Chapter 1

Introduction to Financial Management

An education which does not teach us to discriminate between good and bad, to assimilate the one and eschew the other, is a misnomer.

– Gandhiji, Harijan, 18-2-1939 and 4-3-1939

Meaning – Definition – Scope – Functions – Objectives – Qualities of a Finance Manager – Relationship with other Functional Areas – Organisation of Finance Function – Trading on Equity – Role of Finance Managers – Types of Risks – Case Study and Analysis of the Case Study – Questions for Self-Practice.

Introduction:

Finance is derived from the French word "Finer" which means 'to pay', 'settle' or 'finish'. Business finance can be defined as the activity concerned with the raising and administering of funds used in business.

The term, Finance function in relation to business can broadly be divided into three groups:

(1) The definition of **F. W. Paish** can be put in first group. According to him, "In a modern money – using economy, finance may be defined as the provision of money at the time it is wanted."

The view can be rightly called as "Procurement" view.

(2) The definition of **John J. Hampton** can be put in second category. According to him, "The term finance can be defined as the management of the flows of money through an organisation, whether it will be a corporation, school, Bank or Government agency". It may be summed up as the "custodian function" of finance.

(3) The third approach is concerned with "financial decision-making". In the words of **Howard and Upton,** "Finance may be defined as that administrative area or set of administrative functions in an organisation which relate with the arrangement of cash and credit so that the organisation may have the means to carry out its objectives as satisfactorily as possible."

It is a common knowledge that a business runs on money. Finance is a lubricant that keeps the machinery of business in a continuous state of activity. Finance is the life-blood of various managerial functions, viz., production, marketing, personnel and Research and Development (R & D). Finance is the life-blood of the modern business organisation/ setup. Finance officer in a company, usually known as controller or treasurer, is concerned with the procurement of funds and their effective utilisation in the business.

The functions of finance in a firm may be divided into three major decisions that the firm must make:

(1) The **Investment** Decision: Capital Budgeting.

(2) The **Financing** Decision: Issue of Shares, Debentures, etc.

(3) The **Dividend** Decision: Dividend and Retained Earnings.

Financial Management is that managerial activity which is concerned with the planning and controlling of the firm's financial resources.

The subject of financial management is of immense interest to both academicians and practising managers.

Academicians are interested in this subject because the subject is still developing, and there are still certain areas where controversies exist for which no unanimous solutions have been reached as yet.

Practising managers are interested in this subject because among the most crucial decisions of the firm are those which relate to finance, and an understanding of the theory of financial management provides them with conceptual and analytical insights to make those decisions skillfully.

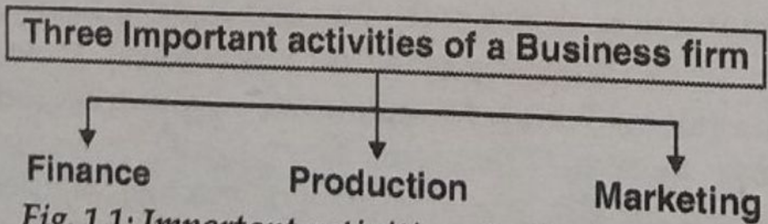

Fig. 1.1: Important activities of a Business Firm

Finance is lifeblood of a modern business enterprise. Adequate availability of finance at a right point of time ensures the smooth functioning of the production and marketing activities.

Scope of Financial Management:

The scope of finance function covers decisions not only for the acquisition of funds but also their effective use.

Financial management is required in the following areas:

(1) **Estimating the requirements of funds:** A careful estimation of the funds required along with the exact timings when such funds are

required has to be made. Such estimation of the funds required can be made only after all the physical activities of the organisation have been forecasted.

(2) **Decision regarding capital structure:** After estimating the requirements of funds a proper mix of the various sources of funds has to be decided. Funds can be raised from various sources such as equity share capital, preference share capital, debentures, term loans from banks and financial institutions, fixed deposits, etc. A proper balance between long-term funds and short-term funds has to be maintained. Also a proper ratio between long term borrowed funds and owned funds has to be maintained.

(3) **Investment decision:** The funds procured from various sources has to be invested in different kinds of assets such as;

(a) Fixed assets.

(b) Current assets e.g. inventory.

Investment decisions in fixed assets is taken through capital budgeting and in case of investment in current assets it is based on credit and inventory policies of the firm.

(4) **Dividend decision:** The finance manager assists the top management in taking the dividend decision. This involves striking a balance between:

(a) Payment of dividend to shareholders.

(b) Retaining a part of the profit in the business itself.

This decision depends upon the investment opportunities and the objectives of the firm.

(5) **Cash management:** Cash management ensures that there is no excessive or shortage of cash. The finance manager has to ensure adequate supply of cash to all departments, branches and units of the organisation at all point of time.

(6) **Evaluation of financial performance:** Management Information and Control Systems (MICS) reviews the financial performance of the entire organisation constantly and it helps in evaluating how the funds have been utilised in various divisions and what can be done to improve it.

(7) **Negotiation for additional funds:** A finance manager has to carry out negotiations with banks, financial institutions, depositors and public by providing a lot of information to facilitate the raising of funds.

(8) **Analysing trends in stock market:** A finance manager has to keep a watch over the stock exchange quotations and behaviour of share

prices. A finance manager has to judge the impact of major trends in the stock market on the prices of the company's share.

Functions performed by Finance Manager:

Finance function may be classified into two groups:

(a) **Executive finance function** – which requires administrative skill in planning and execution.

(b) **Incidental finance function** – for the most part it covers routine work, chiefly clerical, that is necessary to carry into effect financial decisions at the executive level.

