Chapter 1

Financial Management: An Overview

LEARNING OBJECTIVES

After studying this chapter you should be able to:
- Discuss the various forms of business organisation.
- Describe the three broad areas of financial decision making.
- Defend the goal of shareholder wealth maximisation.
- State the fundamental principle of finance.
- Describe the building blocks of modern finance.
- Describe the agency problem in finance.
- Explain what is meant by corporate social responsibility.
- Show how the finance function is organised.
- Elucidate the relationship of finance to economics and accounting.
- Describe the emerging role of financial manager in India.

Suppose you are planning to start your own business. No matter what the nature of your proposed business is and how it is organised, you will have to address the following questions:
- What capital investments should you make? That is, what kinds of real estate, machineries, R & D programmes, IT infrastructure, and so on should you invest in?
- How will you raise money to pay for the proposed capital investments? That is, what will be the mix of equity and debt in your financing plan?
- How will you handle the day-to-day financial activities like collecting your receivables and paying your suppliers?

While these are not the only concerns of financial management, they are certainly the central ones.

This book discusses the theories, analytical methods, and practical considerations that are helpful in addressing various issues in financial management, a discipline that has assumed great significance in recent times. It also describes the financial environment in which the business operates.

Before we begin our odyssey, let us get a bird's eye view of financial management, also referred to as *corporate finance* or *managerial finance*. This chapter provides such an overview.

1.1 FORMS OF BUSINESS ORGANISATION

All firms face the basic problems of capital budgeting, capital structure, dividend policy, working capital management, and financial control. However, these issues tend to be more complex for companies than for other forms of organisation.

Since this book focuses primarily on financial management of companies - note that large firms are almost invariably organised as companies - you should know how a company differs from other forms of business organisation like sole proprietorship, partnership, and cooperative society.

Sole Proprietorship A sole proprietorship firm is a business owned by a single person. This is the simplest form of business, subject to minimal regulation. You can set up a sole proprietorship firm by obtaining a license, if the same is required for the business you want to engage in, and throwing open your doors. Thanks to its simplicity, most businesses begin as sole proprietorship firms. No wonder there are more sole proprietorships than any other form of organisation.

From a legal and tax point of view, a sole proprietorship firm has no separate status apart from its owner. The owner realises all the profits and bears all the losses. The owner indeed has unlimited personal liability for the debts of the business. By the same token, there is no distinction between business and personal income and all business income is taxed as personal income.

The equity capital of a sole proprietorship is limited to the personal wealth of the owner. Hence such firms often cannot grow beyond a point for want of capital. It may be somewhat difficult to transfer the ownership of a sole proprietorship firm as it involves sale of the entire business to the buyer.

Partnership A partnership firm is a business owned by two or more persons. It may be viewed as an extension of sole proprietorship. The partners bear the risks and reap the rewards of the business.

Generally, a partnership comes into being with the execution of a partnership deed that specifies, *inter alia*, the capital contributions, shares, rights, duties, and obligations of the partners. In India, partnerships are governed by the Indian Partnership Act, 1932. This legislation regulates the relationship between the partners *inter se* as well as between the partners and the parties dealing with the partnership firm.

A partnership firm is a distinct legal and tax entity. It can pay interest and remuneration to the partners and claim the same as tax-deductible expenses. Of course, these incomes are taxable in the hands of the partners. The tax rate applicable to the net profit of the partnership firm is presently 30 percent.

While a partnership firm can benefit from the varied experience and expertise of the partners and draw on their combined capital resources, its advantages and disadvantages are more or less similar to that of a sole proprietorship firm.

Limited Liability Partnership Recently a new form of business organisation called Limited Liability Partnership (LLP) was introduced in India. Its distinctive feature is that it is a partnership firm wherein the liability of the partners is limited. An LLP must have at a minimum two partners and at least one of them should be an Indian resident. The partners are accountable for regulatory and legal compliance. The rights and duties of the partners are governed by the agreement between the partners or between the LLP and the partners.

Since the LLP is treated as a firm, it does not have to pay the minimum alternative tax on book profits and the dividend distribution tax. The interest that an LLP can pay on the investments made by the partners is limited to 12 percent of the total income of the LLP.

The remuneration can be paid to the partners as per the slabs fixed under the law. The net profit of the LLP would be taxed at 30 percent. The partners, of course, have to pay taxes for their interest and remuneration received from the LLP.

Cooperative Society A cooperative society may be defined as "a society which has as its objective the promotion of economic interests of its members in accordance with cooperative principles."

The key features of a cooperative organisation are as follows: (a) While there is no maximum limit for membership, a minimum of ten members are required to form a cooperative society. The members of a cooperative society are its owners. (b) The management of a cooperative society is vested in the hands of the managing committee elected by members on the principle of 'one member, one vote'. (c) The dividend payable on the capital contributed by members is subject to a ceiling of 9 percent. The surplus left after the dividend payment is distributed in the form of bonus which is linked to the volume of business done by members with the society.

The advantages of a cooperative organisation are as follows: (a) It can be formed easily. (b) The liability of the members is limited. (c) Grants and financial assistance are provided by the government to cooperative organisations.

The disadvantages of a cooperative organisation are as follows: (a) Cooperatives cannot ordinarily employ outside talent. (b) Members do not have an incentive to provide capital because the dividend rate is low and the principle of 'one member, one vote' is followed. (c) Often, influential members exploit the cooperative society for personal gains.

Company A company is collectively owned by the shareholders who entrust the task of management to their elected representatives called the directors. The salient features of a company are as follows:

- The company is a distinct legal "person", separate from its owners, the shareholders. It can own assets, incur liabilities, enter into contracts, sue and be sued in its name.
- There are two basic requirements for registering a company: (i) The proposed name of the company must be approved by the Registrar of Companies (ROC) of the state in which the company plans to have its registered office. (ii) The Memorandum of Association (which defines the constitution of the company, the objective, and the scope of activities of the business) and the Articles of Association (which specify the rules and regulations for internal governance) have to conform to the provisions of the Companies Act and be approved by the ROC.
- The liability of the shareholders of a company is limited to the share capital subscribed to by them. Once this amount is fully paid up, they have no further obligation.

