BACHELOR OF COMPUTER APPLICATIONS

SEMESTER 4

DCA2204

PRINCIPLES OF FINANCIAL ACCOUNTING AND MANAGEMENT

Unit 5

An Introduction to Financial Management

Table of Contents

1. INTRODUCTION

Financial management is a managerial activity concerned with planning and controlling a firm's financial resources. Finance is the lifeblood of any organization. Any business activity treats finance management as a very important management function. There is a common thread running through all departments of any firm – production, marketing, materials, research and development, etc. The R & D Manager requires finance to carry on research activities to come out with new products or new designs to meet the ever- changing needs of customers. He may be assigned the task of discovering a new process which will help in cost reduction leading to an increase in the firm's revenue. Likewise, the Materials Manager should keep a proper stock of all inventories. Any shortfall in inventory availability in stores leads to production rundowns sending a spiralling effect on the whole company system. Sales promotion activities like advertisement, free gifts etc. requires heavy cash outlays affecting the company's financial resources. Thus, we find that finance binds together all the different functions of an organization. Corporates decide their strategies, be it production, marketing, R & D or any other, based on their financial constraints.

Three Types of Financial Goals. In the context of investment strategy, the Financial Industry Regulatory Authority (FINRA) defines the three types of financial goals as **long-term (more than 10 years), mid-term (3 to 10 years) and short-term (less than 3 years).**

1.1 Objectives

After studying this unit, you will be able to:

- *Explain the meaning of business finance.*
- *State the objectives of financial management.*
- *Explain various interfaces between finance and other functions*.

2. FINANCE FUNCTIONS

We have just learnt that finance runs through all departments, yet the major functions coming under the purview of the Finance Department are mobilizing funds, investing them in proper assets and distributing the profits earned from such investments to the shareholders. These may be identified as financing decision, investment decision and dividend decision respectively. The activities of a Finance Manager can include the following:

- Investment or long-term asset mix structure
- Financing or capital mix structure
- Dividend or profit allocation
- Liquidity or short-term asset mix structure

A Finance Manager should perform all these functions simultaneously and continuously in the normal course of business. These functions do not necessarily occur in a sequence. All these functions require skilful planning, control and execution.

2.1 Investment Decision

Investment or capital budgeting decision involves the allocation of capital to long term funds. A capital budgeting decision may be defined as "the firm's decision to invest its current funds in long term assets in anticipation of an expected flow of benefits over a number of years." Long term assets are those which affect a firm's operations beyond one-year period. Such decisions generally include expansion, acquisition, modernization and replacement of long-term assets. Investment in these assets requires huge cash outlays and most of the long-term asset financing decisions are irreversible in nature. The uncertain future puts long term investment decisions in a precarious state. Expected benefits of investments are difficult to measure with certainty. Such decisions should therefore be evaluated in terms of both expected *return and risk*. Measurement of returns with a *cut- off rate* against the prospective return of new investments should be compared. Cut off rate is also known as hurdle rate, required rate and minimum rate of return.

In most organizations an "Investment Committee" is constituted to study the various investment proposals in line with the technical, marketing and financial dimensions. The proposal is consideredon its worthiness and the decision taken. Deciding on such plans becomes one of the core activities of Finance Manager.

2.2 Financing Decision

Being the second most important function to be performed by the Finance Manager, he must plan and mobilize the required funds from alternative sources as and when they are required and at a reasonable cost. He must be aware of the various sources of funds available in the market, the time required to procure these funds, the rates applicable and the securities to be mortgaged to avail these funds. He should determine the correct proportion of debt (fixed interest source of financing) and equity (variable dividend securities). The mix of debt and capital (Equity) is known as the firm's *capital structure*. The Finance Manager should strive hard to obtain the best *financing mix* or the *optimum capital structure*. A proper balance between debt and equity to ensure a trade-off between risk and return is necessary. The use of debt increases the return to equity holders but the risk is also very high in this proposition. One of the objectives of the Finance Manager is to maximize the shareholders' return with minimum risk, thereby, the market value per share is maximized and ultimately the shareholders benefit. In practice, the firm considers many other factors such as control, flexibility, loan covenants, legal aspects, etc. in deciding the capital structure.

2.3 Dividend Policy Decision

Dividends are the pay-outs to the shareholders. Two alternatives are available in dealing with dividend decision: they can be distributed to shareholders or they can be retained in the business itself. Payment of dividend is required to keep the shareholders happy and increase their share value. Pay-out or retention depends on the growth prospects of the firm. High pay-out is well-taken by shareholders and this is reflected in their share value going up in the market. A growing firm requires large capital investments and it may have to borrow which comes with a huge interest payment on a regular basis. The firm may therefore prefer to retain the earnings and invest them in further investmentsin the newer opportunities available. Thus, the Finance Manager has to strike a balance between maximization of shareholders' wealth and organization's growth.

