – After 16th session
- +Quiz 3 (7.5%) – After 24th session
- +Quiz 4 (7.5%) – After 36th session
- +Group Assignment (15%) – separate guidelines
- +Class test (15%) – 26th session
- +End semester examination (40%) – As per schedule



Questions? – Starting business



- +How will you start?
 - +What kind of decisions you will have to take?
- 

Financial Decisions in a Firm

Capital Budgeting

- Choose and define business
- Invest in assets
- Identify, evaluate, implement
- Magnitude, timing and riskiness of cash flows
- Options embedded in investment

**Application of
Funds**

Working Capital Management

- Day to day activities
- Current assets
- Current liabilities
- Inventory, credit, cash, investment of surplus cash, short term finance

**Application of
Funds**

Capital Structure

- Means of financing
- Debt and equity
- Optimal proportion, instruments of equity and debt, markets, timing
- Distribution policy – dividend decision
- Cost and flexibility

**Acquisition of
Funds
Distribution**

Scope of Finance/Decisions in Finance

- + Financing decisions – capital structure
- + Investment decision – capital budgeting
- + Dividend decision – distribution of profits
- + Liquidity decision – working capital management

Forms of Organisation

+ Sole Proprietorship

- One owner
- Very simple
- Unlimited liability
- The firm has no separate status from a legal and tax point of view

+ Partnership

- Two or more owners
- Fairly simple
- Unlimited liability
- The firm has a separate status – legal and tax

+ Private Limited Company

- Upto 200 members
- Not too complex
- Limited liability
- A distinct legal person