- A company must pay taxes on its profits. Moreover, shareholders of the company are liable to pay taxes on the dividend received by them.[1] So, in effect, there is double taxation.
- Setting up and managing a company is more complicated than setting up and managing other forms of organisation because companies are governed by the Indian Companies Act, a very elaborate and comprehensive piece of legislation.

A company may be a private limited company or a public limited company. The key differences between them are as follows:

- A private limited company must have at least two shareholders (members) whereas a public limited company must have at least seven shareholders. While there is no limit on the number of shareholders of a public limited company, the number of shareholders of a private company cannot exceed fifty.
- A public limited company invites members of the public to subscribe to its shares, whereas a private limited company cannot do so.
- A public limited company permits free transfer of shares whereas a private limited company usually imposes restrictions on such transfers.

On the whole, the public limited company is the most appropriate form of business organisation, except, of course, when the business is small. The reasons are: (a) The risk to investors is limited. (b) The potential for growth is immense because of access to substantial funds. (c) Investors enjoy liquidity because of free transferability. Thanks to these advantages, large and medium-sized businesses are generally organised as public limited companies. Reliance Industries, State Bank of India, Ranbaxy Laboratories, and Infosys Technologies, for example, are public limited companies. So are overseas businesses such as General Electric, Intel, British Petroleum, Sony, and Asea Brown Boveri.

To identify that a firm is a company, the following letters are used after its name: Inc. in the United States, PLC for a public company in the United Kingdom, LTD for a private company in the United Kingdom, AG for a public company in Germany, GmbH for a private company in Germany, SA in France, SpA in Italy, NV in the Netherlands, and AB in Sweden.

1.2 FINANCIAL DECISIONS IN A FIRM

As mentioned in the beginning of this chapter, there are three broad areas of financial decision making viz., capital budgeting, capital structure, and working capital management.

Capital Budgeting The first and perhaps the most important decision that any firm has to make is to define the business or businesses that it wants to be in. This is referred to as strategic planning and it has a significant bearing on how capital is allocated in the firm. As strategic planning calls for evaluating costs and benefits spread out over time, it is essentially a financial decision making process.

Once the managers of a firm choose the business or businesses they want to be in, they have to develop a plan to invest in buildings, machineries, equipments, research and development, godowns, showrooms, distribution network, information infrastructure, brands, and other long-lived assets. This is the capital budgeting process.

[1] Presently in India, however, shareholders are not liable to pay any tax on the dividend received by them. Rather, the company itself has to pay taxes on the dividend paid by it. This is, of course, in addition to the taxes it pays on its profits.

Considerable managerial time, attention, and energy is devoted to identify, evaluate, and implement investment projects. When you look at an investment project from the financial point of view, you should focus on the magnitude, timing, and riskiness of cash flows associated with it. In addition, consider the options embedded in the investment projects.

Capital Structure Once a firm has decided on the investment projects it wants to undertake, it has to figure out ways and means of financing them.

The key issues in capital structure decision are: What is the optimal debt-equity ratio for the firm? Which specific instruments of equity and debt finance should the firm employ? Which capital markets should the firm access? When should the firm raise finances? At what price should the firm offer its securities?

An allied issue is the distribution policy of the firm. What is the optimal dividend payout ratio for the firm? Should the firm buyback its own shares?

Capital structure and dividend decisions should be guided by considerations of cost and flexibility, in the main. The objective should be to minimise the cost of financing without impairing the ability of the firm to raise finances required for value creating investment projects.

Working Capital Management Working capital management, also referred to as short-term financial management, refers to the day-to-day financial activities that deal with current assets (inventories, debtors, short-term holdings of marketable securities, and cash) and current liabilities (short-term debt, trade creditors, accruals, and provisions).

The key issues in working capital management are: What is the optimal level of inventory for the operations of the firm? Should the firm grant credit to its customers and, if so, on what terms? How much cash should the firm carry on hand? Where should the firm invest its temporary cash surpluses? What sources of short-term finance are appropriate for the firm?

1.3 GOAL OF FINANCIAL MANAGEMENT

Much of the theory in corporate finance is based on the assumption that managers should strive to maximise the value of the firm. The value of the firm is equal to the value of its equity and debt claims. Under normal circumstances the value of the debt claims remains fairly stable. So maximising the value of the firm is equivalent to maximising the value of equity. This goal has been eloquently defended by distinguished finance scholars, economists, and practitioners. Here is a sampling of their views:

"In a market-based economy which recognises the rights of private property, the only social responsibility of business is to create value and do so legally and with integrity. It is a profound error to view increases in a company's value as a concern just for its shareholders. Enlightened managers and public officials recognise that increases in stock prices reflect improvement in competitiveness - an issue which affects everyone who has a stake in the company or economy."[2]

"Should a firm maximise the welfare of employees, or customers, or creditors? These are bogus questions. The real question is: What should a firm do to maximise its contribution to the society? The contribution to the society is maximised by maximising the value of the firm."[3]

[2] Alfred Rappaport, "Let's Let Business Be Business," *New York Times*, February 4, 1990.
[3] Michael Jensen, *Economist*, 1997.

"The quest for value drives scarce resources to their most productive uses and their most efficient users. The more effectively resources are deployed, the more robust will be the economic growth and the rate of improvement in our standard of living. Adam Smith's 'invisible hand' is at work when investors' private gain is a public value."[4]

Despite the forceful arguments in favour of the goal of shareholder wealth maximisation, its supremacy has been challenged, among others, by the capital market skeptics, the strategic visionaries, and the balancers. The arguments of these critics and the rebuttal by the defendants of shareholder wealth maximisation principle are summarised below.