Executive Finance Functions: Some of the basic executive finance functions are:

(1) Establishing asset – management policies:

The formation of sound and consistent asset – management policies is an indispensable pre-requisite to successful financial management. The role of financial managers in formulating asset – management policies is not an exclusive one. The determination of asset – management policies includes decisions regarding kinds and coverage of insurance that a company will carry. The financial managers must know, among other things, how much cash will be 'tied up' in the various kinds of non-cash assets. Marketing executives participate in making decisions involving the carrying of inventories of finished goods, customer credit policy, etc. Production managers, likewise, participate in making decisions concerned with the carrying of inventories of raw materials and factory supplies, the purchase or renting of building, machinery and equipment.

(2) Determining the allocation of net profits:

A corporation may be said to have three choices regarding the allocation of net profits after payment of taxes (NPAT):

(a) Pay dividends to the shareholders as a return upon their investment;

(b) Make distributions to people other than the shareholders as to employees in profit – sharing plans; and

(c) Retain earnings for the expansion of business.

As the second alternative is ordinarily made on a large contractual basis or as a matter of fixed policy, the company's continuing free choices in the matter of the use of net profits involve only the other two alternatives, i.e., payment of dividends and the retention of earnings to acquire additional assets.

(3) Estimating and controlling cash flows and requirements:

Since flow of cash originates in sales, therefore the cash requirements are closely related to the volume of sales. A prime responsibility of financial management is to see that an adequate supply of cash is on hand at the proper time for smooth flow of operations of the company.

This function creates an increasing dilemma – the dilemma of **liquidity v/s profitability.**

Ideally the financial manager would like to match the inflow of cash to the outflow of cash so that after providing enough cash to meet current obligations, there would be no idle cash balance earning nothing for the company. But the trouble is that cash inflows are not precisely predictable and seldom offset one another. So the financial manager must keep a cash balance on hand to pay his bills on time. At this point the dilemma sets in. The more he protects his company against risks associated with inability to pay bills on time, the more he loses returns that might have been gained from investment of the idle cash.

(4) Deciding upon needs and sources of new outside financing:

On the basis of the forecasts of the inflow and outflow of cash in the ordinary course of operations, the financial manager should be able to judge rather closely the time when additional funds from outside sources will be needed, how long they will be needed, how best they can be raised, and from what sources they will be repaid. The financial managers, on the basis of their forecasts of the volume of operations, may have to plan upon borrowing to supplement cash flowing from these operations. Borrowings from commercial banks and other financial institutions, and the floatation of debentures is one of the two principal means of outside financing. Another principal method of outside financing is the sale of additional shares.

(5) Carrying on negotiations for new outside financing:

Finance function does not stop with the decision to undertake outside financing, it extends towards carrying on the negotiations to arrange for new outside finance.

Short-term financing requirements are often arranged for on a continuing basis, may be through an establishment of credit with commercial banks. Normally lines of credit are "held open" for not more than a year, hence it is necessary to reopen negotiations annually to continue this arrangement.

The factor of advance planning assumes greater importance in the matter of long-term financing because negotiations and the completion of arrangements for long-term financing always require much more time than does the working out of arrangements for short-term financing.

(6) Checking upon financial performance:

The checking of financial performance in a business deserves much attention in carrying out finance function. It requires retrospective analysis of operating period for the purpose of evaluating the efficiency of financial planning. Analysis of what has happened should be of great value in improving the standards, techniques and procedures of financial control involved in carrying out finance function.

The **incidental (routine) finance functions** are:

(a) Supervision of cash receipts and disbursements and the safeguarding of cash balances.

(b) Custody and safeguarding of securities, insurance policies, and other valuable papers.

(c) Taking care of the mechanical details of financing.

(d) Record keeping and reporting.

(e) Assisting finance executives in the performance of their roles.

The **finance functions** can be divided into **3 broad categories:**

(1) Investment decision,

(2) Financing decision, and

(3) Dividend decision.

In other words, the firm decides how much to invest in short-term and long-term assets and how to raise the required funds. In making these decisions, the financial manager should aim at increasing the value of the shareholders' stake in the firm.

Objective/Goal of Financial Management:

Financial management deals with the planning and control of firm's financial resources.

The most fundamental objective of financial management is wealth maximisation – Whether be a nation's wealth as in the case of public enterprises or wealth of private investors as in the case of private enterprises. In general, the following are the main objectives of financial management which ultimately leads to wealth maximisation in the long run:

(1) **Proper Utilisation of Funds:** The main responsibility of finance managers is to ensure proper utilisation of funds which have been mobilised through various sources. Such funds must be put to best use leading to a value addition.

(2) **Maximisation of Return on Investment (ROI):** It is one of the primary objective of every firm to generate a higher return on investment so that then it need not depend on external borrowings, and at the same time can reward its shareholders in terms of dividends and bonus shares.

Higher levels of Value Addition → Higher Profits → Higher Returns on Investments

(3) **Survival:** To survive means to stay alive. The survival issue is like the question of life and death, therefore it should be given the top

most attention and priority over other objectives. The problem of survival is common to all types of business units and arises due to increased competition, change in consumer behaviour or technology, labour problem and so on. It is an immediate objective of a firm. Survival is the name of the game in today's business world. Every new born firm needs to survive in this competitive business world. A minor wrong move or decision may endanger firm's survival. Even the once powerful and prosperous companies battle it out for their survival in this competitive world.

(4) **Cash Flows:** Another short term or immediate objective of financial management is to ensure availability of adequate cash flow to meet its working expenses such as payment of raw materials, wages and salaries, rent, etc. A healthy cash flow improves an organisation's survival chances. An organisation with good cash flows can take advantage of many opportunities such as availing of cash discounts on purchases, bulk buying, offering credit terms to customers, etc.

(5) **Break-Even Point:** It is one of the important short term objective of financial management. The break-even point refers to a situation when a firm is able to achieve a certain level of sales turnover to cover all costs. There is neither profit nor loss (i.e. TR = TC). Every business must aim to achieve break-even level as early as possible because once this point is achieved then it can begin to make profits sooner or later in the future.

