UNIT: 1 - AN INTRODUCTION TO FINANCIAL MANAGEMENT

[Topics to be covered: Meaning and concept of Finance, Financing, Financial Management; Objectives of Business Firm; Profit Maximisation; Wealth Maximisation; Role of CFO; Financial Environment; Problems on Present Value & Future Value]

What do you mean by finance?

The art and science of managing money is referred to as **FINANCE**.

FINANCING: The process of organising the flow of funds by a business firm to carry out its objectives in the most efficient manner can be called **FINANCING**.

According to financial analyst J. F. Bradley, "***Financial Management** is the area of business management devoted to a judicious use of capital and careful selection of resources of capital in order to enable a business firm to move in the direction of reaching its goals*".

Objectives of a Business Firm

The process of decision making by a finance manager should be goal oriented.
In fact, the opportunities faced by the finance manager and the evaluation of the finance decision taken for exploiting those financial opportunities depend to a large extent on the goal of the business firm.

The goal of the business firm may be either maximisation of the profits or maximisation of the wealth of the shareholders.

Profit Maximisation

Maximisation of profits is often considered as an implied objective of any business operation. Net profit of a business firm is considered as the yardstick for measuring the efficiency of the firm. It is argued that economic resources of a society can be utilised in an efficient manner only when all the business firms aim at profit maximisation.

Thus, the goal of profit maximisation can guarantee efficient allocation of economic resources not only from the viewpoint of a business firm, but also from the viewpoint of the entire society.

Wealth Maximisation

In the theory of financial management, it is generally accepted that the goal of a business firm is to maximise the wealth of the shareholders. The wealth of the equity shareholders is represented by the market value of the equity shares. The shareholders' wealth is maximised only when the market value of the equity shares is maximised.

$W^o = N \times P^o$

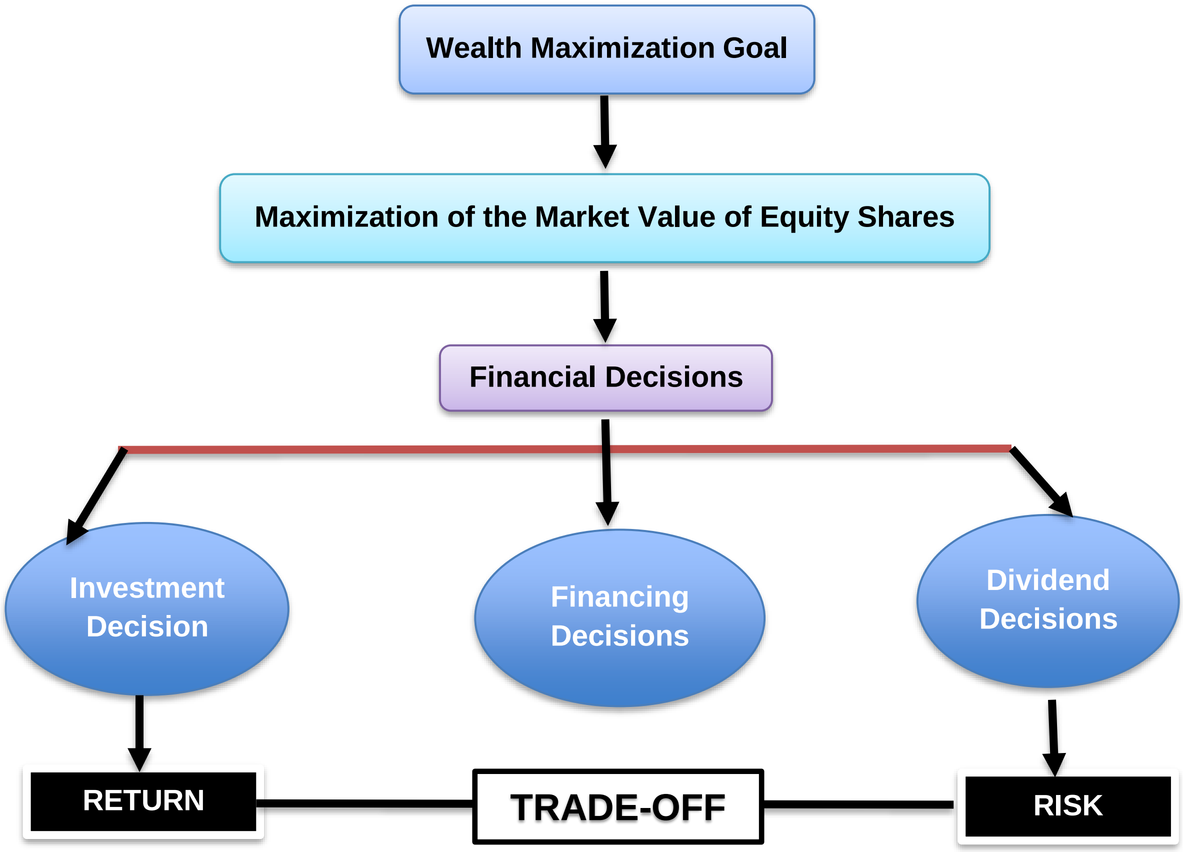
W^o is the wealth of the shareholder. It can be calculated as number of shares owned (N) × current stock price per share (P^o)

The goal of wealth maximisation implies that differential decisions of a business firm should be taken in such a way that they lead to higher market prices of its equity shares.