Critique	*Defence*
■ The *capital market sceptics* argue that the stock market displays myopic tendencies, often wrongly prices securities, and fails to reflect long-term values. Managers,on the other hand, are well-informed and make decisions based on more reliable and robust measures of value creation.	■ Based on extensive empirical evidence, financial economists argue that in developed capital markets, share prices are the least biased estimates of intrinsic values and managers are not generally better than investors in assessing values.
■ The *strategic visionaries* argue that the firms should pursue a product market goal like maximising the market share, or enhancing customer satisfaction, or minimising costs in relation to competitors, or achieving a zero defect level. If the firm succeeds in implementing its product market strategy, investors would be amply rewarded	■ It is true that shareholder wealth is created only through successful product market strategies. For example, satisfied and loyal customers are essential for value creation. However, beyond a certain point customer satisfaction comes at the cost of shareholder value. When that happens, the conflict should be resolved in favour of shareholders to enhance the long-term viability and competitiveness of the firm.
■ The *balancers* argue that a firm should seek to 'balance' the interest of various stakeholders, viz. customers, employees, shareholders, creditors, suppliers, community and others.	■ Balancing the interest of various stakeholders is not a practical governing objective. There is no way to figure out what the right 'balance' is. When managers confront complex problems involving numerous tradeoffs, they will have no clear guidelines on how to resolve the differences. Each manager would be left to his own judgment. In a large organisation this can lead to confusion and even chaos.

Alternative Goals Are there other goals, besides the goal of maximal shareholder wealth, that express the shareholders' viewpoint? Several alternatives have been suggested: maximisation of profit, maximisation of earnings per share, maximisation of return on equity (defined as equity earnings/net worth). Let us examine them.

Maximisation of profit is not as inclusive a goal as maximisation of shareholders' wealth. It suffers from several limitations:

- 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.

[4] Bennett Stewart, *The Quest for Value: A Guide to Senior Management*, New York: Harper & Row, 1991.

- 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.
- If profits are uncertain and described by a probability distribution, the meaning of profit maximisation is not clear.

The goals of maximisation of earnings per share and maximisation of return on equity do not suffer from the first limitation mentioned above. However, they do suffer from the other limitations and hence are also not suitable.

In view of the shortcomings of the alternatives discussed above, maximisation of the wealth of equity shareholders (as reflected in the market value of equity) appears to be the most appropriate goal for financial decision-making. Though the strict validity of this goal rests on certain rigid assumptions, it can be reasonably defended as a guide for financial decision-making under fairly plausible assumptions about capital markets.

A Modification Given a certain number of outstanding shares, managers should act to maximise the current share price of their firm. However, if managers believe that the intrinsic value of their firm's share differs from the current market price of the share, then an important issue arises: Should managers seek to maximise the current market price of the share, which embeds only public information, or should they seek to maximise the intrinsic value of the share, based on their private information? If they seek to maximise the current market price they serve the interest of short-term shareholders; if they seek to maximise the intrinsic value of the share they serve the interest of long-term shareholders.

Given this inherent conflict, managers may strive to maximise a weighted average of the firm's current share price (S_C) and its intrinsic value (S_I) as shown below:

$$W_c S_c + W_I S_I$$

What Do Firms Do? Business firms often pursue several goals. They seek to achieve a high rate of growth, enjoy a substantial market share, attain product and technological leadership, promote employee welfare, further customer satisfaction, support education and research, improve community life, and solve other societal problems. Since managers spend most of their working day dealing with employees, customers, and suppliers, and building relationships with them, it is quite natural for them to consider their interests.

Some of these goals may, of course, be in consonance with the goal of shareholder wealth maximisation. For, a rapid growth rate, a dominant market position, and a higher customer satisfaction may lead to increasing returns for equity shareholders. Even efforts towards solving societal problems may further the interest of shareholders in the long run by improving the image of the firm and strengthening its relationship with the environment. When these other goals seem to conflict with the goal of maximising shareholder wealth, it is helpful to know the cost of pursuing these goals. The tradeoff has to be understood. It should be appreciated that maximisation of the wealth of shareholders constituters the principal guarantee for efficient allocation of resources in the economy and hence is to be regarded as the normative goal from the financial point of view.

Shareholder Orientation in India Most companies in India till the early 1990s paid lip service to the goal of shareholder wealth maximisation. They showed sporadic concern for the shareholders, mainly when they approached the capital market for raising capital. Things, however, have been changing since the mid-1990s. A confluence of forces appears now to be prodding companies to accord greater importance to the goal of shareholder wealth maximisation. The important ones are as follows:

Foreign Exposure The scions of most business families have gone abroad for higher education, particularly to the U.S. Hence they seem to appreciate the importance of shareholder value more.

Greater Dependence on Capital Market In the wake of liberalisation, the investment opportunities for the private sector have expanded considerably and consequently its appetite for funds has increased substantially. Thanks to significant freedom that companies now enjoy in pricing equity issues, there is a stronger incentive to access the capital market. The higher corporate needs for funds and the greater dependence on the capital market have induced firms to become more shareholder friendly.

Growing Importance of Institutional Investors Companies are relying more on mutual funds, private equity funds, financial institutions, and foreign institutional investors for raising equity capital. Institutional investors tend to be more discerning and have the muscle and motivation to nudge companies to pursue shareholder friendly policies.

Abolition of Wealth Tax on Financial Assets Previously wealth tax, subject to some exemptions, was payable on equity shares. This induced many controlling groups to ignore and even depress share prices. With the abolition of wealth tax on equity shares and other financial assets, there is now an incentive to enhance share prices. This gets heightened when business magnates nurture a desire to join the exclusive billionaire's club.

