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Sonargaon University (SU)

সোনারগাঁও ইউনিভার্সিটি (এসইউ)

Course Title: Financial Management

LECTURE SHEET

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Chapter: Introduction to Finance

<u>Topics at a Glance:</u>

- Definition of Finance
- Functions of Finance
- Definition of Financial Management
- Decision Taken by Financial Manager
- Principles of Business Finance
- Goal of Business Finance: Profit Maximization and Wealth Maximization
- Agency Theory / Agency Problem

Definition of Finance

Finance is the study and practice of managing money, investments, and other financial assets. It involves the allocation, acquisition, and efficient utilization of funds by individuals, businesses, and governments to achieve financial objectives.

Key Areas of Finance:

1. Personal Finance – Managing individual or household financial activities, such as budgeting, saving, investing, and retirement planning.
2. Corporate Finance – Dealing with financial decisions in businesses, including capital investment, funding sources, and profit distribution.
3. Public (Government) Finance – Managing revenue (taxes), expenditures, and debt for public institutions and infrastructure.
4. Investments – Analyzing securities (stocks, bonds, etc.) and portfolios to maximize returns while managing risk.
5. Financial Markets & Institutions – Studying banks, stock exchanges, and other entities that facilitate financial transactions.

Finance integrates economics, accounting, and risk management to optimize wealth and ensure sustainable growth.

Functions of Finance

Once upon a time, fund collection was the only consideration in financial activity. But with the evolution of time, financial activities now include fund collection, investment, fund management, risk management, and profit distribution. In short, all fund-related activities are considered financing activities. The key functions of finance are described below:

1. **Financial Planning**: Fund is needed to perform any task. This involves analyzing the source of funds, the time of collection, the cost of collection, different tax considerations, and determining the scope of the task. Every individual, organization, or government formulates financial planning based on their strengths and capabilities.
2. **Identification of Sources of Fund**: Once a financial plan is prepared, the sources of funds are considered. In a business organization, these can be classified into:
    - **Internal Sources:** Owner’s capital, depreciation fund, retained earnings, etc.
    - **External Sources:** Bank credit, creditors, shares, debentures, etc.
3. **Procurement of Fund**: Collecting funds from identified sources is a critical task. It involves considering the amount, payment methods, and any terms or conditions associated with the sources, including fund preservation arrangements.

4. **Investment of Fund**: Based on the financial plan, funds are invested in projects that promise profitability. The potential return, cost, and time required are carefully assessed in the selection of projects.
5. **Distribution of Profit**: The way profits from investments are shared is vital. It involves decisions about how much profit will be retained for reinvestment and how much will be distributed to shareholders.
6. **Risk-Return Trade-off**: The concept of "no risk, no gain" applies here. Risk must be taken to earn returns, but excessive risk could harm capital. Coordinating risk with potential earnings is a key part of financial management.
7. **Protection of Cash Balance & Financial Documents**: Securing cash and maintaining financial documents for individuals and organizations is a significant financial activity.
8. **Cost Control**: Managing and minimizing costs associated with financial tasks is essential. The goal is to maximize output or services at the lowest possible cost.
9. **Projecting Cash Flows**: Cash inflows and outflows must be forecasted accurately, especially for business projects. Consistency between inflows and outflows is essential for smooth operations and decision-making.
10. **Protection of Fund**: Protecting invested capital is critical. Necessary measures must be taken to reduce risk and uncertainty in all financial activities.

Definition of Financial Management

Financial Management is the systematic process of planning, organizing, controlling, and monitoring financial resources to achieve the economic objectives of an organization or individual. It encompasses the acquisition, allocation, and utilization of funds in a way that maximizes efficiency, profitability, and sustainability while minimizing financial risks.

