Table of Contents

1.0 INTRODUCTION

Finance is the application of economic principles and concepts to business decision making and problem solving. The field of finance broadly consists of three categories: Financial Management, Investments and Financial Institutions.

i) **Financial Management:** This area is concerned with financial decision making within a business entity. Financial management decisions, include maintaining optimum cash balance, extending credit, mergers and acquisitions, raising of funds and the instruments to be used for raising funds and the instruments to be used for raising funds etc.

ii) **Investments:** This area of finance focuses on the behaviour of financial markets and pricing of financial instruments.

iii) **Financial Institutions:** This area of finance deals with banks and other financial institutions that specialises in bringing supplier of funds together with the users of funds. There are three categories of financial institutions which act as an intermediary between savers and users of funds, viz., banks, developmental financial institution and capital markets.

Financial management is broadly concerned with the acquisition and use of funds by a business firm. The scope of financial management has grown in recent years, but traditionally it is concerned with the following:

- How large should a firm be and how fast should it grow?
- What should be the composition of the firm's assets?
- What should be the mix of the firm's financing?
- How should the firm analyse, plan and control its financial affairs?

The past two decades have witnessed several rapid changes on the economic and corporate front which have an important bearing on how firms are run and managed. On the one hand we have witnessed economies of several countries opening up thereby throwing new opportunities and on the other hand we have also witnessed that the growth rate of developed countries are stagnating or even declining. The impact of these changes is that the firms have to move out of the saturated markets and explore new markets.

1.1 OBJECTIVES

After going through this unit, you should be able to:

- understand the role and scope of financial management;
- understand the evolution of financial management;
- understand the various decisions taken by financial managers, and
- understand the concept of economic and accounting profit.

1.2 EVOLUTION OF FINANCIAL MANAGEMENT

The evolution of financial management may be divided into three broad phases: i) The traditional phase ii) The transitional phase iii) The modern phase.

In the traditional phase the focus of financial management was on certain events which required funds e.g., major expansion, merger, reorganisation etc. The traditional phase was also characterised by heavy emphasis on legal and procedural aspects as at that point of time the functioning of companies was regulated by a plethora of legislation. Another striking characteristic of the traditional phase was that, a financial management was designed and practiced from the outsiders point of view mainly those of investment bankers, lenders, regulatory agencies and other outside interests.

During the transitional phase the nature of financial management was the same but more emphasis was laid on problems faced by finance managers in the areas of fund analysis planning and control.

The modern phase is characterised by the application of economic theories and the application of quantitative methods of analysis. The distinctive features of the modern phase are:

- Changes in macro economic situation that has broadened the scope of financial management. The core focus is how on the rational matching of funds to their uses in the light of the decision criteria.
- The advances in mathematics and statistics have been applied to financial management specially in the areas of financial modeling, demand forecasting and risk analysis.

1.3 SIGNIFICANCE OF FINANCIAL MANAGEMENT

The main objective of financial management is, to make optimum utilisation of resources which results in maximum profits. The last five decades have witnessed rapid industrial development and policies of globalisation and liberalisation as a result of which financial activities have undergone tremendous changes. The success or the failure of business operations largely depends upon the financial policies pursued by the firm; as **Irwin Friend** has said “a firm’s success and even survival, its ability and willingness to maintain production and to invest in fixed or working capital are to a very considerable extent determined by its financial policies both past and present. In modern time where the ownership of firms is more dispersed, there is a separation of ownership and management and the firms are focusing toward social responsibility the role of financial management has spanned beyond planning and control”. In the words of **Ezra Soloman** “Financial management is properly viewed as an integral part of overall management rather than as a staff specialty concerned with fund raising operations. In addition to raising funds, financial management is directly concerned with production, marketing and other functions within an enterprise where decisions are made about the acquisition or distribution of assets”. The significance of financial management is discussed as follows:

1) **Determination of Business Success:** Sound financial management leads to optimum utilization of resources which is the key factor for successful enterprises. If we analyse the factors which lead to an enterprise turning sick one of the main factors would be mismanagement of financial resources. Financial Management helps in preparation of plans for growth, development, diversification and expansion and their successful execution.