To sum up, in the new environment there is a greater incentive and compulsion to focus on creating value for shareholders. This new corporate thinking has been articulated very clearly in the chairman's statement to the shareholders in the 1993 Annual Report of Reliance Industries Limited, the company with the largest investor base, as follows: "In everything that we do, we have only one supreme goal, that is to maximise your wealth as members of India's largest investor family… Your company does not intend to have any major offerings leading to equity dilution but will always seize highly cost effective opportunities to tap the capital markets at an appropriate time, with a commitment to not only maintain shareholder value but also to substantially enhance them and make your company's financial position even stronger." This view has been echoed by Anand Mahindra: "All of us are beginning to look at companies as owned by shareholders. The key is to raise shareholder returns. Those companies where the promoters continue to believe that they own the company and everything they do is in their own interest, are in trouble." In a similar vein the 2008 annual report of HINDALCO states its goals as follows: "To relentlessly pursue the creation of superior shareholder value by exceeding customer expectations profitably, unleashing employee potential, and being a responsible corporate citizen adhering to our values."

Interestingly, the Kumar Mangalam Committee on Corporate Governance, set up by the Securities Exchange Board of India, in its draft report mentioned that "The fundamental objective of corporate governance is the enhancement of the long-term shareholder value while at the same time protecting the interest of other stakeholders."

1.4 THE FUNDAMENTAL PRINCIPLE OF FINANCE

The key question that you have to ask before making a business decision is: will the decision raise the market value of the firm? To answer this question, let us look at the fundamental principle of finance:

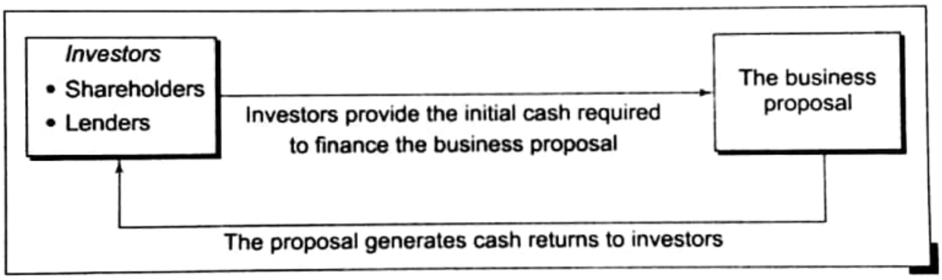
A business proposal – regardless of whether it is a new investment or acquisition of another company or a restructuring initiative – raises the value of the firm only if the present value of the future stream of net cash benefits expected from the proposal is greater than the initial cash outlay required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

The difference between the present value of future cash benefits and the initial outlay represents the net present value or NPV of the proposal:

Net present value = Present value of future cash benefits - Initial cash outlay

Note that the costs and benefits of a business proposal have to be measured in cash. As shown in Exhibit 1.1, investors who finance a proposal invest cash and are hence interested are in cash returns.

Exhibit 1.1 **Cash Alone Matters**



To convert the expected cash returns from the proposal into a present value figure an appropriate discount rate has to be applied. The discount rate reflects the riskiness of the proposal.

1.5 BUILDING BLOCKS OF MODERN FINANCE

While corporate finance emerged as a distinct field of study at the turn of 20th century, the literature on corporate finance through the early 1950s consisted largely of ad hoc theories and institutional detail, but little of systematic analysis. **The Financial Policy of Corporations** by Arthur S. Dewing, published in 1919, was the major textbook on corporate finance for generations. It focused primarily on certain episodic events like formation, issuance of capital, major expansion, mergers, reorganisaton, and liquidation in the life cycle of a firm and discussed them mainly in descriptive and institutional terms. Prior to the 1950s, corporate finance theory was riddled with inconsistencies and had a predominantly prescriptive orientation. Likewise, the theory of financial markets in 1950s was as undeveloped as the theory of corporate finance.

In the 1950s, fundamental changes began to occur in the field of finance. The analytical methods and techniques of economics began to be applied to problems in finance, resulting in a major transformation. This evolution was accompanied by a change from the normative to the positive. The focus shifted from questions such as "What should the investment, financing, and dividend policies of the firm be?" to questions such as "What are the effects of alternate investment, financing, or dividend policies on the value of the firm?" This shift was essential to provide a scientific basis for formulating corporate policy decisions.

It must be recognised that a richer set of positive theories provides the basis for answering normative questions. This important relation between positive and normative theories is often not realised. Purposeful decisions are founded on an explicit or implicit use of positive theories. To decide what action you should take to meet your objective, you should know how the alternative actions affect the desired outcome – and this is what a positive theory does. For example, to choose among alternative financial structures you should know how the alternatives affect expected cash flows, risk, and therefore the firm value. If you use incorrect positive theories, your decisions would have unexpected and undesirable outcomes.

The years since the early 1950s have witnessed the development of the following major building blocks of modern financial economics.

- **Efficient markets theory**: Analysis of how prices change over time in speculative markets.
- **Portfolio theory**: Formation of an optimal portfolio of securities.
- **Capital asset pricing theory**: Determination of asset prices under conditions of uncertainty.
- **Option pricing theory**: Determination of the prices of contingent claims such as call options.
- **Agency theory**: Analysis of incentive conflicts in contractual relations.

Apart from the above building blocks, which form the core of the neoclassical finance, another major development that has a bearing on financial decisions is **behavioural finance.** Unlike neoclassical finance which assumes that people are rational, behavioural finance considers social, cognitive, and emotional factors that influence decisions and examines their effects on market prices, returns, and allocation of resources.

