CHAPTER 1

Financial Management —An Introduction

CHAPTER OUTLINE

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INTRODUCTION

Financial management can be defined as the management of flow of funds. It deals with the financial decision making. It encompasses the procurement of the funds in the most economic and prudent manner and employment of these funds in the most optimum way to maximize the return for the owner. Since raising of funds and their best utilization is the key to the success of any business organization, the financial management as a functional area has got a place of prime relevance. It is concerned with overall managerial decision making in general and with the management of economic resources in particular. All business decisions have financial implications and therefore financial management is inevitably related to almost every aspect of business operations. Broadly speaking, the financial management includes any decision made by a business/investor that affects its finances.

DEVELOPMENT OF FINANCE

Finance has emerged as a distinct area of study during second half of the twentieth century. But even before that, some direct or indirect references to finance function were made on a casual basis. The evolution of finance function and the changes in its scope appeared due to two factors namely (1) the continuous growth and diversity in business, and (2) the gradual appearance of new financial analytical tools. Broadly speaking, there are two phases of evolution of finance function.

Finance upto 1950–Traditional Phase

Initially, finance was a part of economics and no separate attention was paid to finance. Business owners were more concerned with operational activities. In the traditional phase, the finance manager was concerned with record keeping, preparing different report, and managing cash. A finance manager was called upon in particular only when his speciality was required to locate new sources of funds whenever there was a need felt for the funds. The traditional phase can be summarized as follows :

(i) Finance function was concerned with procuring of funds to finance the expansion or diversification activities and thus the occurrence of finance function was casual in nature. Finance function was not a part of regular managerial operations.

(ii) Finance was concerned with procuring of fund primarily by issue of securities such as equity shares, preference shares and debt instruments. So, a knowledge of the sources of funds, what securities to sell, to whom and by what techniques to sell, was needed.

(iii) Finance function was viewed particularly from the point of view of supplier of funds *i.e.*, the lenders, both individuals and institutions.

(iv) The focus of attention was on the long-term resources and only the long-term finance was of any concern. The concept of working capital and its management was virtually non-existent.

(v) In order to finance business growth, there was an emergence of institutional financing and institutional banking giving rise to finance industry.

(vi) The treatment of different aspects of finance was more of a descriptive nature rather than analytical. In fact, there were no analytical financial decision making as such.

After 1950 – Modern Phase of Finance Function

As a result of the gradual increase in competition and growth in business, the scope of finance function has widened further and includes not only the measures of procuring funds at episodic events but also the optimum utilization through data based analytical decision making. The finance manager has emerged as a professional manager involved with capital funds to be raised by the firm, with the allocation of these funds to different projects and with the measurement of the results of each allocation. Today's finance manager deals with a variety of situations arising in any organization. These situations may be diversification into new markets and new products; countering the inflation that significantly affects the planning of operations; high financing cost and capital intensive environment; and emphasis on growth, *etc*. Two significant contributions to the development of modern theory of financial management are :

(1) Theory of Portfolio Management developed by *Harry Markowitz* in 1950, which deals with portfolio selection with risky investments. This theory uses statistical concepts to quantify the risk-return characteristics of holding a group/portfolio of securities, investments or assets. A significant contribution of this theory is that the risk of an investor is viewed in its totality rather than evaluating the risk of one security only. This theory in a later development lead to the development of Capital Asset Pricing Model which deals with pricing of risky assets and the relationship between risk and return.

(2) **The Theory of Leverage and Valuation of Firm** developed by Modigliani and Miller in 1958. They have shown as to how the financial decision making in any firm be oriented towards maximization of the value of the firm and the maximization of the shareholders' wealth.

The modern phase of finance function can be summarized as follows :

(*i*) The scope has widened to include the optimum utilization of funds through analytical decision making.

(*ii*) The finance function is now viewed from the point of view of the insiders *i.e.*, those who are taking decisions in the firm.

Thus, over the last sixty years, the finance has emerged as relatively a new field of study and a separate management function. As of today, the finance function has developed as decision oriented and includes among its analytical tools, the quantitative and computer techniques. The subject matter of finance function is still developing and many new theories as well as refinement to existing theories may be in the offing.