FORMS OF BUSINESS ORGANISATIONS

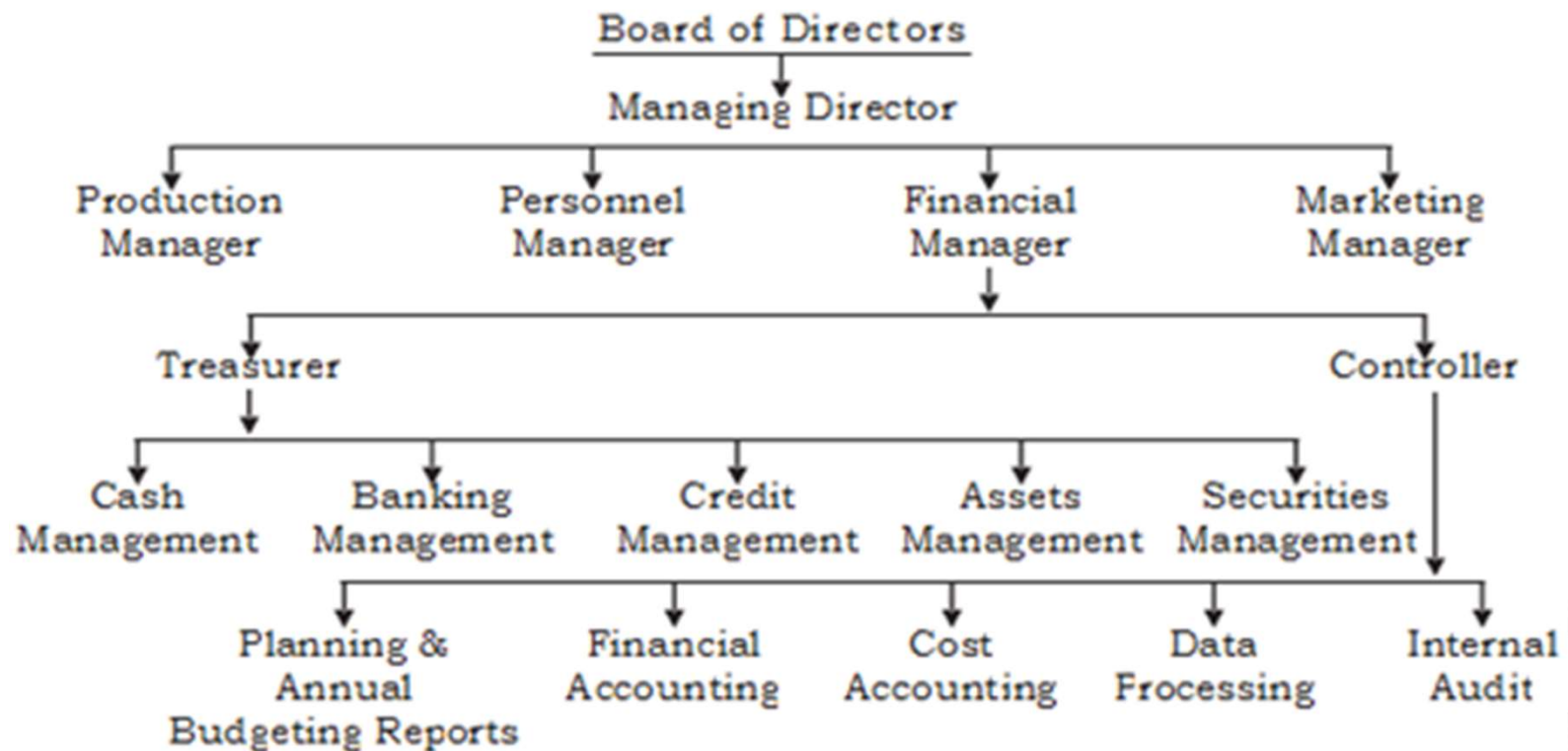
+ Public Limited Company

- + Many owners
- Somewhat complex
- Limited liability
- Distinct legal person
- Free transferability of shares

+ Public Limited Company's Attraction

- Risk dispersion
- The potential for growth is immense because of access to substantial funds
- Investors enjoy liquidity because of free transferability of securities
- The scope for employing talented managers is greater

Organisation of Finance Function



Evolution of financial management

- + Traditional phase – lasted four decades
 - Focus on formation, expansion, merger, liquidation
- + Transitional phase – 1940 to 1950 roughly
 - Emphasis on day to day problems – funds analysis, planning and control
- + Modern phase – 1950 to today
 - Maximizing shareholders' wealth
 - Capital budgeting, CAPM, agency theory, valuation models, dividend policy, financial modeling, behavioral finance

Emerging role of finance manager

- + Investment planning
- + Tax Management
- + Working capital management – Inventory, Receivables, Cash.
- + Mergers, acquisitions, and restructuring
- + Risk management – Exchange rate
- + Investors relations – communication with the external world

Goal of Financial Management

- + Maximization of shareholder wealth
- + Separation of ownership and management
- + Different tastes, wealth, investment horizons, personal opportunities but common objective – maximize market value of firm thereby shareholder wealth
- + Finance theory rests on the premise that managers should manage their firm's resources with the objective of enhancing the firm's market value.

CRITIQUE AND DEFENCE OF SHAREHOLDER WEALTH MAXIMISATION GOAL

Critique

- + The capital market sceptics argue that **stock prices fail to reflect true values**
- + The balancers argue that a firm should seek to **'balance' the interests of various stakeholders**
- + Advocates of social responsibility argue that a business firm must **assume wider social responsibilities**

Defense

- + Financial economists argue that stock prices are **the least biased estimates of intrinsic values** in developed markets
- + Balancing the interests of various stakeholders is **not a practical** governing objective
- + The only social responsibility of business is to **create value and do so legally and with integrity**

ALTERNATIVE GOALS

+ Maximisation of Profit

- + This goal is not as inclusive a goal as maximization of shareholders' wealth. Its limitations are:
- + Profit in absolute terms is not a proper guide to decision making. It should be expressed either on a per share basis or in relation to investment.
- + It leaves considerations of timing and duration undefined.
- + Ignores the factor of risk