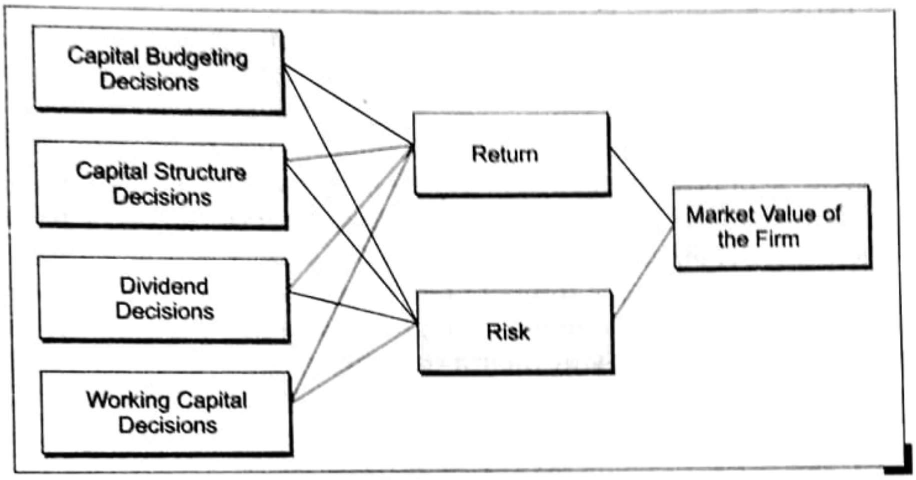
1.6 RISK-RETURN TRADEOFF

Financial decisions often involve alternative courses of action. Should the firm set up a plant which has a capacity of one million tons or two million tons? Should the debt-equity ratio of the firm be 2:1 or 1:1? Should the firm pursue a generous credit policy or niggardly credit policy? Should the firm carry a large inventory or a small inventory?

The alternative courses of action typically have different risk-return implications. A large plant may have a higher expected return and a higher risk exposure, whereas a small plant may have a lower expected return and a lower risk exposure. A higher debt-equity ratio, compared to a lower debt-equity ratio, may save taxes but expose the firm to greater risk. A 'hot' stock, compared to a defensive stock, may offer a higher expected return but also a greater possibility of loss.

In general, when you make a financial decision, you have to answer the following questions: What is the expected return? What is the risk exposure? Given the risk-return characteristics of the decision, how would it influence value? Exhibit 1.2 shows schematically the relationship between the key financial decisions, return, risk, and market value.

Exhibit 1.2 **Decisions, Return, Risk and Market Value**



1.7 AGENCY PROBLEM

In proprietorships, partnerships, and cooperative societies, owners are actively involved in management. But in companies, particularly large public limited companies, owners typically are not active managers. Instead, they entrust this responsibility to professional managers who may have little or no equity stake in the firm. There are several reasons for the separation of ownership and management in such companies:

- Most enterprises require large sums of capital to achieve economies of scale. Hence it becomes necessary to pool capital from thousands or even hundreds of thousands of owners. It is impractical for many owners to participate actively in management.
- Professional managers may be more qualified to run the business because of their technical expertise, experience, and personality traits.
- Separation of ownership and management permits unrestricted change in owners through share transfers without affecting the operations of the firm. It ensures that the 'knowhow' of the firm is not impaired, despite changes in ownership.
- Given economic uncertainties, investors would like to hold a diversified portfolio of securities. Such diversification is achievable only when ownership and management are separated.

While there are compelling reasons for separation of ownership and management, a separated structure leads to a possible conflict of interest between managers (agents) and shareholders (principals). Though managers are the agents of shareholders they are likely to act in ways that may not maximise the welfare of shareholders.

In practice, managers enjoy substantial autonomy and hence have a natural inclination to pursue their own goals. To prevent from getting dislodged from their position, managers may try to achieve a certain acceptable level of performance as far as shareholder welfare is concerned. However, beyond that their personal goals like presiding over a big empire, pursuing their pet projects, diminishing their personal risks, and enjoying generous compensation and lavish perquisites tend to acquire priority over shareholder welfare.

The lack of perfect alignment between the interests of managers and shareholders results in **agency costs** which may be defined as the difference between the value of an actual firm and value of a hypothetical firm in which management and shareholder interests are perfectly aligned.

To mitigate the agency problem, effective monitoring has to be done and appropriate incentives have to be offered. Monitoring may be done by bonding managers, by auditing financial statements, by limiting managerial discretion in certain areas, by reviewing the actions and performance of managers periodically, and so on.

Incentives may be offered in the form of cash bonuses and perquisites that are linked to certain performance targets, stock options that grant managers the right to purchase equity shares at a certain price thereby giving them a stake in ownership, performance shares given when certain goals are achieved, and so on.

1.8 BUSINESS ETHICS AND SOCIAL RESPONSIBILITY

Is the goal of shareholder wealth maximisation congruent with high standards of ethical behaviour and concern for societal problems? Yes, it is. Many companies which have created enormous value for their shareholders are highly admired for their ethical behaviour and concern for society.

Every company should consider its business ethics and its corporate social responsibility. Business ethics essentially focuses on the behaviour of employees and corporate social responsibility is concerned with the contributions that a company should make to worthwhile social causes.

Business Ethics Business ethics refers to the standards of conduct or moral behaviour as applied to business practices. Ethics and fraud are used commonly in business reporting, but they have different meanings. *Fraud* involves violating the law, whereas *unethical behaviour* involves breaching the code of ethics or moral behaviour. While fraud can be defined objectively, unethical behaviour is defined rather subjectively.

A business firm is deemed to practice high standards of ethics if it deals with its employees, suppliers, customers, creditors, shareholders, and community in a fair and honest manner.

In general, ethical behaviour and long-run profitability are positively correlated. Ethical behaviour helps a firm to avoid fines and legal expenses, build public trust, attract and retain talented people, and gain the loyalty of customers who appreciate its policies. As Kumaramangalam Birla, Chairman of the Aditya Birla group, put it: "Doing business with a strong sense of values is a win-win game for all. Customers, employees, suppliers and investors trust organisations that live by a clear set of values. Most important, good corporate behaviour tends to attract the best talent to work for an organisation. So being good is not only good for itself, but also very good for business growth and sustainability."

Conscious of the virtues of ethical behaviour, many firms have put in place codes of ethical behaviour. However, the most important thing is the example set by top management through its actions and behaviour and the system of reward and punishment.

Of course, given the subjective nature of ethics, in many cases the choice between ethics and profits is not unambiguous. Consider the case of a pharmaceutical company that has developed a new product which is quite effective in treating a certain medical condition. While independent government tests show that the product has no adverse side effects, the research done by the company suggests, though not convincingly, that the product may have some harmful side effects. If the company abandons the product, it denies the benefit of the product to patients and sacrifices potential profit for itself. If the company makes the product, it has to live with the discomfort of knowing that the product may cause problems to some patients. What should it do? The choice may not be easy.