2) **Optimum Utilisation of Resources:** One of the basic objectives of financial management is to measure the input and output in monetary terms. Since finance managers are responsible for the allocation of resources, they are also responsible to ensure that resources are used in an optimum manner. In fact, the failure of business enterprise is not due to inadequacy of financial resources, but is the result of defective management of financial resources. In a country like India, where capital is scarce effective utilisation of financial resources is of great significance.

3) **Focal Point of Decision Making:** Financial management is the focal point of decision-making as it provides various tools and techniques for scientific financial analysis. Some of the techniques of financial management are comparative financial statement, budgets, ratio analysis, variance analysis,

cost- volume, profit analysis, etc. These tools help in evaluating the profitability of the project.

4) **Measurement of Performance:** The performance of the firm is measured by its financial results. The value of the firm is determined by the quantum of earnings and the associated risk with these earnings. Financial decisions which increases earnings and reduces risk will enhance the value of the firm.

5) **Basis of Planning, Co-ordination and Control:** Each and every activity of the firm requires resource outlays which are ultimately measured in monetary terms. The finance department being the nodal department is closely associated with the planning of most of the activities of the various departments. Since most of the activities of the firm require co-ordination among various departments, the finance department facilitates this co-ordination by supplying the requisite information. Since the result of various activities are measured in monetary terms, again the finance department is closely involved in control and monitoring activities.

6) **Advisory Role:** The finance manager plays an important role in the success of any organisations.

7) **Information Generator for Various Stakeholders:** In this modern era where business managers are trustees of public money, it is expected that the firm provides information to the various stakeholders about the functioning of the firm. One of the major objectives of financial management is to provide timely information to various stakeholders.

1.4 PRINCIPLES OF FINANCIAL MANAGEMENT

The broad principles of corporate finance are:

1) Investment Decision
2) Financing Decision
3) Dividend Decision 4) Liquidity Decision

1.4.1 Investment Decision

The firm has scarce resources that must be allocated among competing uses. On the one hand the funds may be used to create additional capacity which in turn generates additional revenue and profits and on the other hand some investments results in lower costs. In financial management the returns, from a proposed investment are compared to a minimum acceptable hurdle rate in order to accept or reject a project. The hurdle rate is the minimum rate of return below which no investment proposal would be accepted. In financial management we measure (estimate) the return on a proposed investment and compare it to minimum acceptable hurdle rate in order to decide whether or not the project is acceptable. The hurdle rate is a function of riskness of the project, riskier the project higher the hurdle rate. There is a broad argument that the correct hurdle rate is the opportunity cost of capital. The opportunity cost of capital is the rate of return that an investor could earn by investing in financial assets of equivalent risk.

1.4.2 Financing Decision

Another important area where financial management plays an important role is in deciding when, where, from and how to acquire funds to meet the firm’s investment needs. These aspects of financial management have acquired greater importance in recent times due to the multiple avenues from which funds can be raised. Some of the widely used instruments for raising finds are ADRs, GDRs, ECBs Equity Bonds and Debentures etc. The core issue in financing decision is to maintain the optimum capital structure of the firm that is in other words, to have a right mix of debt and equity in the firm's capital structure. In case of pure equity firm (Zero debt firms) the shareholders returns should be equal to the firm's returns. The use of debt affects the risk and return of shareholders. In case, cost of debt is used the firm's rate of return the shareholder's return is going to increase and vice versa. The change in shareholders return caused by change in profit due to use of debt is called the financial deverage.