(6) **Minimum Profits:** The firm must be able to earn minimum profits in the short term which must be able to cover up the cost of capital, whether dividends are paid or not. It also motivates owners/management to work hard. All business decisions are influenced by economic considerations like return on capital or profit. In the words of *Peter Drucker*, "Profit is a condition of survival." Profit is the soul of business and it is rightly said that "No Profit no business." Investments in business proposals is made in anticipation of good returns. Profit is justified as a return on investment. If profit is not remunerative, it would make people withdraw their investment and discourage future investors.

(7) **Ensure Co-ordination:** To ensure proper co-ordination in the activities of finance departments with those of other departments in the organisation is one of the very important objective.

(8) **Good Image for the Organisation:** One of the aim of finance department is to bring a good name, reputation, image and goodwill for the firm in the market which will help not only to survive in the short run but also to succeed in the long run even during tough times.

Financial Management Objectives:

Clear objectives are required for wise decision-making. Objectives provide a framework for optimum financial decision-making. In other words they are concerned with designing a method of operating the internal investment and financing of a firm. There are alternative approaches in financial literature regarding objectives. Two of the most widely discussed approaches are:

(1) Profit maximisation approach
(2) Wealth maximisation approach

(1) **Profit maximisation decision criterion:** Under this approach, actions that increase profits should be undertaken and those that decrease profits are to be avoided. In specific operational terms, the profit maximisation criterion implies that the investment, financing and dividend policy decisions of a firm should be oriented towards the maximisation of profits.

The rationale behind profit maximisation as a guide to financial decision making, is due to the following reasons:

(a) Profit is a test of economic efficiency. It provides the yardstick by which economic performance can be judged.

(b) It leads to efficient allocation of resources as resources tend to be directed to uses, which in terms of profitability are the most desirable.

(c) It ensures maximum social welfare. This is so because the quest for value drives scarce resources to their most productive uses and their most efficient uses. The more effectively resources are deployed; the more robust will be the economic growth and the rate of improvement in the standard of living.

The profit maximisation criterion however has been questioned and criticised on several grounds. It suffers from the following limitations:

(a) Profit in absolute terms is not a proper guide to decision making. It has no precise connotation. It should be expressed either on a per share basis or in relation to investment. Also, profit can be long term or short term, before tax or after tax, it may be the return on total capital employed or total assets or shareholders equity and so on. If profit maximisation is taken to be the objective, which of these variants of profit should a firm try to maximise? Therefore, a loose term like profit cannot form the basis of operational criterion for financial management.

(b) It leaves considerations of timing and duration undefined. There is no guide for comparing profit now with profit in future or for comparing profit streams of different durations.

(c) It glosses over the risk factor. Since higher the risk, higher will be the returns and vice-versa. It cannot, for example, discriminate between an investment project, which generates a certain profit of Rs. 50,000, and an investment project, which has a variable profit outcome with an expected value of Rs. 50,000.

(d) **Prof. Drucker** and **Prof. Galbraith** contradict the theory of profit maximisation and observe that exclusive attention on profit maximisation misdirects managers to the point where they may endanger the survival of the business. **Prof. Galbraith** gives the following points to argue his line of reasoning:

(i) it undermines the future for today's profit,

(ii) it shortchanges (reduces) research, promotion and other investments,

(iii) it may shy away from any capital expenditure that may increase the invested capital base against which profits are based, and the result is dangerous – obsolescence of equipment.

In other words, the managers are directed into the worst practices of management.

(2) **Wealth maximisation decision criterion:** This is also known as value maximisation or net present worth maximisation. The focus of financial management is on the value to the owners or suppliers of equity capital. The wealth of the owners is reflected in the market value of the shares. So wealth maximisation implies the maximisation of the market price of shares. It has been universally accepted as an appropriate operational decision criterion for financial management decisions as it removes the technical limitations, which characterize the earlier profit maximisation criterion. Its operational features satisfy all the three requirements of a suitable operational objective of financial courses of action, namely exactness, quality of benefits and the time value of money.

Advantages of Shareholder Wealth Maximisation:

(a) It is a long-term strategy which emphasises on raising the present value of the owner's investment in a company and the implementation of projects that will increase the market value of the firm's securities.

(b) Recognises the risk or uncertainty.

(c) Recognises the timing of returns by taking into account the trade-off between the various returns and the associated levels of risk.

(d) Considers the shareholders return by taking into account the payment of dividend to shareholders.

Ezra Solomon has defined wealth maximisation objective in the following manner: *"The gross present worth of a course of action is equal to the capitalised value of the flow of future expected benefits, discounted (or capitalised) at a rate which reflects the certainty or uncertainty. Wealth or net present worth is the difference between gross present worth and the amount of capital investment required to achieve the benefits."*

Despite the forceful arguments in favour of the goal of maximising shareholder value many have challenged its supremacy. Maximisation of the wealth of shareholders (as reflected in the market value of equity) appears to be the most appropriate goal for financial decision-making.

Profit Maximisation v/s Wealth Maximisation:

Prof. Solomon (Stanford University) has handled the issue of profit maximisation versus wealth maximisation logically. He argues that it is useful to distinguish between profits and profitability. Maximisation of profit in the sense of maximising the wealth accruing to shareholders is clearly an unrealistic motive. *Prof. Solomon* has made a good case for the thesis stating that wealth maximisation also maximises the achievement of these other objectives. *Prof. Solomon* concludes that maximisation of wealth provides a useful and meaningful objective as basic guideline (yardstick) by which financial decisions should be evaluated.

Finance theory rests on the premise that the goal of a firm should be to maximise the value of the firm to its equity shareholders. This means that the goal of the firm should be to maximise the market value of its equity shares – which represents the value of the firm to its equity shareholders.

Profit and Profitability:

Profit refers to the net earnings. In other words it is simply Revenue minus Expenditure. It reflects the actual earnings of the business including any non-operating income or loss. It could be profit after tax or profit before tax.

Profitability reflects the final result of business operation. It refers to the operating net profit i.e. profit before considering non-operating income or expenses. It helps to establish future earning capability of the business. Profit is an absolute figure whereas profitability is in relation to the sales or capital employed.