2.4 Liquidity Decision

Liquidity decisions are concerned with the current assets management. Managing current assets is an integral part of financial management. Current assets should be managed efficiently in order to safeguard the firm's profitability and liquidity. It also requires a trade-off between profitability and risk (liquidity). There is always a conflict in the manager's mind as to these two aspects. A firm holding too much cash giving importance to the liquidity element loses on the profitability aspect. Likewise, by not investing sufficient funds in current assets, the firm may become illiquid and not have the ability to meet its current obligations inviting the risk of bankruptcy. The Finance Manager should ensure sound techniques of managing current assets to ensure that neither insufficient not unnecessary funds are invested in current assets. He should be capable of assessing the right requirements and make sure that funds are available at the time they are required most.

Self-Assessment Questions -1

1. ____________ is required to keep the shareholders happy and increase their share value. depends on the growth prospects of the firm.
2. The mix of debt and capital is known as the firm's ____________ .
3. Financing decisions should be evaluated in terms of ___________ and____________ .
4. Current Assets Management is a trade-off between __________ and____________ .

3. INTERFACE BETWEEN FINANCE AND OTHER FUNCTIONS

A common bond running through all departmental heads is that they use resources and since resources are obtained in exchange for money, they are effectively making investment decision and, in the process, ensuring that the investment is effectively used.

3.1 Marketing-Finance Interface

The Marketing Manager decides on a number of factors which have a bearing on the profitability of the firm. For example, he should have a clear idea about the credit terms extended to customers. Liberal credit terms will have an impact on the firm's profits while a restrictive policy will not bring in the desired amount of sales. Product promotion and advertisement policies should also be very clear. In these days of cut-throat competition, a firm spends enormously on sales promotion activities to keep their product sales going, to build brand image and to continue with the customer's brand preferences. The moneys so spent will have an implication on the firm's resources.

3.2 Production-Finance Interface

The Production Manager is responsible for the production related activities, be it materials, men or machines. He should organize his work in such a way that the equipment is put to use most productively and keep track of all required inventory for smooth production of goods and see that the idle time is minimized.

3.3 Top Management-Finance Interface

The top management is interested in ensuring that the firm's long-term goals are met and there is overall effectiveness of the organization. Strategic planning and management control are two important functions of the top management. Finance function provides the basic inputs needed to undertake these activities.

4. FINANCIAL GOALS

The firm's investment rationale and financing decisions are continuous. It is generally agreed that the financial goal of the firm should be the maximization of the owners' economic welfare. The owners' economic welfare can be maximized by maximizing the shareholders' wealth as reflected in the market value of shares. Profit maximization and wealth maximization are two important aspects.

4.1 Profit Maximization

Profit maximization means increasing the rupee income of firms. Pricing of goods is a very important function and is determined by the type of economy in which the firm is functioning. This may be done by market competitive forces if the economy is a market economy (or free economy) and by Government in a Government -controlled economy. Firms in a market economy can function the best only if they produce goods and services desired by the customers and prices are as competitive as possible for the customers to have a wide choice of products available at very competitive prices. It is generally held that under conditions of free competition, businessmen pursuing their own self-interests also serve the interest of society. When individual firms pursue the interest of maximizing the profits, society's resources are efficiently used.

The profit maximization objective has been criticized in recent years. This objective developed in the early 19th century when private property, self- financing and single entrepreneurship were the order of the day. With the passage of time, businesses have had a complete change-over and now there is a separation between ownership and management. Today's corporates are financed by shareholders and lenders but are run by professional managers. In reality, the objectives of these two constituents – owners and managers may conflict with each other. In the present circumstances, profit maximization is regarded as unrealistic and difficult.

An alternative to profit maximization is the objective of wealth maximization which is discussed below.

4.2 Wealth Maximization

This is also known as *value maximization and net present worth maximization*. Shareholders' Wealth Maximization (SWM) is an appropriate and operationally feasible criterion to choose among the alternative financial actions. SWM is the maximization of the net present value or wealth of a course of action to shareholders. A financial action that creates wealth for shareholders is desirable. The benefits are measured in terms of cash flows. In investment and financing decisions the flow of cash is important and not the accounting profits.

Increasing the shareholders' economic welfare is equal to increasing the utility of their consumption over time. The wealth created by the company is echoed in the market value of company's shares which in other words is a reflection of the firm's financial decisions.

4.3 Other Objectives

Besides the above objectives, there are other objectives of financial management. These include:

i) Ensuring operational efficiency by efficient and effective utilization of finances and other resources.
ii) Ensuring financial discipline in the management.
iii) Building reserves for growth and expansion.