All the financial decisions of a business firm are interrelated and they jointly affect the market value of these equity shares. The finance manager while aiming at wealth maximisation should strive to maximise returns from investment in relation to a given level of risk. The relationship between risk and return can simply be expressed as **Return = risk free rate + risk premium**. A proper balance between risk and return should be maintained by the financial managers to maximise the market value of the equity shares of the firm.

If the financial managers take higher risks in their investment decisions it would lead to higher costs of raising the required capital (since the investors expect higher returns to undertake risks).

As a result, the dividend income of the shareholders may decline in future. The situation would become worse if the investment projects do not generate cash flows as per expectations. In that case the market price of the equity shares of that form will lead to decline in the wealth of the shareholders. Hence every financial decision involves a risk return trade-off.



Role of CFO

The finance manager should shape his decisions and recommendations in such a manner so as to contribute to the overall progress of the business. The role or functions of a CFO in a modern business are as follows:

1. **Estimation of Financial Requirements:** It is the primary responsibility of a financial manager to make a sound financial forecast for meeting the capital and revenue expenditure.

2. **Capital Structuring:** Capital structure of a business enterprise implies different components of financial capital and its proportions. If the capital is viewed from the liability side of the balance sheet of a company it would include both debt and equity capital, which determines the capital structure of a company.

3. **Investment Decisions:** The investment decisions refer to the careful selection of viable and profitable investment projects. The economic viability of such projects is judged on the basis of expected returns, risk associated with each project and cost involved in implementing the same.

4. **Portfolio Management:** It is concerned with the efficient management of investment in securities. Here investment can be defined as the current commitment of funds for a period of time in order to derive a flow of funds in future which would compensate the investors. The duty of the finance manager here is to select the right securities taking into account different types of risks involved in such investment as well as return from such investment.

5. **Management of Working Capital:** A business firm also requires short-term funds or assets for the daily operations of the business. The management of short-term assets and liabilities is regarded as working Capital Management.

6. **Management of Retained Earnings:** In any business firm a portion of its profits has to be distributed as dividends to its shareholders and the remaining portion is written for reinvestment purposes. This retained earnings constitute the internal source of funds for any firm.

7. **Management of Cost-Volume-Profit:** Another important tool of financial management that helps the manager to evaluate different proposals of investment is management of cost volume profit. Make or buy decision, continuation or deletion of a product, can be made by adopting cost volume profit or break-even point analysis.

8. **Management of Liquidity:** This is considered to be the prime objective of a finance manager. Increased liquidity builds the firm's ability to meet short term obligations and their food provide cushion in favour of short-term money lenders like creditors and bankers.

9. **Management of fixed assets:** Fixed assets are the resources by which the firm is able to conduct business. The finance manager must decide the total amount of fixed assets required by the firm to carry out its business.

10. **Business Valuation and Corporate Restructuring:** The business valuation assumes special significance in cases of merger between firms or acquisition of one firm by another. Such changes in the ownership structure of assets in the company is called corporate restructuring.

Financial Environment

A business enterprise operates within the financial environment which is constituted by the following:

1. **Financial institutions:**
    - Financial intermediaries (eg: commercial banks, insurance companies, housing finance companies, lease finance and hire purchase finance companies, etc) and Financial non-intermediaries (development finance institutions like IDBI, SIDBI, etc.)
    - Banking and non-banking financial institutions
    - Other Financial institution
2. **Financial markets:**
    - Money market (short-term investment) and Capital market (long-term investment)
    - Primary market (IPO) and secondary market (second hand securities)

- Organised Market and Unorganised market

3. **Financial services:**
   - Fund-based services
   - Fee-based services
4. **Financial Assets**
   - Direct and indirect financial assets (eg: shares, debentures, treasury bills, units of mutual funds etc.)
   - Derivative instruments (eg: futures, options, etc.)
5. **Financial Regulators**
   - RBI (regulates Money market)
   - SEBI and IRDA (regulates Capital market)

NUMERICALS

SUMS ON PRESENT VALUE & FUTURE VALUE TO BE SOLVED IN CLASS