Thus, loss due to fire would reduce the profit of a business but not the profitability of a business since it is not an operating loss. Similarly any abnormal gain would increase the profit of a business but the profitability would remain the same.

Financial Management Objectives: Hierarchical Arrangement

(1) Maximising Sales/Revenue/Earnings

(2) Maximising Profit

(3) Maximising Return on Sales/on Investments

(4) Maximising Corporate Wealth

(5) Maximising Shareholder Value

(6) Social Acceptability and Recognition.

(7) Maximising Social Wealth

(1) **Maximising Sales/Revenue/Earnings:** The main aim of financial management is to maximise sales thereby boosting revenue and earning levels. Increase in sales and earnings would in turn influence the ROI, thereby meeting the goal of the management.

(2) **Maximising Profit:** Another objective of financial management would be to maximise the profits of the firm. The profit maximisation criterion implies that the investment, financing and dividend policy decisions of a firm should be oriented to the maximisation of profits. Management should undertake actions that increase profits and those that decrease profit should be avoided.

(3) **Maximising Return on Sales/on Investments:** Profit is the difference between the buying and selling price. Financial management aims at maximising the returns on the sales effected by the firm. In case of an efficient firm which maximises the output by using minimum resources at lower cost the profits of the concern goes up. Return on Investments is the relationship of returns (Profits) of a firm to its investments. Rate of return on investments is a better measure of testing the profitability of a firm. Management should frame policies and take decisions that will help to increase the ROI. ROI provides motivation for optimal resource allocation and asset utilisation. A comparison of this ratio with similar firms, with the industry average and over a period of time would provide sufficient insight into how efficiently the long-term funds of owners and creditors are being utilised.

(4) **Maximising Corporate Wealth:** Another objective that the financial management of a firm needs to keep in mind is that of maximising corporate wealth. It is required by the management that wealth of the company is maximised to enhance the overall value of the firm.

(5) **Maximising Shareholder Value:** One of the prime objectives of financial management is to enhance shareholder value. This can be achieved through timely and reasonable dividends and efficient use of the shareholder's equity so as to increase the return on the equity capital and provide benefits to the shareholders.

(6) **Social Acceptability and Recognition:** Businessmen should not be allergic to profit motive but at the same time they should not get addicted to it. In the words of *Henry Ford*, "A business that makes nothing but money, is a poor kind of business." *Richard J. Hoayen* has rightly said, "There is something sick about a person whose only interest is money and the same thing can be said for the company whose sole goal is profit." A business organisation undertaking its socio–economic functions has to co–ordinate its business activities with social wants. Fulfillment of social obligations will help a firm earn a separate image, goodwill and reputation in the society.

(7) **Social Wealth:** The shareholders of a company form a part of the society. Their investments in the company form a large part of social wealth. As the society provides finance to a company, the goal of Financial Management is to maximise the present wealth of the owners i.e. equity shareholders in a company. It is defined as value maximisation. The wealth of the shareholders is represented in the market value of equity shares. The market price of a share serves as an index of the performance of the company. It indicates how well management is doing on behalf of stockholders. The factors that bear upon the market price of stock are the present and prospective future earnings per share, the timing and the risk of these earnings, the dividend and retention policies of the firm and many others. Shareholder's wealth and in turn social wealth is maximised only when the market value of the share is maximised.

Qualities of a Finance Manager:

(1) **Good personality:** Personality is the sum total of mental, physical and social qualities. For the successful performance of various assigned responsibilities good personality plays an important role.

(2) **Intelligence:** A good finance manager should have good educational and technical knowledge more than that of his followers.

(3) **Initiative:** A finance manager should be in a position to do the right thing at the right time without being told by others.

(4) **Innovative:** A finance manager should be innovative and must develop new ways of handling the activities.

(5) **Self-confidence:** A finance manager must have self-confidence which will enable him to solve the problems that he encounters and to face challenging situations.

(6) **Communication skills:** A finance manager has to have effective communication skills as he has to issued orders and instructions to his followers. Also he has to have good negotiation skills to negotiate with banks, financial institutions and other government departments.

(7) **Decision maker:** A finance manager has to take the right decision without causing any delay and loss to the organisation.

(8) **Human skills:** A finance manager need to possess good knowledge of human skills as he constantly interacts with people within as well as outside the organisation.

(9) **Administrative skills:** A finance manager needs to have the ability to plan, to organise, to direct and to control the activities of the finance department.

(10) **Positive thinker:** A finance manager has to be positive thinker so as to formulate appropriate lines of action.

(11) **Vision and foresight:** A finance manager needs to have the required vision and foresight so as to imagine the situation or problems likely to develop in the near future and to take appropriate decisions.

(12) **Technical knowledge:** A finance manager needs to have technical knowledge relating to his area of operation so as to discharge his various duties properly.

(1) Relationship between Finance Function and Production Function:

Production is a process which transforms raw materials into semi-finished goods and semi-finished goods into finished goods. The production manager has to select the best product-mix which is most feasible and profitable. Profit is determined by the best combination of the products. The decisions made by the production managers ultimately affects the financial aspects of the business. Finance manager has to be consulted by the production manager because the total production to be made and the product-mix affects the finance. Production operations cannot be isolated because the level of production ultimately affects the financial position of the firm.

(2) Inter-relationship between the Finance Function and Purchase Function:

Materials accounts for as much as 56 to 69 per cent of the total cost of the products all over the world. Also a huge portion of working capital is in the form of inventories. Of the different types of inventories materials occupy a key position in respect of the amount of investment involved in them. This calls for proper attention to materials management which starts right from the designing stage and ends with optimum consumption of and proper accounting for materials. Purchasing is one of the important functions falling in this chain. Therefore it is essential that the purchasing department must operate very efficiently so that capital is not unnecessarily blocked up. The decisions made by the purchase managers ultimately affect the financial aspects of the business. Purchase operations cannot be isolated and the financial manager has to be consulted. Purchase manager has to take decisions about bulk purchases so as to avail quantity discounts, centralised or decentralised purchasing, avoiding holding excess stock thereby reducing carrying cost and threat of loss due to obsolescence, using techniques like Just-in-Time (JIT) purchase, etc. The purchase requirements ultimately affects the financial picture of the firm.