Decision Taken by Financial Manager

Financial managers are responsible for making strategic decisions to achieve the overall financial goals of a business. According to James C. Van Horne, financial management involves three major decisions: investment decisions, financing decisions, and dividend decisions. These are described below:

1. Investment Decision: The most important decision of financial management is the investment decision. This involves determining the best asset or project in which to invest so as to earn the maximum expected rate of return or benefits. The selection of assets or projects is crucial and can be classified into two types:

A. Working Capital Management: Capital is required to carry out day-to-day business operations. The main components of working capital include cash, inventory, debtors, and accounts receivable. The challenge is to strike a balance between profitability and liquidity.

- Investing too much in working capital reduces profitability.

- Investing too little may lead to problems in paying current liabilities and increases the risk of bankruptcy.

Thus, working capital investment must be managed in a way that maintains profitability while avoiding liquidity crises.

B. Investment in Long-Term Asset or Project (Capital Budgeting): Long-term investments can yield long-term benefits or income. To make such investments, it is necessary to evaluate:

- How much capital is required,
- The expected income over the project's life,
- The certainty of returns.

Capital budgeting techniques are used to assess these factors and help managers make informed investment decisions.

2. Financing Decision: This decision involves determining how to source the required capital for implementing investment projects. It focuses on:

- Selecting the source(s) of finance (e.g., debt or equity),
- Determining the proportion of owner's capital vs. borrowed capital.

This is also known as the capital structure or leverage decision.

The goal is to create an optimum capital structure—one that minimizes the cost of capital and maximizes the value of the firm's shares. Achieving this optimum mix is a key responsibility of financial managers.

3. Dividend Decision: After earning profits from investments, a company must decide how much of the profit to distribute to shareholders (dividends), and Retain for future reinvestment. This is known as the dividend decision.

- The ratio of profit distributed is called the dividend payout ratio.
- The optimum dividend payout ratio is the one that satisfies shareholders and supports the company's long-term value.

The financial manager must carefully analyze the company's financial position and growth prospects to make an appropriate dividend decision.

Principles of Business Finance

1. **Principle of Risk and Return**: Every investment carries a certain level of risk. According to this principle, the higher the risk, the higher the expected return should be, and vice versa. Business finance decisions must balance the trade-off between risk and return to maximize value.
2. **Principle of Time Value of Money**: This principle states that a dollar today is worth more than a dollar in the future due to its potential earning capacity. Therefore, financial decisions should consider the timing of cash flows—sooner is better.

3. **Principle of Cash Flow**: Profit is not the same as cash. Business finance focuses more on actual cash flows rather than accounting profits. A business needs sufficient cash inflows to cover its outflows to remain solvent and grow.
4. **Principle of Profitability and Liquidity**: A company must be both profitable and liquid. Profitability ensures long-term survival, while liquidity ensures short-term survival. Financial managers must ensure a proper balance between these two aspects.
5. **Principle of Cost-Benefit Analysis**: Every financial decision should be evaluated based on its benefits relative to its costs. A decision should be implemented only when its benefits outweigh the associated costs.
6. **Principle of Continuity**: Financial planning and decisions should be made with a long-term perspective. A business is assumed to be a going concern, and financial strategies should support sustainable growth and continuity.
7. **Principle of Diversification**: "Don't put all your eggs in one basket." Diversifying investments and sources of finance helps to spread risk and reduce the potential negative impact of poor financial performance in one area.

Goal of Business Finance: Profit Maximization and Wealth Maximization

The primary objective of business finance is to ensure that financial decisions contribute to the overall goal of the business. Traditionally, this goal has been interpreted in two major ways: Profit Maximization and Wealth Maximization. Both have their own significance, merits, and limitations.

1. Profit Maximization: Profit maximization refers to the objective of a business to earn the highest possible profit in a given time period. It is a traditional and straightforward approach to financial decision-making.

Favorable Arguments (Advantages):

- **Simple and Clear Objective:** Easy to understand and measure using accounting profits.
- **Short-Term Performance Indicator:** Helps assess business efficiency and success in the short run.
- **Encourages Efficiency:** Promotes cost control and revenue maximization.
- **Basis for Survival:** Profit is essential for a business to survive and grow.