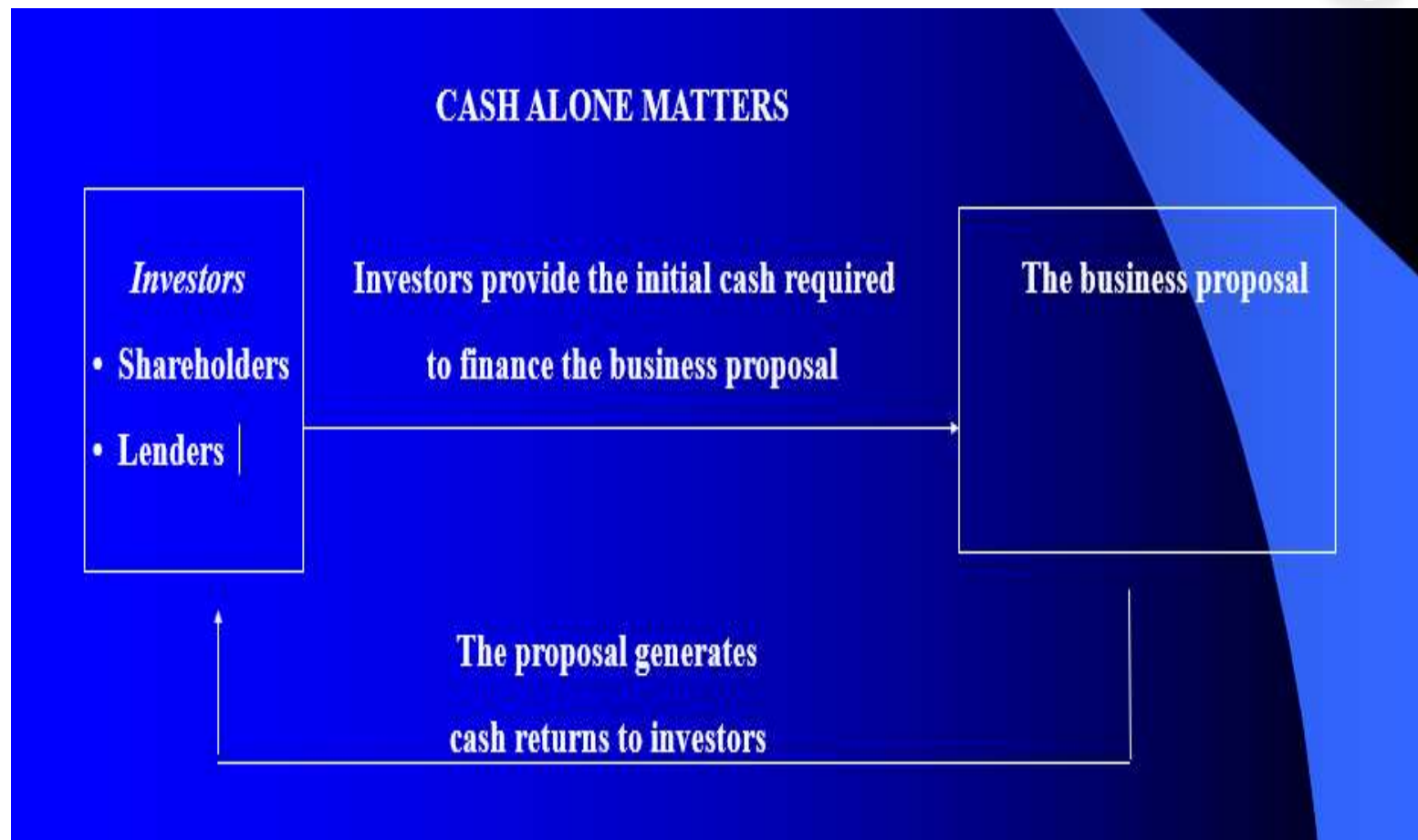
+ Maximisation of EPS or ROE

- + While these goals do not suffer from the first limitation mentioned above, they suffer from the other two limitations.