THE FUNCTIONS OF A FINANCE MANAGER/SCOPE OF FINANCE FUNCTION

Initially, the finance manager was concerned and called upon whenever funds were required by the firm. The finance manager was formally given a target amount of funds to be raised and was given the responsibility of procuring these funds. So, his function was limited to raising funds as and when the need arose. Once the funds were procured, his function was over. However, over a period of time, the scope of his function has tremendously widened. His presence at present is required at every moment whenever any decision having involvement of funds is to be taken. Nowadays, the financial manager is required to look into the financial implications of any decision in the firm. The function of finance manager now is to manage the funds. Any act, procedure, decision relating to funds comes under the purview of the finance manager. Since every activity in a business organization, be it purchase, production, marketing or capital expenditures has financial implications, the finance function is interlined with all other areas. In particular, the finance manager has to focus his attention on the following :

(*i*) Procuring the required quantum of funds as and when necessary, at the lowest cost,

(*ii*) Investing these funds in various assets in the most profitable way, and

(*iii*) Distributing returns to the shareholders in order to satisfy their expectations from the firm.

These three functions of the finance manager encompasses most of the financial activities in any firm. Thus, the functions of finance manager may be summarized to include the following :

(*i*) Overall financial planning and control,

(ii) Raising funds from different sources,

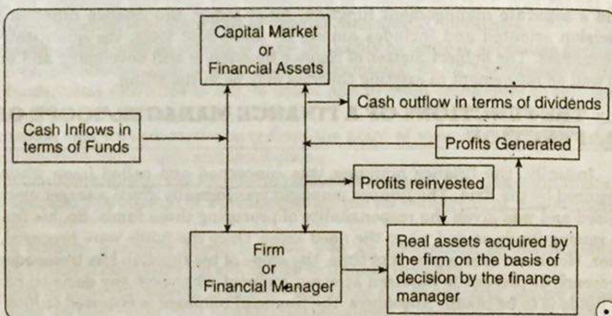
(iii) Selection of fixed assets,

(iv) Management of working capital, and

(v) Any other financial event.

While performing these functions, a finance manager has to operate as a link between the firm's operations on one hand and the capital market on the other. The role of finance manager as an intermediary arises because of two-way cash flows between the firm and the investors. In the first instance, the investors provide funds through capital market, to the firm, and second, the firm distributes profits among the investors in the form of interest or dividends. The firm raises funds by selling ownership securities or debt securities in the capital market. The funds raised in this way become the pool of the investible funds which are committed to the investment projects of the firm. The investment projects generate profit which are either distributed to the suppliers of investible funds or retained in the business for reinvestment in the future projects. So, the finance manager has to take care of the interest of the investors as well as the firm. His position as an intermediary has been depicted in the Figure 1.1.

FIGURE 1.1 Role of Finance Manager and two-way cash flows to Capital Market



In performing his role, a finance manager is faced with the following distinct scenarios:

(i) **What should be the size of firm and how fast should it grow ?** The size of the firm is measured by the value of its total assets as shown in the balance sheet. The firm's growth can be measured by the yearly percentage change in the assets of the firm. The finance manager has to decide about the size as well as the growth pattern of the assets. He should recognize how large assets and growing even larger is good for the firm and therefore should take the decisions accordingly.

(ii) **What are the various types of assets to be acquired ?** or What should be the composition of the assets of the firm. Whenever and whichever assets are acquired by the firm, the finance manager has to evaluate as to how it is going to contribute to the wealth of the firm. This is also known as the ***Investment Decision.***

(iii) **What should be the pattern of raising funds from various sources?** or, What should be the composition of the liabilities of the firm ? The liabilities and capital represent the sources which the firm uses to raise funds. The raising of funds from these sources in varying compositions has different implications. Deciding about the best mix of the liabilities and capital is referred to as the ***Financing Decision.***

Depending upon the nature and size of the firm, the finance manager is required to perform all or some of these functions from time to time. While performing these functions, he is required to take different decisions which can be broadly classified into three groups. Those relating to resource allocation (the investment decision), those covering the financing of these investments (the financing or capital structure decision) and those determining how much cash be taken out and how much reinvested (the dividend decision). These decisions are discussed below. objectives → Profit Maximisation and wealth