Self-Assessment Questions -2

5. _____________ will have an impact on the firm's profits while a ____________will not bring in the desired amount of sales.
6. __________ and _____________ are two important functions of the top management.
7. _________ and _____________ are two important aspects of financial goal.
8. Ensuring ____________ ,_____________ and _____________ are other objectives of

5. SUMMARY

The goal of a company will be to maximize the wealth of the shareholders. The Finance Manager should take necessary actions in this direction.

He must make proper investment or capital budgeting decisions. He must plan and mobilize the required funds from alternative sources as and when they are required and at a reasonable cost. He has to strike a balance between maximization of shareholders' wealth and organization's growth.

Glossary

Bankruptcy: A company files for the legal process of bankruptcy when it is unable to meet its debt or credit obligations.

Liberal credit policy: A credit policy that is flexible and not strict with its collection process

6. TERMINAL QUESTIONS

Short answer type questions:

1. What are the objectives of financial management?
2. How is the optimum mix of capital structure achieved by a Finance Manager?
3. What is Shareholders' wealth maximisation?

Long answer type questions:

4. Write a short note on the finance-marketing interface.
5. What do you mean by liquidity decision?
6. Write a short note on dividend decision.

7. ANSWERS

Self-Assessment Questions

1. Payment of dividendCapital structure
2. Return; risk
3. Profitability; risk
4. Liberal credit terms; restrictive policy
5. Strategic planning; management control
6. Profit maximization; wealth maximization
7. Operational efficiency; financial discipline; building reserves for growth and expansion

Terminal Questions

Short answer type questions

1. Profit maximization and wealth maximization are two important objectives of financial management.
2. The Finance Manager must plan and mobilize the required funds from alternative sources as and when they are required and at a reasonable cost. He must be aware of the various sources of funds available in the market, the time required to procure these funds, the rates applicable and the securities to be mortgaged to avail these funds. In this way, the finance manager tries to achieve the optimum mix of capital structure.
3. Shareholders' Wealth Maximization (SWM) is an appropriate and operationally feasible criterion to choose among the alternative financial actions. SWM is the maximization of the net present value or wealth of a course of action to shareholders.

Long answer type questions

4. The Marketing Manager decides on a number of factors which have a bearing on the profitability of the firm. For example, he should have a clear idea about the credit terms extended to customers. Liberal credit terms will have an impact on the firm's profits while a restrictive policy will not bring in the desired amount of sales. Product promotion and advertisement policies should also be very clear. In these days of cut-throat competition, a firm spends enormously on sales promotion activities to keep

their product sales going, to build brand image and to continue with the customer's brand preferences. The moneys so spent will have an implication on the firm's resources.

5. Liquidity decisions are concerned with the current assets management. Managing current assets is an integral part of financial management. Current assets should be managed efficiently in order to safeguard the firm's profitability and liquidity. It also requires a trade-off between profitability and risk (liquidity). There is always a conflict in the manager's mind as to these two aspects. A firm holding too much cash giving importance to the liquidity element loses on the profitability aspect. Likewise, by not investing sufficient funds in current assets, the firm may become illiquid and not have the ability to meet its current obligations inviting the risk of bankruptcy. The Finance Manager should ensure sound techniques of managing current assets to ensure that neither insufficient not unnecessary funds are invested in current assets. He should be capable of assessing the right requirements and make sure that funds are available at the time they are required most.
6. Dividends are the pay-outs to the shareholders. Two alternatives are available in dealing with dividend decision: they can be distributed to shareholders or they can be retained in the business itself. Payment of dividend is required to keep the shareholders happy and increase their share value. Pay-out or retention depends on the growth prospects of the firm. High pay-out is well-taken by shareholders and this is reflected in their share value going up in the market. A growing firm requires large capital investments and it may have to borrow which comes with a huge interest payment on a regular basis. The firm may therefore prefer to retain the earnings and invest them in further investments in the newer opportunities available. Thus, the Finance Manager has to strike a balance between maximization of shareholders' wealth and organization's growth.

8. CASE STUDY

Identify in the following cases factor affecting the choice of capital:

1. Raj an has an option of taking loan from his relatives. These people have assured him to give loan at a low interest rate. So he decides to use debt as a source of financing his project. Now he goes to different relatives and friends to see if he can get a cheaper source of debt with even lower rate of interest.
2. Prerak Iron Ltd. is thinking of raising finance to further its projects overseas. For this the company is observing the other companies' raising of finance. Their debt equity ratios are being thoroughly studied by the financial experts of the company.
3. A company is trying to raise funds after consulting the experts. The owner of the company has decided to find out the banks which can grant loan under norms. He will assure that all norms are followed by the company. He has also decided to gain knowledge about the SEBI guidelines related to public issues of shares and debentures.

Source: CBSE Tuts

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