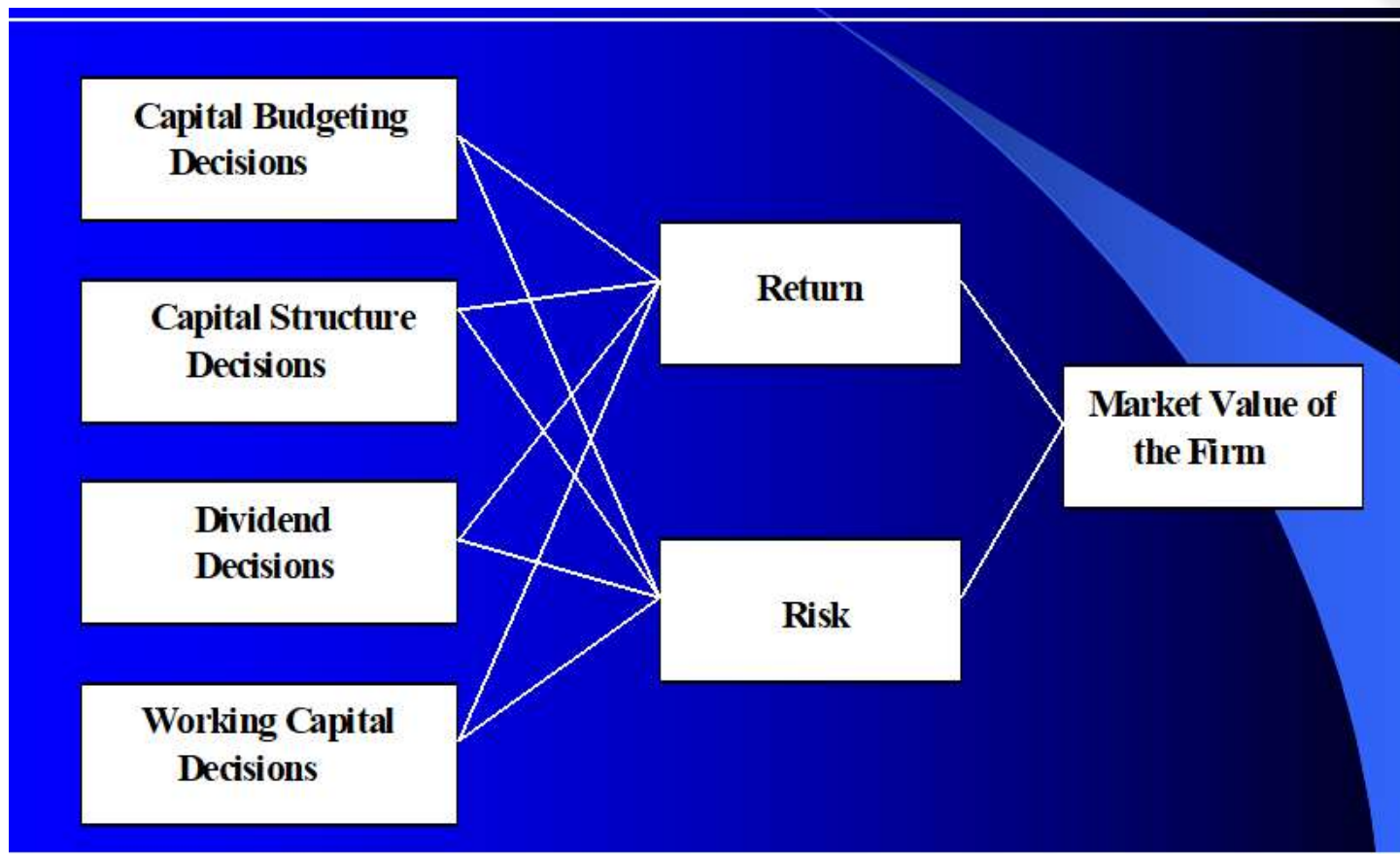
Fundamental Principle of Finance

- +A business proposal-regardless of whether it is a new investment or acquisition of another company or a restructuring initiative –raises the value of the firm only if the present value of the future stream of net cash benefits expected from the proposal is greater than the initial cash outlay required to implement the proposal.
- +Net Present Value (NPV) = Present value of future cash flows – initial cash outlay