(*i*) **Investment Decisions :** Firms have scarce resources that must be allocated among competitive uses. The financial management provides a framework for firms to take these decisions wisely. The investment decisions include not only those that create revenues and profits (*e.g.*, introducing a new product line) but also those that save money (*e.g.*, introducing a more efficient distribution system). The investment decisions are the decisions relating to assets composition of the firm. Assets represent investment or uses of the funds that the firm makes in expectation of earning a return for its ~~investors~~ owner. In other words, investment decisions deal with the size and composition of the asset side of the balance sheet.

Broadly, assets of a firm can be classified into fixed assets and current assets, and therefore, the investment decisions can also be bifurcated into *Capital Budgeting Decisions* (relating to fixed assets) and the *Working Capital Management* (relating to current assets).

Capital Budgeting decisions deal with the size and composition of fixed assets. The fixed assets of a firm are the primary determinants of the profitability a firm. The earnings of the firm are basically caused by the fixed assets composition and also the total fixed assets *vis a vis* total assets of the firm. A finance manager may be asked to decide about (1) which asset should be purchased out of different alternative options, (2) to buy an asset or to get it on lease, (3) to produce a part of the final product or to procure it from some other supplier, (4) to buy or not another firm as a running concern, (5) proposal of merger of other group firms to avail the synergies of consolidation, *etc.* All these decisions have long-term ramification and are generally irreversible. The objective of Capital Budgeting decisions is to identify those assets which are worth more than they cost. Capital Budgeting decisions are very critical for every firm. A finance manager therefore has to take utmost care in dealing with these decisions. The Chapter 3 of this book deals with Capital Budgeting decisions.

Working Capital Management on the other hand, deals with the management of current assets of the firm. Though the current assets do not contribute directly to the earnings, yet their existence is necessitated for the proper, efficient and optimum utilization of fixed assets. There are problems of both the excessive working capital as well as the shortage of working capital. A finance manager has to ensure sufficient and adequate working capital to the firm. He has to take various decisions in this respect. These decisions may include how much and what inventory to be maintained, and whether and how much credit be given to customers, *etc.* The working capital management has been discussed in Chapters 12 to 16 of the book.

(ii) **Financing Decisions :** Financing Decisions deal with the financing pattern of the firm. As firms make decisions concerning where to invest these resources, they also have to decide how they should raise resources. There are two main sources of finance for any firm, the shareholders funds and the borrowed funds. These sources have their own peculiar features and characteristics. The key distinction between these two sources lies in the fixed commitments created by borrowed funds to pay interest and the principal. The borrowed funds are always repayable (except when the debt instrument is convertible into shares) and require payment of a committed cost in the form of interest on a periodic basis. The borrowed funds are relatively cheaper but always entail a risk. This risk is known as the financial risk *i.e.*, the risk of insolvency due to non payment of interest or non-repayment of capital amount.

On the other hand, the shareholders' fund is the main source of funds to any firm. This may comprise of the equity share capital, preference share capital and the accumulated profits. There is no committed outflow for equity share capital neither in the form of a return nor in the form of repayment of capital. However, the preference share capital has a commitment to be paid a minimum dividend (which is of course conditional) and also for repayment of capital when these shares are to be redeemed after some time (as the preference share in India can only be redeemable preference share).

Firms usually adopt a policy of employing both the borrowed funds as well as the shareholders funds to finance their activities. The employment of these funds in combination is also known as *financial leverage*. Every such combination has its own implications and is related to the value of the firm. Leverage Analysis, EBIT–EPS analysis, Capital Structure Models, *etc.*, are some of the tools available to a finance manager for this purpose. The financing decision and the processes employed by a finance manager have been analyzed in Chapters 6 to 9 of the book.