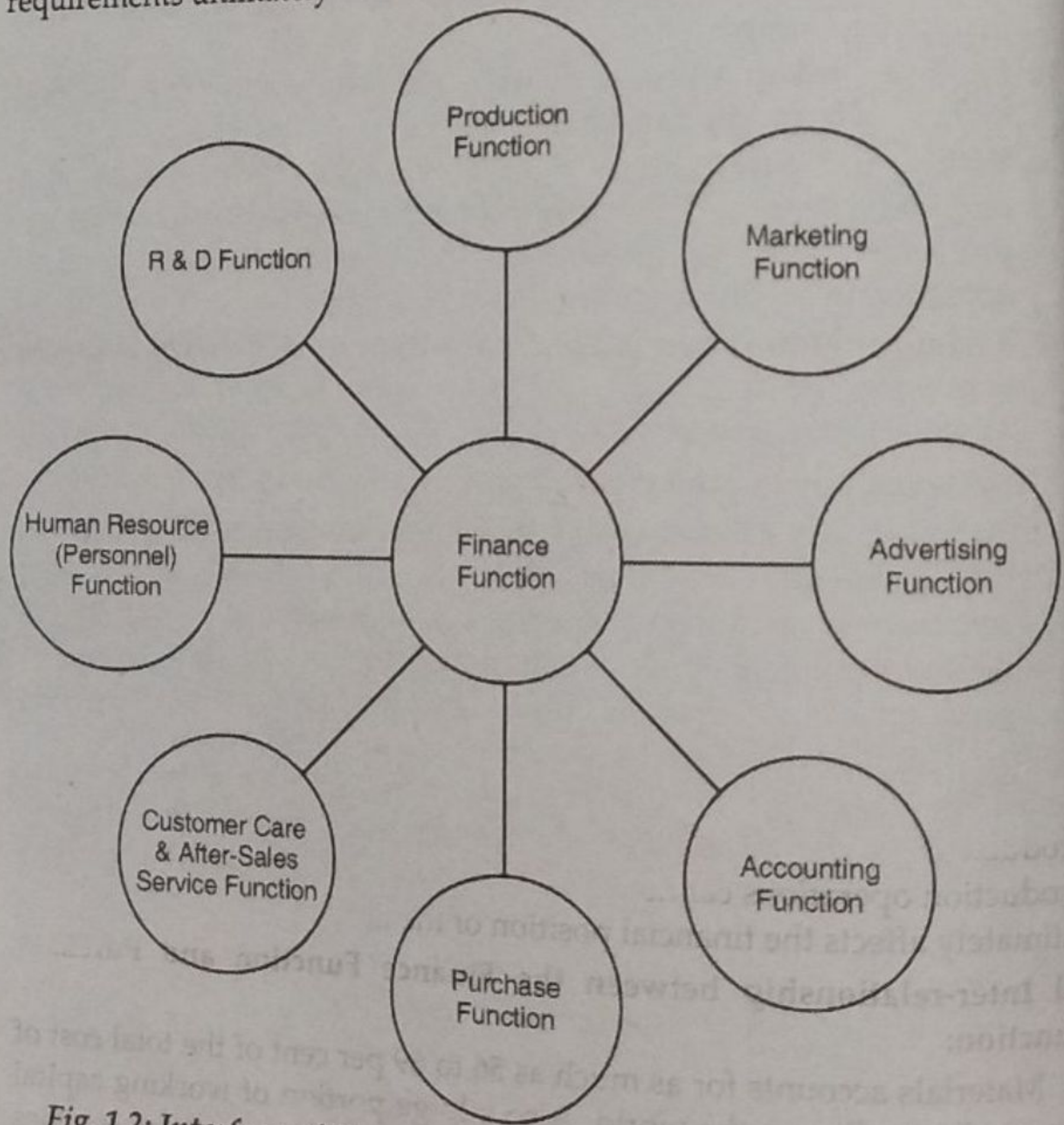

Fig. 1.2: Interface of Finance function with other functional areas

(3) Relationship between Finance Function and Marketing Function:

(a) Finance is required to undertake market research in order to determine the customers' response for the company's products.

(b) Finance is required to pay salary and commission to the salesmen / sales executives.

(c) Finance is required to pay dealers commission and incentives.

(d) Finance is required to train the sales staff and dealers in new product knowledge and selling skills.

(e) Finance is required to recruit and select competent sales staff.

(f) Finance is required to develop a new product, in order to undertake product modification.

(g) It is through the sales revenue that finance flows back into the business.

(h) Finance is required for hiring the media space and time in order to advertise the company's products/services.

(i) Finance is required in order to undertake all forms of sales promotion techniques.

(j) Finance is required in order to distribute free samples.

(k) Finance is required in order to undertake test marketing.

(l) Finance is required for packaging.

(m) Finance is required for brand image building.

(4) Relationship between Finance Function and Human Resource (Personnel) Function:

(a) Finance is required in order to recruit and select competent employees in an organisation.

(b) Finance is required for training and development of the employees at all levels in all job related skills.

(c) Finance is required in order to retain competent staff in an organisation.

(d) Finance is required in order to pay salaries and wages to the employees.

(e) Finance is required in order to pay bonus, provide all forms of non-monetary benefits and perquisites like medical reimbursement, paid leave, L.T.A., free accommodation, etc.

(f) Finance is required in order to give increment and all forms of monetary incentives to employees at all levels.

(5) Relationship between Finance Function and Research and Development (R & D) Function:

(a) Finance is required for new product development and launching it in the market.

(b) Finance is required for undertaking market research in order to determine consumers response towards the product.