Fundamental Principle of Finance



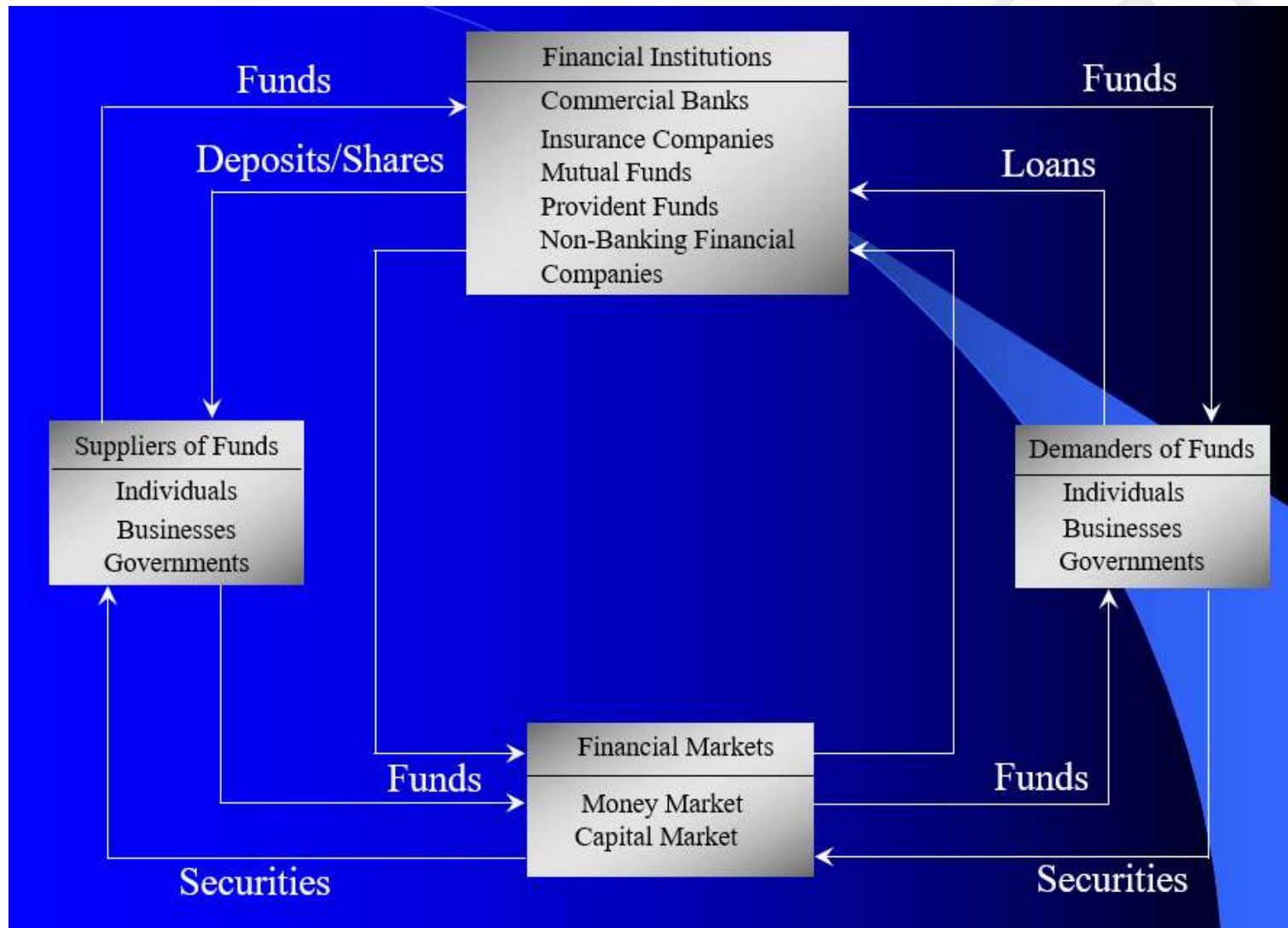
DECISIONS, RETURN, RISK, AND MARKET VALUE



Financial System

- +Financial system provides means for transforming savings into investments and thus allocation of resources
- +Financial manager – raise funds and invest surplus funds
- +Financial decisions are made in the context of a financial system that constrains and facilitates them
- +Financial system comprises of various intermediaries, markets and instruments that are related to each other

Financial System - Interrelationships



Functions of Financial System

- Payment System (banks)
- Pooling of Funds (pool household savings)
- Transfer of Resources
- Risk Management (hedging, diversification & insurance)
- Price Information for Decentralized Decision Making (interest rates, security prices, portfolio allocations)
- Dealing with Incentive Problems (agency problems and information asymmetry)

Financial Assets

Financial assets are intangible assets that **represent claims to future cash flows**. The terms financial asset, instrument, or security are used interchangeably

Examples :

- A 20-year bond issued by the GOI carrying an interest rate of 9 percent.
- Equity shares issued by XYZ Co. to the general investing public through an initial public offering.

Financial Markets

A financial market is a market for **creation and exchange of financial assets**.