1.4.3 Dividend Decision

Dividend decisions is the third major financial decision. The share price of a firm is a function of the cash flows associated with the share. The share price at a given point of time is the present value of future cash flows associated with the holding of share. These cash flows are dividends. The finance manager has to decide what proportion of profits has to be distributed to the shareholders. The proportion of profits distributed as dividends is called the dividend pay out ratio and the retained proportion of profits is known as retention ratio. The dividend policy must be designed in a way, that it maximises the market value of the firm's share. The retention ratio depends upon a host of factors− the main factor being the existence of investment opportunities. The investors would be indifferent to dividends if the firm is able to earn a rate or return which is higher than the cost of the capital. Dividends are generally paid in cash, but a firm may also issue bonus shares. Bonus share are shares issued to the existing shareholders without any charge. As far as dividend decisions are concerned the finance manager has to decide on the question of dividend stability, bonus shares, retention ratio and cash dividend.

1.4.4 Liquidity Decision

A firm must be able to fulfill its financial commitments at all points of time. In order to ensure this the firm should maintain sufficient amount of liquid assets. Liquidity decisions are concerned with satisfying both long and short-term financial commitments. The finance manager should try to synchronise the cash inflows with cash outflows. An investment in current assets affect the firm's profitability and liquidity. A conflict exists between profitability and liquidity while managing current assets. In case, the firm has insufficient current assets it may default on its financial obligations. On the other hand excess funds result in foregoing of alternative investment opportunities.

Check Your Progress 1

1) List the three broad phases of evolution of financial management.

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2) List the significance of financial management.

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3) What are the major principles of financial management?

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1.5 OBJECTIVES OF FINANCIAL MANAGEMENT

For optimal financial decisions, it is essential to define objectives of financial management. These objectives serve as decision-criterion. Financing is a functional area of business and, therefore, the objectives of financial management must be in tune with the overall objectives of the business. The main objectives of business are survival and growth. In order to survive in the business and to grow, a business must earn sufficient profits. It must also maintain good relations with investors, employees, customers and other groups of society. Financial management of an organisation may seek to achieve the following objectives:

- ensure adequate and regular supply of funds to the business,
- provide a fair rate of return to the suppliers of capital,
- ensure efficient utilisation of capital according to the principles of profitability, liquidity and safety,
- devise a definite system for internal investment and financing,
- minimise cost of capital by developing a sound and economical combination of corporate securities,
- co-ordinate the activities of the finance department with the activities of other departments of the organisation.

Generally, maximisation of economic welfare of its owners is accepted as the financial objective of the firm. But, the question is, how does one maximise the owners' economic welfare? Financial experts differ while finding a solution to this problem. There are two well known criteria in this regard: i) Profit Maximisation ii) Wealth Maximisation.

Profit Maximisation

The basic objective of every business enterprise is the welfare of its owners. It can be achieved by the maximisation of profits. Therefore, according to this criterion, the financial decisions (investment, financing and dividend) of a firm should be oriented to the maximisation of profits (i.e. select those assets, projects and decisions which are profitable and reject those which are not profitable). In other words, actions that increase profits are be undertaken and those that decrease profits are to be avoided. Profit maximisation as an objective of financial management can be justified on the following grounds:

1) Rational
2) Test of Business Performance
3) Main Source of Inspiration
4) Maximum Social Welfare
5) Basis of Decision-Making

Drawbacks of Profit Maximisation Concept

1) It is vague

2) It ignores time value of money

3) It ignores risks

4) It ignores social responsibility

From the above description, it can be easily concluded that profit maximisation criterion is inappropriate and unsuitable as an operational objective of financial management. In imperfect competition, the profit maximisation criterion will certainly encourage concentration of economic power and monopolistic tendencies. That is why, the objective of wealth maximisation is considered as the appropriate and feasible objective as against the objective of profit maximisation.

We shall discuss this criteria in detail and arrive at a satisfactory conclusion to determine the goals or objectives of financial management.

Wealth Maximisation

The objective of profit maximisation, as discussed above, is not only vague and ambiguous, but it also ignores the two basic criteria of financial management i.e. (i) risk and (ii) time value of money. Therefore, wealth maximisation is taken as the basic objective of financial management, rather than profit maximisation. It is also known as 'Value Maximisation' or 'Net Present Value Maximisation'. According to **Ezra Soloman** of Stanford University, the ultimate objective of financial management should be the maximisation of wealth. **Prof. Irwin Friend** has also supported this view.