(c) Finance is required for undertaking innovations and laboratory testing of the products.

Finance management aims at generating profits. Every action of a finance manager must aim at improving the profits and reducing the losses. It is termed as the **"MINIMAX"** principle which means minimize the losses and maximize the profits. Financial management aims at using outsiders funds in order to generate higher returns to the shareholders who are the true owners in a company form of business organisation. Finance manager should aim at increasing the EPS, DPS and MPS which will help in achieving the end objective of financial management, i.e. maximization of shareholders wealth.

(6) Relationship between Finance Function and Advertising:

Finance is required in media planning, hiring the media space and time for advertising, conducting advertising research, studying the effectiveness of an advertising campaign, etc. Finance is needed for payment to the advertising agencies for creating an advertisement. It is also required to pay to the models for shooting in an advertisement campaign. Good advertisement creates a positive impact and good recall in the mind of the audience and helps in generating more finance in the form of higher sales revenue.

(7) Relationship between Finance Function and Accounting:

Finance is required by the accounts department in order to pay salaries to the staff working in accounts department. For maintaining up-to-date accounting records in a systematic data processing systems such as computers, installation and maintenance of accounting software programmes, printing of books of accounts and other statements, finance is required.

(8) Relationship between Finance Function and Customer Care and After – Sales – Service:

Finance is required in order to understand the needs and satisfaction level of the customers. Customers grievances need to be understood and to set up consumer grievance cell finance is necessary. In order to provide after-sales-service such as free door-step delivery, installation, training regarding usage of products, mainly in case of consumer durables and industrial products finance is required.

Organisation of Finance Function:

In a corporate form of an organization the shareholders who are the owners of the business appoints the Board of Directors who in turn appoints the Managing Director who in turn will have control over the General Manager. All functional heads including the head of the finance department will be reporting to the General Manager. Finance Manager would be assisted by two sub-ordinates, i.e. the treasurer and the controller. The role of treasurer is to bring finance from outside within the organization and the role of the controller is to control the finance within the organization and to curtail wasteful expenditure.

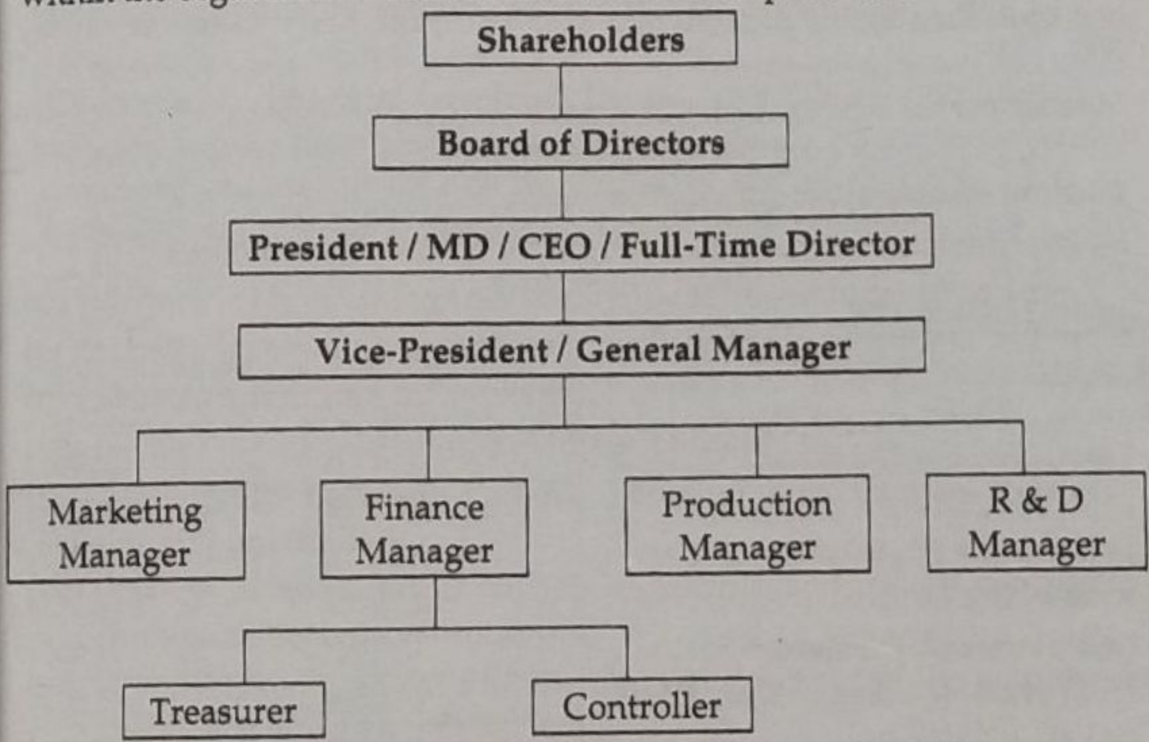

Fig. 1.3: Organisational Structure of Finance Function

Conclusion:

The company should move from profit maximisation to wealth maximisation since the ultimate objective of financial management is maximisation of wealth of the shareholders. Thus the suggested action plan will help in improving the goodwill of the company, more money in the hands of the employees, value to the shareholders and dynamism to the management.

Trading on Equity:

Trading on equity means using borrowed funds carrying a fixed charge in the expectation of obtaining a higher return to the equity shareholders.

Illustration:

Source	Situation (I) (Rs.)	Situation (II) (Rs.)
Equity Share Capital	10,00,000	2,00,000
8% Preference Share Capital	–	3,00,000
10% Debentures	–	5,00,000
Total Capital Employed	10,00,000	10,00,000
Amount Net Profit before Tax	3,20,000	3,20,000

Income Tax @ 30%

The above illustration will make the concept of Trading on Equity very clear.

In situation – I the total capital employed is Rs. 10 lakhs which is entirely financed by Equity Share Capital. The annual net profit before tax is Rs. 3,20,000. In this case there is no Debentures and preference shares and therefore there is no debenture interest and preference dividend.