Corporate Social Responsibility Corporate social responsibility (CSR), an allied issue, has received a great deal of attention particularly in recent years. There are various definitions of corporate social responsibility. The World Business Council, for example, defines it as follows:

"Corporate social responsibility is the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large."

The advocates of corporate social responsibility argue that a business firm must contribute to solve societal problems. Their argument rests on the following premises:

- A business operates with the franchise given to it by the society and hence it has a reciprocal obligation to the society.
- Government, NGOs, and other non-business institutions may not have enough resources and capabilities to address all the societal problems. So, business firms with their massive resources and managerial capabilities must pitch in.

Economists like Frederick Hayek and Milton Friedman, however, have argued that a business firm should not swerve from its economic goal. If a business firm engages itself in social programmes it may become vulnerable to competitive encroachment. Let shareholders decide in their personal capacity what they want to contribute in various social programmes. This role should not be arrogated by corporate managements whose primary mandate is economic. Milton Friedman put it as follows: "Few trends could so thoroughly undermine the very foundation of our society as the acceptance by corporate officials as a social responsibility other than to make as much money for their stockholders as possible. This is a fundamentally subversive doctrine."

Notwithstanding the forceful argument of Milton Friedman, many business firms in practice do contribute to various social causes. They give donations to hospitals and educational institutions, contribute to relief programmes, sponsor sport events, encourage and motivate their employees to participate in community development projects, so on and so forth.

The government has been laying emphasis on 'inclusive growth.' Corporate leaders have been echoing this sentiment. The motivation and compulsion to contribute to social causes is even greater in a country like India with its stark inequalities. That is why, the central government has asked public sector enterprises to spend at least 2 percent of net profit on CSR projects. Likewise private sector firms such as Infosys and Mahindra & Mahindra have set up foundations for CSR projects to which they contribute 1 percent or so of their net profit.

While these initiatives may appear very laudable, they entail costs and not all firms voluntarily incur such costs. Hence, compared to a firm which does not contribute to such causes, a firm which supports such causes may be at a competitive disadvantage. As long as a firm enjoys super-normal profits it can afford to bear such costs. But if a firm operates in a very competitive market and earns just normal profits, it can ill-afford to incur such costs if its competitors refrain from doing so. Thus, if the society expects business firms to solve social problems, it must impose a mandatory obligation on all firms so that the costs are evenly borne by all the firms.

Although a company that engages in socially responsible projects may *prima facie* suffer from competitive disadvantage, it may have an edge in attracting, retaining, and motivating talented employees who find meaning in participating in corporate social responsibility (CSR) projects. That may be an important reason why companies are embracing CSR projects. For example, Mahindra & Mahindra launched what it calls the Employee Social Options Plan (ESOP), which offers employees a wide range of CSR projects that they can participate in. As Rajeev Dubey of Mahindra & Mahindra put it: "In addition to doing their job well, people seek a connection with a larger cause. Through ESOP, we are offering them a structured platform."

1.9 ORGANISATION OF THE FINANCE FUNCTION

Financial management is in many ways an integral part of the jobs of managers who are involved in planning, allocation of resources, and control. The responsibilities for financial management are dispersed throughout the organisation. For example:

- The engineer, who proposes a new plant, shapes the investment policy of the firm.
- The marketing analyst provides inputs in the process of forecasting and planning.
- The purchase manager influences the level of investment in inventories.
- The sales manager has a say in the determination of the receivables policy.
- Departmental managers, in general, are important links in the financial control system of the firm.

There are, however, many tasks of financial management and allied areas (like accounting) which are specialised in nature and which are attended to by specialists. These tasks and their typical distribution between the two key financial officers of the firm, the treasurer and the controller[5], are shown in Exhibit 1.3. Note that the treasurer is responsible mainly for financing and investment activities and the controller is concerned primarily with accounting and control.

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[5] Even though a firm may not have two separate financial officers designated as treasurer and controller it is helpful to distinguish the functions of treasurership and controllership.

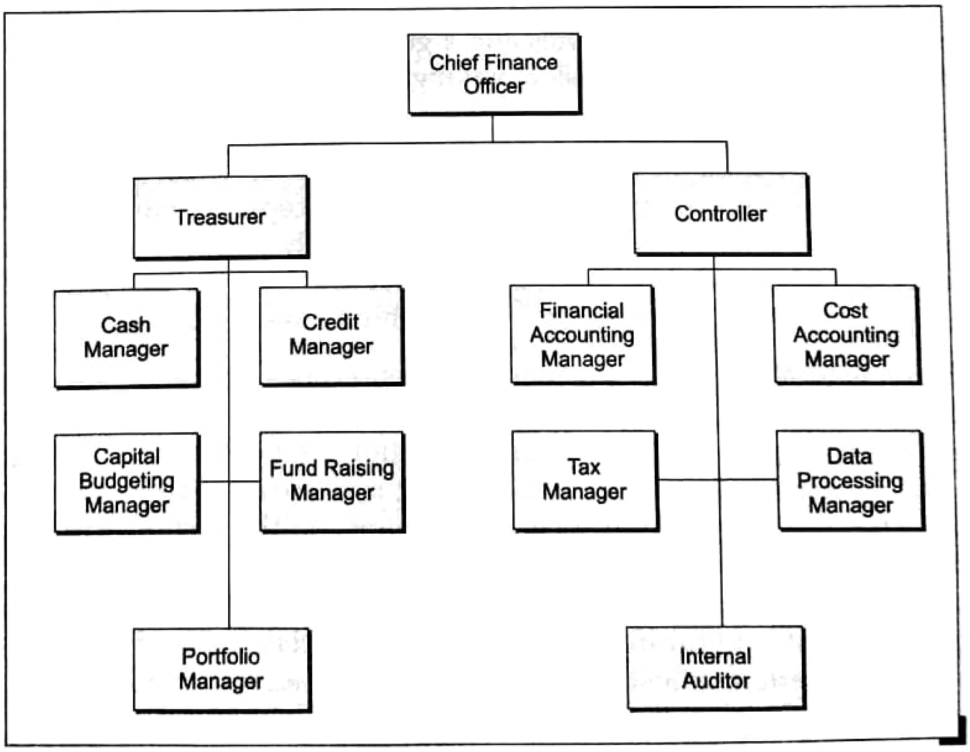
Exhibit 1.3 **Functions of the Treasurer and the Controller**

Treasurer	*Controller*
Obtaining finance	Financial accounting
Banking relationship	Internal auditing
Cash management	Taxation
Credit administration	Management accounting
Capital budgeting	and control

Typically, the chief finance officer, who may be designated as Director (Finance) or Vice President (Finance), supervises the work of the treasurer and the controller. In turn, these officers are assisted by several specialist managers working under them. The finance function in a large organisation may be organised as shown in Exhibit 1.4.