Unfavorable Arguments (Limitations):

- **Ignores Time Value of Money:** Does not consider when the profit is earned.
- **Neglects Risk Factor:** Assumes certainty in outcomes, ignoring business risk.
- **Focus on Short-Term:** Can lead to decisions that harm long-term sustainability.
- **No Consideration for Stakeholders:** Focuses only on shareholders and ignores employees, customers, and society.

2. Wealth Maximization: Wealth maximization means increasing the value of the business in terms of the market price of shares. It considers long-term growth, cash flows, and the timing and risk of financial returns.

Favorable Arguments (Advantages):

- **Considers Time Value of Money:** Evaluates financial decisions based on discounted cash flows.
- **Risk-Adjusted Returns:** Takes into account the uncertainty of outcomes.
- **Long-Term Focus:** Encourages sustainable growth and value creation.
- **Stakeholder-Oriented:** Aims to increase overall firm value, benefiting shareholders and other stakeholders.
- **Aligned with Modern Financial Theory:** Accepted as the appropriate goal in corporate finance.

Unfavorable Arguments (Limitations):

- **Difficult to Measure:** Market value of shares can be influenced by external, non-financial factors.
- **Information Asymmetry:** Not all investors may have access to the same information.
- **Long-Term Focus May Ignore Short-Term Needs:** May overlook immediate operational needs in favor of future gains.

While profit maximization is simple and useful in the short term, wealth maximization is considered a more comprehensive and modern goal of business finance. It provides a better framework for making sound financial decisions that ensure the long-term success of the business. Hence, wealth maximization is widely accepted as the primary objective of business finance in today's corporate world.

Agency Theory / Agency Problem

Agency Theory is a principle in corporate finance that explains the relationship between principals (owners/shareholders) and agents (managers/executives) in a business. It addresses the conflicts of interest that arise when the agents, who are hired to manage the company on behalf of the owners, pursue their own personal goals instead of maximizing shareholder wealth. This conflict is known as the Agency Problem.

Key Terms:

- **Principal**: The owner or shareholder of the firm who delegates authority.
- **Agent**: The manager or executive hired to operate the business on the principal’s behalf.
- **Agency Relationship**: A contract under which one or more persons (principals) engage another person (agent) to perform some service and delegate decision-making authority to the agent.

- **Agency Problem**: The conflict that arises when the goals of the agent do not align with those of the principal.

Examples of Agency Problems:

1. **Managerial Perks**: A manager may use company funds for luxury office space, business-class travel, or excessive bonuses.
2. **Empire Building**: Managers might acquire other companies to increase the size of the firm (and their personal influence), even if the acquisition doesn't benefit shareholders.
3. **Underinvestment**: Managers might avoid high-risk projects that could benefit shareholders because they fear personal job loss if the project fails.

Causes of Agency Problem:

- **Information Asymmetry**: Managers often have more information than shareholders, making it difficult for shareholders to monitor decisions.
- **Separation of Ownership and Control**: In large firms, owners and managers are not the same people.
- **Misaligned Incentives**: Managers may prioritize their own compensation, job security, or personal reputation.

Solutions to the Agency Problem:

1. **Incentive Alignment:**
    - Offering stock options**,** profit-sharing**, or** performance-based bonuses to managers so that their interests align with shareholders.
2. **Monitoring Mechanisms:**
    - **Board of Directors**: Independent boards can supervise management decisions.
    - **Audits and Reporting**: External audits and transparent financial reporting increase accountability.
3. **Market Discipline:**
    - **Threat of Takeovers**: Poorly managed firms may be taken over by more efficient ones.
    - **Reputation and Career Concerns**: Managers may behave in the best interest of shareholders to maintain a good professional reputation.
4. **Contracts and Agreements:**
    - Designing executive contracts that tie compensation to performance targets.

Agency Theory plays a critical role in understanding how to manage and structure organizations effectively. The Agency Problem highlights the importance of aligning the interests of managers (agents) with those of shareholders (principals) to ensure efficient decision-making and the long-term success of a company.