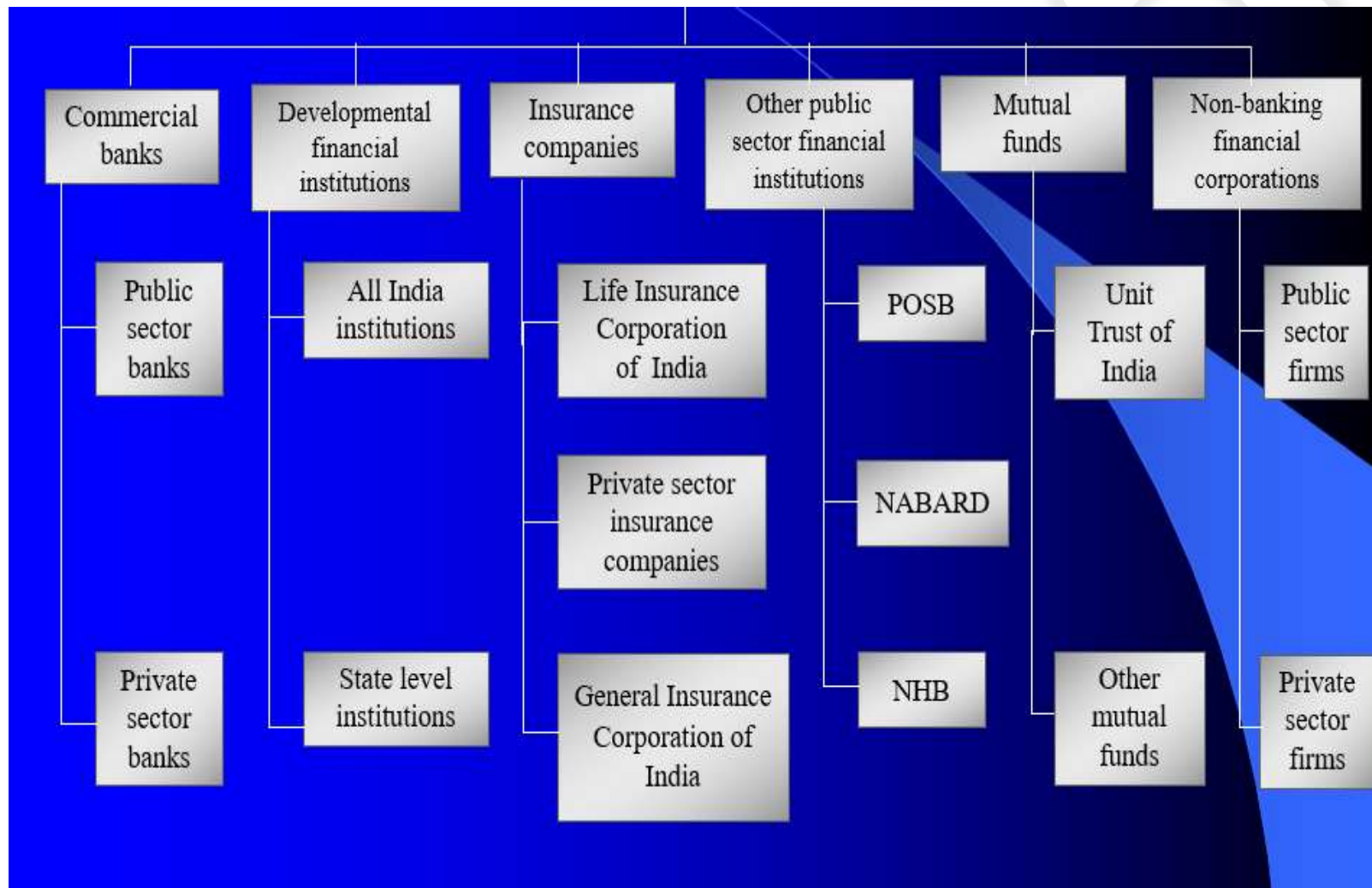
Financial markets play a very pivotal role in allocating resources in the economy by performing three important **functions** as they :

- Facilitate price discovery.
- Provide liquidity.
- Reduce the cost of transacting.

Classification of Financial Markets



Financial Intermediaries





Sources of Long Term Finance

- +Equity Capital
- +Internal Accruals
- +Preference Capital
- +Term Loans
- +Debentures

Working Capital Financing

- Accruals
- Trade credit
- Working capital advance by commercial banks
- Regulation of bank finance
- Public deposits
- Inter-corporate deposits
- Short-term loans from financial institutions
- Rights debentures for working capital
- Commercial paper
- Factoring