The financial officers, in addition to their specialised responsibility, have significant involvement in injecting financial discipline in corporate management processes. They are responsible for emphasising the need for rationality in the use of funds and the need for monitoring the operations of the firm to achieve desired financial results. In this respect, the tasks of financial officers have assumed new dimensions. Instead of just looking after routine financing and accounting activities, they guide and participate in the tasks of planning, funds allocation, and control so that the financial point of view is sufficiently emphasised in the process of corporate management.

Exhibit 1.4 **Organisation of Finance Function**



1.10 RELATIONSHIP OF FINANCE TO ECONOMICS AND ACCOUNTING

Financial management has a close relationship to economics on the one hand and accounting on the other.

Relationship to Economics There are two important linkages between economics and finance. The macroeconomic environment defines the setting within which a firm operates and the microeconomic theory provides the conceptual underpinning for the tools of financial decision making.

Key macroeconomic factors like the growth rate of the economy, the domestic savings rate, the role of the government in economic affairs, the tax environment, the nature of external economic relationships, the availability of funds to the corporate sector, the rate of inflation, the real rate of interest, the market risk premium, and the terms on which the firm can raise finances define the environment in which the firm operates. No financial manager can afford to ignore the key developments in the macroeconomic sphere and the impact of the same on the firm.

While an understanding of the macroeconomic developments sensitises the financial manager to the opportunities and threats in the environment, a firm grounding in microeconomic principles sharpens his analysis of decision alternatives. Finance, in essence, is applied microeconomics. For example, the principle of marginal analysis - a key principle of microeconomics according to which a decision should be guided by a comparison of incremental benefits and costs - is applicable to a number of managerial decisions in finance.

To sum up, a basic knowledge of macroeconomics is necessary for understanding the environment in which the firm operates and a good grasp of microeconomics is helpful in sharpening the tools of financial decision making.

Relationship to Accounting The finance and accounting functions are closely related and almost invariably fall within the domain of the chief financial officer as shown in Exhibit 1.5. Given this affinity, it is not surprising that in popular perception finance and accounting are often considered indistinguishable or at least substantially overlapping. However, as a student of finance you should know how the two differ and how the two relate. The following discussion highlights the differences and relationship between the two.

Score Keeping vs. Value Maximising Accounting is concerned with score keeping, whereas finance is aimed at value maximising. The primary objective of accounting is to measure the performance of the firm, assess its financial condition, and determine the base for tax payment. The principal goal of financial management is to create shareholder value by investing in positive net present value projects and minimising the cost of financing. Of course, financial decision making requires considerable inputs from accounting. As Gitman says: "The accountant's role is to provide consistently developed and easily interpreted data about the firm's past, present, and future operations. The financial manager uses these data, either in raw form or after certain adjustments and analyses, as an important input to the decision making process."

Accrual Method vs. Cash Flow Method The accountant prepares the accounting reports based on the accrual method which recognises revenues when the sale occurs (irrespective of whether the cash is realised immediately or not) and matches expenses to sales (irrespective of whether cash is paid or not). The focus of the financial manager, however, is on cash flows. He is concerned about the magnitude, timing, and risk of cash flows as these are the fundamental determinants of values.

Certainty vs. Uncertainty Accounting deals primarily with the past. It records what has happened. Hence, it is relatively more objective and certain. Finance is concerned mainly with the future. It involves decision making under imperfect information and uncertainty. Hence, it is characterised by a high degree of subjectivity.

1.11 EMERGING ROLE OF THE FINANCIAL MANAGER IN INDIA

Until the early 1990s, the financial manager in India functioned in a highly regulated environment and enjoyed limited freedom in designing key financial policies. From the early 1990s, however, the complexion of the economic and financial environment has changed in many ways. The important changes have been as follows.

- The industrial licensing framework has been substantially relaxed, leading to considerable expansion in the scope of private sector investment.
- The Monopolies and Restrictive Trade Practices Act has been virtually abolished and the Foreign Exchange Management Act has been considerably liberalised.
- Freedom has been given to companies in designing and pricing the securities issued by them.
- The system of cash credit has been largely replaced by a system of working capital loans.
- Stable and administered interest rates have given way to volatile and market-determined interest rates. Exchange rates, too, have become more volatile and market-determined.
- The scope for foreign direct investment has expanded considerably and foreign portfolio investment has assumed great significance.
- Investors have become more discerning, demanding, and assertive.
- The pace of mergers, acquisitions, and restructuring has intensified.
- Derivative instruments such as options and futures have been introduced.

Thanks to these changes, the job of the financial manager in India has become more important, complex, and demanding. More so in the wake of global competition, technological developments, volatile financial prices, economic uncertainty, tax law changes, ethical concerns over financial dealings, and shareholder activism.

The key challenges for the financial manager appear to be in the following areas.

- Investment planning
- Financial structure
- Mergers, acquisitions, and restructuring.