(iii) **Dividend Decisions :** Another major area of decision making by a finance manager is known as the Dividend decision which deals with the appropriation of after-tax profits. These profits are available to be distributed among the shareholders (subject to legal provisions) or can be retained by the firm for reinvestment within the firm. The profits which are not distributed are impliedly retained in the firm. All firms whether small or big, have to decide how much of the profits should be reinvested back in the business and how much should be taken out in form of dividends. On one hand, paying out more to the owners may help satisfying their expectations, on the other hand, doing so has other implications. A business that reinvests less will tend to grow slower. There cannot be any readymade policy for any firm regarding how much profit is to be distributed and how much portion is to be retained.

The distribution of profits by any firm is required to satisfy the expectations of the shareholders. The profits can be distributed to shareholders either as revenue income (*i.e.*, the dividends) or as capital receipt (*i.e.*, bonus share). These have their own tax implications in the hands of the shareholders as well as the firm. Both have their effect on the market value of the firm also. The finance manager is required to take various decisions regarding distribution of profit as dividends or as bonus shares. In his attempt, he has to look into the funds requirements of the firm and the shareholders' interest. The trade-off on Dividend decisions has been analyzed in Chapters 10 and 11 of the book.

FINANCIAL DECISION MAKING

In the previous section, it has been stated that the finance manager has to take different types of decisions from time to time. Some of these decisions may be taken once a while, *e.g.*, a capital structure decision or capital budgeting decision. However, the decisions regarding the working capital management are taken on a regular basis. The dividend decision is also almost a regular decision in the sense that it is taken whenever the firm wants to distribute interim dividend, final dividend or bonus share to the shareholders.

In order to make this process of financial decision making an efficient and effective one, it is necessary (1) to identify the groups whose interest is to be considered, and (2) to identify the goals, the achievement of which helps in measuring the impact of these decisions on the relevant group.

Relevant Groups

The various groups which may have stakes in the financial decision making of a firm and therefore required to be considered while taking financial decisions are :

1. The shareholders,
2. The debt investors,
3. The employees,
4. The customers and the suppliers,
5. The public,
6. The government, and
7. The management.

These groups have different perceptions about the firm and the firm has different relative importance for these perceptions. The shareholders are no doubt of primary concern to any firm and therefore their interest is put on the top priority. Traditionally, the public interest gets the last priority but due to the legislative measures and the work of different non-government organizations, the public interest has also emerged as the stakeholder in the financial decisions making process of any firm.

In financial management, the techniques and processes of financial decisions making are based on the assumption that it is only the shareholders group whose interest is to be considered and protected. This is not without reasons. The extent of the effect of a particular financial decision on the shareholders interest can be easily, fairly and accurately measured whereas the effect on other groups is difficult to be measured and often depends upon the subjective considerations. But, it does not mean that the interest of the other groups is unimportant. In fact, interest of the other groups is protected and taken care of either by the government or themselves. For example, the creditors may add conditions in sale agreement to safeguard their interest, whereas the debt investors can protect their interest by getting their investments secured or by getting a director nominated on the Board of Directors. The government often passes legislations to protect the interest of the public, the employees, *etc.*

So, the financial decision making in business firms is undertaken on the premise that it is the shareholders group whose interest is to be explicitly taken care off. At this stage, there is a question as to how the interest of the shareholders can be protected and measured. What is the goal or objective which if achieved, will result in protecting and safeguarding the interest of the shareholders ?

Identification of the Goal or Objective of the Financial Decision Making

A finance manager must have a well defined objective in the light of which he has to take various decisions. A goal of the firm may be defined as a target against which the firm's operating performance can be measured. The objective specifies what the decision maker is trying to accomplish and, by doing so, provides a framework for analyzing different decision rules. In most cases, the objective is stated in terms of maximizing some function or variable (profit, size, value, social welfare, *etc.*) or minimizing some function or variable (risk, cost, *etc.*)

A clear understanding of the objective of the financial management is a prerequisite as the objective provides a frame-work for optimum financial decision making. It may be noted that the objective of financial management will provide a selection/decision criterion for the relevant decision fields *i.e.*, the goal which the finance manager should pursue. However, in practice the finance manager may have other preferences also from time to time.

It may be noted that the objective of financial management should have the following characteristics : (*i*) it should be clear and unambiguous, (*ii*) It comes with a clear and timely measure that can be used to evaluate the success or failure of a decision, and (*iii*) It should be consistent with the long-term existence of the firm.