Wealth Maximisation means to maximise the net present value (or wealth) (NPV) of a course of action. It NPV is the difference between the gross present value of the benefits of that action and the amount of investment required to achieve those benefits. The gross present value of a course of action is calculated by discounting or capitalising its benefits at a rate which reflects their timings and uncertainty.

Superiority of Wealth Maximisation

We have discussed the goals or objectives of financial management. Now, the question arises as to the choice i.e., which should be the goal of financial management in decision –making i.e., profit maximisation or wealth maximisation. In present day changed circumstances, wealth maximisation is a better objective because it has the following points in its favour:

- It measures income in terms of cash flows, and avoids the ambiguity now associated with accounting profits as, income from investments is measured on the basis of cash flows rather than on accounting profits.
- It recognises time value of money by discounting the expected income of different years at a certain discount rate (cost of capital).
- It analyses risk and uncertainty so that the best course of action can be selected from different alternatives.
- It is not in conflict with other motives like maximisation of sales or market value of shares. It helps rather in the achievement of all these other objectives.

Therefore, maximisation of wealth is the operating objective by which financial decisions should be guided.

1.6 ECONOMIC PROFIT VS. ACCOUNTING PROFIT

Economic profit is the difference between revenues and costs where costs include both the actual businesses costs (the explicit costs) and the implicit costs. The implicit costs are the payments that are necessary to secure the needed resources, the cost of capital. Accounting profits is the difference between revenues and costs recorded according to accounting principles. The implicit cost-opportunity cost and normal profits which reflects the uncertainty and timing of future cash flows are not taken into consideration in according profits.

Economic Value Added

i) Calculate the firm's operating profit ii) Calculate the cost of capital iii) Compare operating profit with cost of capital.

A related measure of economic profit is market value added (MVA), which focuses on the market value of capital as compared to the cost of capital.

- Calculate the market value of capital
- Calculate the amount of capital invested.
- Compare the market value of capital with capital invested.

In theory market value added is the present value of all expected future economic profits.

In a nutshell financial decisions are concerned, with the firm's decision to acquire and dispose off assets and commitment of funds on a continuous basis. Financial decisions affect the size, growth, profitability, risk and ultimately, the Value of the firm.

1.7 AGENCY RELATIONSHIP

When firms are small they usually function as sole proprietorship firms or partnership firms where owner/partners make the decisions. As the volume and complexity of

business increases the sole proprietorship partnership firms convert themselves into public limited companies or joint stock companies. With increased geographical spread and other complexities often it is not possible for owners to look after all the aspects of the business. The decision making power is delegated to the managers (agents). An agent is a person who acts for, and exerts power on behalf of another person or group of persons. The person (or group of persons) whom the agent represents is referred to as the principal. The relationship between the agent and the principal is an agency relationship. There is an agency relationship between the managers and shareholders of a company.

1.7.1 Problems Related with Agency Relationship

In an agency relationship the agent is charged with the responsibility of acting for the principal and in the best interest of the principal. But, it is possible that the agent may act in a fashion which serves his/her own self-interest rather than that of the principal. In recent years we have witnessed numerous corporate frauds i.e. Enron, Xerox, etc., where the agents had misappropriated the authority vested in them by the principal. The problems associated with agency relationship can manifest itself in many ways. The most common being the misuse of power and authority by the managers, which includes financial misappropriation, using the funds of the company for the personal self (fringe benefits) etc. In case the reward and compensations are based on certain parameters, for example sales; managers may indulge in practices which would yield result in the short run but prove detrimental in the long run, i.e., overstocking the various intermediaries in the supply chain, offering huge discounts, dumping of goods in the territory of another manager etc. Another facet of this problem is, where managers put a little effort towards expanding and exploring the market for new business. In a nutshell the problems with agency relationship is that the managers act in a fashion which serves their own interest rather than that of the shareholders.