- Working capital management.
- Performance management.
- Risk management
- Investor relations

1.12 OUTLINE OF THE BOOK

A manager should strive to maximise the value of his firm. To achieve this goal, he must understand how businesses are organised, how the financial system functions, what the tax code is, and how accounting information is used to assess business performance. In addition, he must be familiar with the fundamentals of the time value of money, risk and return relationship, and valuation of securities and derivative instruments. This background helps in making decisions that have a bearing on the value of the firm's securities. Organised to reflect these considerations, the book is divided into ten parts.

Part I — *Introduction* Chapter 1 provides an overview of the discipline of financial management. Chapter 2 discusses the principal components of the Indian financial system.

Part II — *Financial Analysis and Planning* Chapter 3 examines the contents of financial statements and discusses the basics of taxation and cash flow. Chapter 4 discusses the techniques for analysing financial statements and applications of financial statement analysis. Chapter 5 presents various tools of financial planning.

Part III — *Fundamental Valuation Concepts* Chapter 6 dwells on the ideas of compounding and discounting and their use in establishing financial equivalences. Chapter 7 explains how financial securities, bonds and equity stocks, may be valued. Chapter 8 discusses the concepts of risk and return and shows how they are related. Chapter 9 examines portfolio theory and asset pricing models. Chapter 10 discusses how options work and explains option pricing models.

Part IV — *Capital Budgeting* Chapter 11 discusses the techniques of capital budgeting. Chapter 12 shows how the project cash flows are developed. Chapter 13 explains the techniques of risk analysis. Chapter 14 presents the concept and measurement of cost of capital. Chapter 15 explores some advanced issues in capital budgeting.

Part V — *Long-Term Financing* Chapter 16 discusses the efficient market hypothesis and examines its implications for corporate finance. Chapter 17 describes the characteristics of various sources of long-term financing. Chapter 18 explains how securities are issued in the primary market for raising long-term finance.

Part VI — *Capital Structure and Dividend Decisions* Chapter 19 expounds various views on the relationship between capital structure and cost of capital. Chapter 20 dwells on the considerations and tools helpful in planning the capital structure. Chapter 21 examines various positions on the relationship between dividend policy and share valuation. Chapter 22 discusses practical aspects of the dividend decision.

Part VII — *Working Capital Management* Chapters 23 through 28 focus on working capital management, which is concerned with the management of current assets and liabilities. Chapter 23 clarifies the key issues relating to working capital policy. Chapter 24 presents the tools of cash management. Chapter 25 discusses important aspects of credit management. Chapter 26 dwells on various facets of inventory management. Chapter 27 describes various sources of financing current assets. Chapter 28 explains some advanced techniques for managing working capital.

Part VIII — *Debt and Hydrid Financing* Chapter 29 throws light on the nature of debt financing and explains analytical issues relating to debt. Chapter 30 analyses the features of leasing, hire purchase, and project finance. Chapter 31 discusses convertible debentures, warrants, and hybrid securities.

Part IX — *Corporate Valuation and Shareholder Value* Chapter 32 explains the discounted cash flow and non-discounted cash flow methods of corporate valuation. Chapter 33 expounds various approaches to value-based management. Chapter 34 explains the mechanics of mergers, acquisitions, and restructuring and discusses the financial and managerial facets of these transactions. Chapter 35 looks at various aspects of corporate governance and executive compensation.Chapter 36 discusses various issues in performance measurement and balanced scorecard.

Part X — *Special Topics* Comprising Chapters 37 through 42, Part X discusses several special topics in financial management. Chapter 37 explains the distinctive features of international financial management. Chapter 38 examines the causes, symptoms, prediction, and revival of sick units. Chapter 39 explores financial management in companies with special characteristics. Chapter 40 describes a variety of hedging devices, mostly derivative instruments, and their use in corporate risk management.Chapter 41 comments on the recent global financial crisis. Chapter 42 summarises the state of our knowledge in finance.

SUMMARY

- The three broad areas of financial management are **capital budgeting, capital structure,** and **working capital management**.
- The primary goal of financial management is to **maximise the value of the firm.**
- A business proposal augments the value of the firm if its **net present value** is positive.
- The important forms of business organisation are the **sole proprietorship,** the **partnership firm,** the **private limited company**, and the **public limited company**. From the point of view of shareholder wealth maximisation, the public limited company form appears to be the most appropriate.
- The major building blocks of financial economics are **efficient markets theory, portfolio theory, capital asset pricing theory, option pricing theory, agency theory, and behavioural finance**.

- The lack of perfect alignment between the interests of managers and shareholders results in the **agency problem.** To mitigate this problem, **effective monitoring** has to be done and **appropriate incentives** have to be offered.
- Financial management is an integral part of the job of managers. There are, however, many tasks of financial management and allied areas (like accounting), which are specialised in nature and attended to by key financial officers, like the **treasurer** and the **controller.**
- A basic knowledge of **macroeconomics** is necessary for understanding the environment in which the firm operates and a good grasp of **microeconomics** is helpful in sharpening the tools of financial decision making.
- Financial decision making requires considerable inputs from **accounting.**
- Since the early 1990s the complexion of the economic and financial environment has altered in many ways, making the job of the financial manager more important, complex, and demanding.

QUESTIONS

1. What are the advantages and disadvantages of the following forms of business organisation: sole proprietorship, partnership, cooperative society, private limited company, and public limited company?
2. Discuss the three broad areas of financial decision making.
3. What is the justification for the goal of maximising the wealth of shareholders?
4. What do the critics of the goal of maximising shareholder wealth say? What is the rebuttal provided by the advocates of maximising shareholder wealth?
5. Critically evaluate the goals of maximisation of profit and maximisation of return on equity.
6. What forces are prodding companies in India to accord greater importance to the goal of shareholder wealth maximisation?
7. Discuss the risk-return tradeoff in financial decisions.
8. Describe briefly the building blocks of modern finance.
9. Why is there a separation of ownership and management in large companies?
10. What are agency costs and how can they be mitigated?
11. "Financial management is in many ways an integral part of the jobs of managers." Comment.
12. How is the finance function typically organised in a large company?
13. Discuss the relationship of financial management to economics and accounting.
14. Comment on the emerging role of the financial manager in India.