Several goals of financial management have been cited *viz.* maximization of sales revenue, net profit, return of investment, size of the firm, percentage market share, *etc.* It is already discussed that the main stakeholder group for the financial management is the shareholders group. Therefore, the problem is to identify one out of these several goals which will give the best reflection of the shareholders' interest. The following are often considered as the objectives of the financial management :

1. Maximization of the profits of the firm, and
2. Maximization of the shareholders' wealth.

In the following paragraphs, these objectives have been critically evaluated.

Maximization of the Profits of the Firm : For any business firm, the maximization of the profits is often considered as the implied objective, and therefore, it is natural to retain the maximization of profit as the goal of the financial management also. Various types of financial decisions be taken with a view to maximize the profit of the firm. So, out of different mutually exclusive options only that one should be selected which will result in maximum increase in profit. This profit can be measured in terms of the total accounting profit available to the shareholders.

The profit maximization as the objective of financial management has a built-in favour for its choice. The profit is regarded as a yard stick for the economic efficiency of any firm. If all business firm of the society are working towards profit maximization then the economic resources of the society as a whole would have been most efficiently, economically and profitably used. The profit maximization will ensure the maximization of the welfare of the society. So, the profit maximization as objective of financial management will result in efficient allocation of resources not only from the point of view of the firm but also for the society as such.

However, the profit maximization as the objective of financial management fails to deliver the goods in its operational terms. As already stated that various parties have stakes in the firm. Though the stake of the shareholders is of prime relevance, yet the interest of other parties such as lenders, creditors, society, *etc.* cannot be ignored. The finance manager faces a tough task of reconciling the interest of all these parties. The profit maximization overlooks the interest of parties other than the shareholders. There are various problems with the profit maximization as the objective of financial management. Some of these are as follows :

1. **It ignores the risk.** The profit maximization does not take into account the amount of risk which the firm undertakes in its attempt to increase the profit. With profit maximization as the objective, the management may undertake all profitable investment opportunities regardless of the associated risk, whereas that investment may not be worth the risk, despite its potential profitability.
2. **Profit maximization concentrates only on the profitability and ignores the financing aspect of that decision** and the risk associated with that financing. For example, in order to finance a profitable investment, a firm may borrow even beyond capacity.
3. **It ignores the timings of costs and returns and thereby ignores the time value of money,** All the monetary benefits and costs are considered in the absolute value terms without adjusting for time value.
4. **Profit maximization as an objective is vague and ambiguous.** Does it refer to maximization of short-term profit or long-term profit; after-tax profit or profit before tax; profit from the point of view of total funds employed or from the point of view of shareholders only, *etc.* ?
5. **Profit maximization borrows the concept of profit from the field of accounting and thus tends to concentrate on the immediate effect** of a financial decision as reflected in the increase in the profit of that year or in near future. This will not necessarily be correct because many decisions have their costs and benefits scattered over many years.

A variant of the objective of profit maximization is often suggested as the maximization of the return on investment. The firm would undertake all those investment opportunities which have the percentage return in excess of percentage cost of funds. In this case, the financial decision making will be directed more or less the same way as in the case of profit maximization. Therefore, the maximization of return on investment also suffers from the same drawbacks as the profit maximization.

On the basis of the above discussion, it may be concluded that the profit maximization fails to be an operationally feasible objective of financial management. A goal should be precise, well defined and must be capable of taking cognizance of all possible costs and benefits of all the alternatives being evaluated. One such goal is termed as the maximization of shareholders' wealth.

⊙ **Maximization of Shareholders' Wealth :** In the theory of financial management, it is well accepted that the objective of financial management is the maximization of shareholders' wealth. This objective is generally expressed in term of maximization of the value of a share of a firm. It is necessary to know and determine as to how the maximization of shareholders' wealth is to be measured.

The measure of wealth which is used in financial management is the concept of economic value. The economic value is defined as the present value of the future cash flows generated by a decision, discounted at appropriate rate of discount which reflects the degree of associated risk. This measure of economic value is based on cash flows rather than profit.