1.7.2 Costs of the Agency Relationship

In order to minimise the potential for conflict between the principal's interest and the agent's interest certain costs are to be incurred by the principal as well as the agent and the cumulative effect of these costs is referred to as the agency costs. Agency costs are of three types: monitoring costs, bonding costs and residual cost.

Monitoring Costs

These are the costs incurred by the principal to monitor and limit the actions of the agent. In companies the shareholders may require the managers to periodically report on their activities via audited financial statements. The cost of resources spent on preparing these statements is monitoring cost. Another example is the implicit cost incurred when the principal limits the decision making power of the agent; by doing so, the principal may miss profitable investment opportunities. The foregone profit is the monitoring cost.

Bonding Costs

These are the costs incurred by the agents to assure the principal that they will act in the best interest of the principal.

Residual Costs

Residual costs is the remaining costs after taking into consideration of the above costs (i.e., monitoring costs, bonding costs).

1.8 THE CHANGING FINANCIAL LANDSCAPE

The past two decades have been witnessing radical changes in the financial system world over. The significant changes which has been taking place over the years are:

a) Low interest rate regime
b) Exchange control and convertibility
c) Development of capital markets
d) Less intermediation
e) Introduction of hybrid financial instruments
f) Increase in risk exposure
g) Volatility in commodity prices
h) Substantial lowering of custom duty (Removal of trade barriers).

These changes coupled with changing customer needs, technology driven innovations and regulatory changes are imposing substantial changes in the financial systems world over.

The impacts of these changes are as follows:

1) Increased competitions have resulted in the rationalisation of pricing and costs. Companies having high cost structure are being forced to rationalise operations. 2) National financial system is now more closely integrated with international financial system.

1.9 ORGANISATION OF FINANCIAL MANAGEMENT

Organisation of financial management means the division and the classification of various functions which are to be performed by the finance department.

In small organisations where partners or proprietors have main say in the running of the firm, no separate finance department is established. At the most they may appoint a person for book keeping and liasioning with banks and debtors.

In medium size organisations a separate department to organise all financial activities may be created at the top level under the direct supervision of the Board of Directors or a very senior executive. The important feature of this type of set up is that there is no further sub division based on various functional areas of finance.

In large size organisations the finance department is further sub divided into functional areas. In these organisations two main sub-divisions are that of the Financial Controller and the Treasurer. The Financial Controller is concerned with planning and controlling, preparation of annual reports, capital and working capital budgeting, cost and inventory management maintenance of books and records and pay-roll preparation. The treasurer is concerned with raising of funds both short term and long term. In addition to this the treasurer is responsible for cash and receivable management, auditing of accounts, protection and safe keeping of securities and the maintenance of relations with banks and institutions.

1.10 TASKS AND RESPONSIBILITIES OF MODERN FINANCIAL MANAGER

The task and responsibilities of finance managers vary from organisation to organisation depending upon the nature and size of the business, but inspite of these variations the main tasks and responsibilities of finance manager can be classified as follows:

a) Compliance with policy and procedures laid by the Board of Directors.
b) Compliance with various rules and procedures as laid by law.
c) Information generation for various stakeholders.
d) Effective and efficient utilisation of funds.

The main tasks and responsibilities of a financial manager are discussed below:

1) **Financial Planning and Forecasting:** Financial manager is also concerned with planning and forecasting of production, sales and level of inventory. In addition to this, he has also to plan and forecast the requirement of funds and the sources from which the funds are to be raised.

2) **Financial Management:** Fund management is the primary responsibility of the finance manager. Fund management includes effective and efficient acquisition, allocation and utilisation of funds. The fund management includes the following:

- ***Acquisition of funds:*** The finance manager has to ensure that adequate funds are available from the right sources at the right cost at the right time. The finance manager will have to decide the mode of raising fund, whether it is to be through the issue of securities or lending from the bank.