Income Statement:

Particulars	Situation I (Rs.)	Situation II (Rs.)
NPBIT	3,20,000	3,20,000
Less: Interest on Debentures	Nil	50,000
NPBT	3,20,000	2,70,000
Less: Income Tax @ 30%	96,000	81,000
NPAT	2,24,000	1,89,000
Less: Preference Dividend	Nil	24,000
Profit available to Equity Shareholders	2,24,000	1,65,000
Return on Equity	22.4%	82.5%

Income tax rate is @ 30%. The profit available to Equity Shareholders is Rs. 2,24,000. The return on equity is 22.4%.

$$\text{ROE} = \frac{2,24,000}{10,00,000} \times 100 = 22.4\%$$

In situation – II the total Capital employed is the same i.e. Rs. 10 lakhs; comprising of Equity Share Capital Rs. 2 lakhs; Preference Share Capital Rs. 3 lakhs and the balance Rs. 5 lakhs by way of Debentures.

The interest on Debentures = Rs. 5,00,000 × 10% = Rs. 50,000.

The Preference dividend = Rs. 3,00,000 × 8% = Rs. 24,000.

The profit available to Equity Shareholders is Rs. 1,65,000. The return on equity is 82.5%.

$$ROE = \frac{1,65,000}{2,00,000} \times 100 = 82.5\%$$

Trading on Equity is a Concept where a firm operates with less proportion of equity shareholders funds and more proportion of borrowed funds and thus helps in maximising the returns on the owners funds. Every action that helps in increasing the returns on the owners funds must be undertaken by the finance manager because the ultimate objective of financial management is wealth maximisation of the shareholders. Trading on Equity can be successfully used by only those companies with stability in their earnings or increasing earning year after year.

But it cannot be successfully used by companies with fluctuating earnings year – to – year. Trading on equity helps in generating higher returns to the shareholders by utilizing the benefits of low cost borrowed funds. Only Companies with higher earnings ability than its cost of capital can utilize this concept effectively.

Had the firm not financed itself as indicated in situation – II by less proportion of equity Capital and more proportion of fixed returns bearing securities, then its returns on equity would have been only 22.4% as indicated in situation – I. It is only because of low cost debentures and preference capital that the firm is able to generate a returns of 82.5% much higher than that of situation – I. This concept is known as Trading on Equity i.e. using the funds carrying a fixed rate of returns in order to generate a higher returns to the equity shareholders.

Role of Finance Managers:

(1) **In the traditional days:** Traditionally the role of the finance manager was concerned only with raising of the required funds in an enterprise. This approach is also known as the traditional approach. It covered the instruments, institutions, practices through which funds are raised as well as the legal and accounting relationships between the company and its sources of funds. The traditional approach to finance was prevalent during the 1940's and early 1950's. However, it could not last for long because of its shortcomings. This approach did not emphasise on decision making within the firm. The function of efficient employment of resources was totally ignored. It laid emphasis on the external sources of long term finance and considered the aspect of an outsider lender.

(2) **In the Modern days:** Due to the inherent limitations of the traditional approach in finance the modern approach came into existence. According to the modern approach the concept of finance

is concerned not only with the optimum way of raising of funds but also their proper utilization in time and at the low cost in such a manner that each rupee is made to work at its optimum without endangering the financial solvency of the firm. The modern approach to finance is concerned with:

(a) Determining the total amount of funds required in the firm;

(b) Allocating these funds, efficiently to the various assets;

(c) Obtaining the best mix of financing – i.e. type and amount of corporate securities,

(d) Use of financial tools to ensure proper and efficient use of funds.

Functions of Controller and Treasurer:

Vice – President Finance

Controller (Internal Matters)	Treasurer (External Matters)
(1) Planning and control	(1) Provision of Finance
(2) Reporting and Interpreting	(2) Investor Relations
(3) Tax Administration	(3) Short – term financing
(4) Government Reporting	(4) Banking and Custody
(5) Protection of Assets	(5) Credit and Collections
(6) Economic Appraisal	(6) Investments
	(7) Insurance

Fig. 1.4: Functions of Controller and Treasurer

Emerging role of Finance Manager in India:

The changes that have taken place in the last two decades in India have made the job of a finance manager more important, complex and demanding and there is a shift in the attitude from "my accountant" to the person at the top management level.

In this 21st century with new hopes and new expectations, it is imperative and needs to be appreciated that the world around us is changing rapidly, throwing open great challenges and innumerable opportunities. Driven by the growing trend of globalisation, the revolutionary developments in Information Technology and the emergence of the digital era, the world is witnessing phenomenal changes in the world of finance. In the emerging scenario, finance professionals will be operating in a totally new financial landscape of atoms and electrons.

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Businesses all over the world are living in an age of uncertainty. This is a time when traditional rules are no longer applicable. Survival and success in such an age depend on the ability to be creative, flexible and adaptable. And even in that there are no defined models that can be followed. The best course is to simply trust your own instincts, stay away from conformity, set your own rules and embrace challenges. This means treading untrammeled roads in every aspect of business. Be it developing new products or services, carving out new relationships with old customers – external or internal, strengthening core businesses or boldly going into new areas.

All this demands risk-taking of the strategic kind – where you step into untested waters, but those that reflect your core strengths and those that will help you deliver more to your customer and investor. And as you walk along these less travelled roads, you find your skills further honed to take on the unexpected.

Finance which is at the heart of any business is to be well understood by all managers so that the organisation achieves its major goal, namely to maximise shareholders' wealth. The far-reaching developments in the world of finance have redefined the role of the finance manager, placing a premium on well-trained young men and women possessing superior professional skills in financial analysis and management.

Important changes are:

(1) The economic policies have changed since 24th July, 1991 with the introduction of the New Economic Policy – 1991.

(2) SEBI has allowed free pricing of the securities through 100% Book building route.