The economic value concept is objective in its approach and also takes into account the timing of cash flows and the level of risk through the discounting process.

The shareholders' wealth is represented by the present value of all the future cash flows in the form of dividends or other benefits expected from the firm. The market price of share reflects this present value. Therefore, the economic value of the shareholders' wealth is the market price of the share which is present value of all future dividends and benefits expected from the firm. Since each shareholder's wealth at any time is equal to the market value of all his holdings in shares, an increase in the market price of firm's shares would increase the shareholder's wealth.

Maximization of shareholders' wealth as an objective of financial management implies that the financial decisions will be taken in such a way that the shareholders receive highest combination of dividends and the increase in market price of the share. In other words, the shareholders' proportional ownership of a firm represented by a share should be maximized. All financial decisions therefore, are evaluated in terms of their effect on the firm's future cash flows and hence on the market price of the share.

The goal of maximization of shareholders' wealth as reflected in the market price of the share makes the interest of the shareholders compatible with that of the management. With this objective in sight, the management will allocate the available economic resources in the best possible way. This goal directly affects the policy decision of a firm about what to invest in and how to finance these investments. Further, the goal of maximization of shareholders' wealth implies a long-term perspective of the goal.

Maximisation of shareholders' wealth as an objective seems to be practical and operative. The types of decisions taken by the firm and their effect on the firm in the long run are immediately reflected in the market price of a share. The objective implies that the market price of a share is linked to three basic financial decisions *i.e.*, the investment decision, the financing decision and the dividend decision. The link between these decisions and the value of the share can be made by recognizing that the market price of a share is the present value of its expected cash flows, discounted back at a rate that reflects both the riskiness of the project and the financing mix used to finance it. The investors form expectations about future cash flows and these expectations are reflected in the market price of the share.

However, there are certain problems with the implementation of the goal of maximization of shareholders' wealth. The main problem is the assumption underlying this goal, *i.e.*, there is an efficient capital market wherein the effect of a decision is truly reflected in the market price of share. In practice, the share price in the market is subject to the influence of so many factors. The market price of a share is influenced by the overall economic and political scenario in the country. More often than not, the market price of a share may also fluctuate because of speculative activities. All these factors are assumed to be given and constant in this objective.

⊙ **Profit Maximization *Versus* Wealth Maximization:** The objective of profit maximizations measures the performance of a firm by looking at its total profit. It does not consider the risk which the firm may undertake in maximization of the profits. The profit maximization, as an objective does not consider the effect of earnings per share, dividends paid or any other return to shareholders on the wealth of the shareholders.

On the other hand, the objective of shareholders' wealth considers all future cash flows, dividends, earnings per share, risk of a decision, *etc.* So, the objective of maximization of the shareholders' wealth is operational in its approach. A firm that wishes to maximize the profit may opt to pay no dividend and to reinvest the retained earnings, whereas a firm that wishes to maximize the shareholders' wealth may pay regular dividends. The shareholders would certainly prefer an increase in wealth against the generation of increasing flow of profits to the firm. Moreover, the market price of a share, theoretically speaking, explicitly reflects the shareholders' expected return, considers the long term prospects of the firm, reflects the differences in timing of the returns, considers risk and recognizes the importance of distribution of returns. Therefore, the maximization of shareholders' wealth as reflected in the market price of a share is viewed as a basic goal of financial management. The profit maximization can be considered as a part of the wealth maximization strategy, but should never be permitted to overshadow the latter. Throughout this work, the objective of maximization of shareholders' wealth has been taken as the primary goal of financial decisions making.

⊙ **Conflict Among Goals:** In a business firm, there may be different departments such as sales departments, purchase department, production department, marketing department, *etc.*, and often a conflict may appear among the goals of these departments and this conflict must be resolved. Moreover, the internal operative goal of a department may conflict with the goal of the firm. This conflict may arise as the departmental head may stick to internal objective only and fails to visualize the ultimate corporate goal.

Sometimes, the management may concentrate on easily attainable and measurable goals such as increase in sales revenue or production, *etc.*, and ignore the effect of these variables on the market price of a share. The management may also be forced by the external factors to adopt a course of action which is expected to give less than maximum results. Consequently, the firm may be prevented from pursuing the goal of maximization of the shareholders' wealth.