- ***Allocation of funds:*** Once funds are acquired the funds have to be allocated to various projects and services as per the priority fixed by the Board of Directors.

- ***Utilisation of funds:*** The objective of business finance is to earn profiles, which on a very large extent depend upon how effectively and efficiently allocated funds are utilised. Proper utilisation of funds is based on sound investment decisions, proper control and asset management policies and efficient management of working capital.

3) **Disposal of Profits:** Finance manager has to decide the quantum of dividend which the company wants to declare. The amount of dividend will depend upon mainly the future requirement of funds for expansion and the prevailing tax policy.

4) **Maximisation of Shareholder's Wealth:** The objective of any business is to maximise and create wealth for the investors, which is measured by the price of the share of the company. The price of the share of any company is a function of its present and expected future earnings. The finance managers should pursue policies which maximises earnings.

5) **Interpretation and Reporting:** Interpretation of financial data requires skills. The finance manager should analyse financial data and find out the reasons for variance from standards and report the same to the management. He should also assess the likely financial impact of these variances.

6) **Legal Obligations:** All the companies are governed by specific laws of the land. These laws relate to payment of taxes, salaries, pension, corporate governance, preparation of accounts etc. The finance manager should ensure that a true and correct picture of the state of affairs should be reflected in the statement of accounts. He should also ensure that the tax returns and various other information should be submitted on time.

Check Your Progress 2

1) What are the significant changes taking place in the financial system?

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2) List the main tasks and responsibilities of a Financial Manager.

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1.11 SUMMARY

Financial Management has undergone several changes over the last five decades as more and more companies are raising funds from markets both domestic and overseas. The modern phase of financial management is characterised by the application of economic theories and advanced mathematical and statistical tools. Financial management's significance is increasing day by day as it play the role of facilitator among various departments. The objective of the firm has also changed from profit maximisation to that of wealth maximisation. The agency problem is concerned with how managers behave when, delegated with decision making powers.

1.12 SELF-ASSESSMENT QUESTIONS/EXERCISES

1) "Finance is the life blood of industry." Elucidate this statement with suitable illustrations.

2) What is the finance function? Explain in brief the different approaches (or concepts) to Finance Function.

3) What is Financial Management? How does a modern financial management differ from traditional financial management?

4) What is meant by 'Financial Management'? What are the salient features of Financial Management?

5) Define Financial Management and discuss its main functions.

6) Explain the scope of financial management. What role should the financial manager play in modern enterprise?

7) What do you understand by 'Financial Management'? Discuss its significance in business management.

8) "The importance of financial management has increased in modern times". Elucidate.

9) "Sound Financial Management is a key to the progress for corporation." Explain.

10) "Without adequate finance no business can survive and without efficient financial management, no business can prosper and grow." Comment on this statement bringing out the role of financial management.

11) Discuss the objectives and goals of Financial Management.

1.13 SOLUTIONS/ANSWERS

Check Your Progress 1

1) The three broad phases of evolution of financial management are as follows:
   a) The traditional phase
   b) The transitional phase
   c) The modern phase

2) The significance of financial management are:

   a) Determination of business success
   b) Optimum utilisation of resources
   c) Focal point of decision making
   d) Measurement of performance
   e) Basis of planning coordination and control
   f) Advisory role
   g) Information generator for various stakeholders

3) The broad principles of corporate finance are:

   a) Investment Decision
   b) Financing Decision
   c) Dividend Decision
   d) Liquidity Decision

Check Your Progress 2

1) The following are the significant changes taking place in the financial system:

   a) Low interest rate regime
   b) Exchange control and convertibility
   c) Development of capital markets
   d) Less intermediation
   e) Introduction of hybrid financial instruments
   f) Increase in risk exposure
   g) Volatility in commodity prices
   h) Substantial lowering of custom duty

2) The main tasks and responsibilities of a financial manager are

   a) Financial planning and forecasting
   b) Financial management
   c) Disposal of profits
   d) Maximisation of shareholder's wealth
   e) Interpretation and reporting
   f) Legal obligations