(3) FERA has been replaced by FEMA.

(4) MRTP Act has been replaced by the Competition Act.

(5) Companies are given considerable freedom in order to decide the face value of their securities.

(6) Several changes and reforms has been introduced by SEBI in the capital markets.

(7) A number of new financial instruments have come into existence for raising the funds from the capital markets.

(8) The Indian rupee has been made fully convertible.

(9) Indian rupee is becoming stronger against the US Dollar and other foreign currencies.

(10) Interest rate restrictions have been relaxed by RBI. Also there is existence of floating interest rates along with the traditional fixed interest rates.

Types of Risks:

(1) **Credit Risk / Default Risk:** Credit risk is the possibility that the borrower / debtor will fail to repay the loan instalments or the value of the goods on time. Credit risk is also known as default risk.

(2) **Interest Rate Risk:** Interest rate risk is the risk due to increase in the bank interest rates or decrease in the interest rates on deposits.

(3) **Business Risk:** Business risk means the risk of failure of a particular business resulting in decline in the firm's earnings. It may be caused due to decline in the sales of a particular product line. Business risks may be caused due to external or internal factors. External business risks is due to conditions beyond its control whereas internal business risks is due to operational inefficiency.

(4) **Inflation Risk:** The possibility that increase in the cost of living will reduce or eliminate the returns generated.

(5) **Industry Risk:** The possibility that the performance of a single industry would decline due to certain developments in that industry.

(6) **Liquidity Risk:** Liquidity risk arises from the inability to convert an investment into cash quickly. Liquidity is a very important feature of marketable securities.

(7) **Systematic Risk / Undiversifiable Risk:** Systematic risk is the fluctuation in an investments returns attributable to changes in the broad social, economic or political factors which influence the return on investment. Systematic risk is undiversifiable risk and investors cannot avoid such a risk arising from the factors like inflation, money supply, level of government spending, level of rainfall, etc. which are economy wide factors.

(8) **Unsystematic Risk / Diversifiable Risk:** Unsystematic risk is also termed as diversified risk. Such a risk is the variation in returns due to factors which are related to the individual firm / security. It arises due to factors which are specific to a particular firm such as labour strikes, plant break down, stoppage of raw materials, etc. It is possible to reduce unsystematic risk hence it is termed as diversifiable risks. In investment management combining securities into diversified portfolios reduces such a risk.

It is based on the principle of "Don't put all the eggs in the same basket", diversify it. Since diversification reduces the risk.

Case Study – I

M/s. Sona Chandi Heera Ltd. is a Stock Exchange listed Company making good profits every year. However the Board of Directors are very conservative and has declared dividend at fixed rate of Rs. 2 per share, when EPS is always above Rs. 25 for last five years. The last bonus issue was made six years ago. The salary packages are also not attractive. As a result there is a high turnover of employees and low volume of company's shares on bourses. The young members of the Directors family wish to make the company more dynamic, employee friendly and darling of shareholders so as to make it: most valued one. What steps you would suggest to achieve these objectives?

(M.U., BMS, Oct. 2004)

Solution: Name of the Company: M/s Sona Chandi Heera Ltd.:

(I) **Facts:**

(1) M/s. Sona Chandi Heera Ltd. is a stock exchange listed company.

(2) The company is making good profits every year.

(3) The Board of Directors have declared a DPS of Rs. 2 when the EPS is always above Rs. 25 for last five years.

(4) The previous bonus issue was made six years ago.

(5) The company's salary packages are not attractive.

(6) There is a very high turnover of employees.

(7) Low volume of company's shares being traded (on bourses).

(8) Young members of the Directors family express their interest in making the company more dynamic, employee friendly and darling of the shareholders so as to make it most valued one.

(II) **Observation:**

(1) The company is a reputed company since its shares are listed on the stock exchange.

(2) The company has a track record of consistent profits every year.

(3) The Board of Directors adopts a conservative dividend policy.

(4) The dividend payout ratio of the company is 8% for the last five years.

(5) In the last five years the company has been retaining 92% of its earnings.

(6) There is a scope for bonus issue since the company has been retaining above Rs. 23 per share every year for the last five years and also the last bonus issue was made six years ago.

(7) Due to low image of the company and less volume of shares of the company, low volume of company's shares are traded on the stock exchanges.

(8) Due to unattractive salary packages there is high employees turnover which is not a good sign for the company's future prospects.

(9) Since the young members of the Directors family are expressing their interest in making the company most valued one there is a possibility of flow of new ideas, vision, thinking in the company.

(III) Suggestions/Steps:

Suggestions to the management would be:

(1) Enhance **dividend payout ratio** which is at present very low just 8% in the last five years. Since shareholders invest in a company's shares with an expectation of higher returns in the form of dividends.

(2) Make liberal **bonus issues** at regular intervals. Bonus issue will increase the volume of shares traded with higher dividend payout ratio and bonus issue the prices of the shares in the stock markets will come in a popular range and more volume of the shares will be traded on the stock exchange.

(3) Revise the pay structure. Increased salary packages will help in reducing employees turnover.

(4) Also non-monetary incentives, employees training, motivation, employees participation in management through suggestion schemes, etc. can be used in order to reduce employees turnover.

(5) The company should aim at retaining employees loyalty and building confidence amongst the shareholders rather than increasing EPS.

(IV) Conclusion:

The company should move from profit maximisation to wealth maximisation since the ultimate objective of financial management is maximisation of wealth of the shareholders. Thus the suggested action plan will help in improving the goodwill of the company, more money in the hands of the employees, value to the shareholders and dynamism to the management.

Points to Remember

(1) Finance is the life-blood of the modern business organisation.

(2) Finance manager is concerned with the procurement of funds and their effective utilisation in the business.

(3) Finance functions may be divided into executive and incidental finance functions.

(4) The ultimate goal of financial management is wealth maximisation of the shareholders.

(5) The qualities of a finance manager are intelligence, self-confidence, communication skills, administrative skills, etc.