In case of corporate firms, the ownership (*i.e.*, the shareholders) is separated from the management (*i.e.*, the board of directors). Usually, the shareholders are ill-organized and scattered which results in the fact that the shareholders have no active interest and participation in the decision making of the company. On the other hand, the management having functional autonomy may tend to develop its own goals. This may also result in differing view points of the ownership and the management. The professional management may alienate from the viewpoint of the shareholders and a conflict may arise between the two. The management must adopt the objective of maximization of shareholders' wealth otherwise the difference in perspective may widen. So long as there is no separation of ownership from the management (*i.e.*, the case of proprietorship or partnership), there is no room for a conflict. However, any conflict or expectation of a conflict among departmental goals, management goals, corporate goals, or owners goals, *etc.* must be resolved.

On the whole, the maximization of the shareholders' wealth seems to be a normative goal towards which the firm should strive. A finance manager though operating with the objective of maximization of shareholders' wealth need not undermine the importance of other goals. He must take decisions only after weighing the relevant considerations.

⊙ RISK AND RETURN : BASIC DIMENSIONS OF FINANCIAL DECISIONS

Every financial decision has two aspects *i.e.*, the risk and the return. There is a risk involved in every decision. The degree of risk, however, may differ from one decision to an other. A riskless decision is difficult to be visualized. Further, every decision has a return also. It may be emphasized that the risk and return go together and there is always a conflict between the return from a decision and the risk it brings into the firm. The finance manager must understand that the risk and return associated with a decision are the two key determinants of the market price of the share.

In financial management, the risk is defined as the variability of expected returns from an investment. For example, an investor makes a fixed deposit at an interest of 10% p.a. for a particular period with a scheduled bank. There is virtually no risk attached with this investment since there is no variability associated with the return. However, if the same amount is used to buy the equity shares of a company, then the return in the form of dividends from this investment may vary from one year to another. So, the investment in equity shares is risky as the returns are variable. The more certain the returns are from asset/investment, the less is the variability and therefore lesser the risk. It may be noted that the terms risk and uncertainty are usually used interchangeably. However, the risk exists when the decision maker is able to estimate the probabilities associated with the different outcomes. On the other hand, the uncertainty exists when the decision maker has no historical data to develop the probabilities associated with the outcome.

Return, on the other hand, associated with a decision is measured as the total gain or loss expected over a given period of time by the decision maker. It may be defined as the return on the original investment made in the particular asset/investment.

A finance manager cannot avoid the risk altogether nor can he make a decision by considering the return aspect only. Usually, as the return from an investment increases, it's risk also increases. In an attempt to increase the return, the finance manager will have to undertake greater degree of risk also. Therefore, a finance manager is often required to trade-off between the risk and return. At the time of taking any financial decision, the finance manager has to optimize the risk and return. A particular combination of risk and return where both are optimized may be known as *Risk-Return Trade off*. At this level of risk-return, the market price of the share will be maximized. Therefore, in the course of decision making process, the finance manager seeks to strike a balance between risk and return that will maximize the wealth of the shareholders.

For example, borrowing made by a firm to finance a profitable project without considering the liquidity position of the firm, may increase the financial risk of the firm. The borrowing for financing a profitable project has to be weighed against it's effect on the ability of the firm to repay the lenders and providing a satisfactory return to the shareholders. No doubt, a finance manager must attempt to keep down the cost of financing, but he should also consider the risk associated with different financing patterns. Thus, such decisions will ultimately rest on the analysis of the effect of risk-return on the market price of the share. Investors and firms taking higher risk should be compensated with a higher expected return.

But what is the relationship between risk-return and market price of the share. The financial decisions do not affect the market price of a share directly but by affecting the risk and profitability of the firm. This relationship has been depicted in Figure 1.2.

The Figure 1.2 shows that the various types of financial decisions are taken with in the limits set by legal and procedural constraints. These decisions then affect the risk-return composition of the firm. This risk-return compositions in fact, ultimately, affect the value of the firm reflected in the market price of a share. In other words, the financial decisions which are made subject to legal constraints, affect both risk and return which jointly determine the value of the firm.

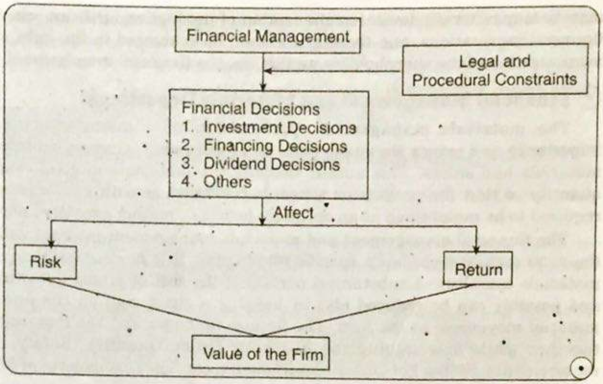


FIGURE 1.2
Financial Management, Risk-Return and Value of the Firm

The above discussion can be summarized by saying that the financial management :

- is concerned with various types of decisions,
- has an operational goal of maximization of shareholders' wealth,
- includes the analysis of different types of information,
- evaluates the risk and return perspective of all alternatives,
- encompasses the management of long-term as well as short-term assets.

FINANCIAL MANAGEMENT AND OTHER AREAS OF MANAGEMENT

In the management of business firms, there are various well known functional areas such as Production Management, Materials Management, Marketing Management, Human Resource Management, Financial Management, *etc*. All these functional areas are interrelated and equally important in any firm. The financial management provides oxygen to the life of a firm by providing uninterrupted flow of funds throughout the firm and thus helps achieving the ultimate objectives of the firm. The finance function is related to every other functional area of the management, wherever and whenever a policy decision is to be taken. The reason is obvious, every policy decision involves some or other financial implication. The relationship between financial management and other functional areas can be identified as follows:

Financial Management and Production Department

The production department in any firm is concerned with provision of production facilities, production cycle, skilled and unskilled labour, storage of finished goods, capacity utilization, *etc*. The financial management has a useful role to play in interaction with the production management as the cost of production assumes a substantial portion of the total cost. The production department may be required to take various decision like increase in capacity utilization, installation of a safety device, replacing a machinery, installation of materials monitoring device, improvisation of production facilities, *etc*. All the decision have financial implications, and therefore, should be evaluated in the light of the objective of the maximization of the shareholders wealth. So, the financial management has a role to play.

⊙ Financial Management and Materials Department

The materials management, particularly in a manufacturing firm is of utmost importance and covers the areas such as procurement, storage, maintenance and supply of materials and stores. This entails keeping the materials in good condition and sufficient quantity so that the production schedule continues smoothly. The inventory of any item is required to be maintained at an optimum level *i.e.*, neither excessive nor inadequate.

The financial management and materials management interact with each other and the financial management has a specific role to play. It is no denying the fact that generally the materials constitute a substantial portion of the cost of production which can be controlled and possibly can be reduced also by keeping a strict vigil on the financial implications of material movement in the firm. The finance manager and the material manager may come together while determining the Economic Order Quantity, Safety Level, Storing Place requirements, Stores Personnel requirements, *etc*. The cost aspects of all the decisions are to be evaluated against the expected savings. For this, the finance manager can come forward to help the material manager.

⊙ Financial Management and Human Resource Department

The human resource department of a firm is entrusted with the responsibility of recruitment, training and placement of the staff for the firm. The department is also required to critically analyze and suggest means to reduce if any, the manpower requirement for various departments of the firm. This department is also concerned with the welfare of the employees and their families. In this connection, different decisions are to be taken from time to time.

The human resource department has to work with the finance manager while evaluating different schemes of training programmes, employees welfare, economy in manpower, computerization, incentives schemes, revision of pay scales, *etc*. The best possible option should be identified keeping in view both the employee's welfare and the interest of the firm. Considering the financial implications of all these decisions is an important dimension.

⊙ Financial Management and Marketing Department

The marketing department of a firm is concerned with the ultimate activity of the firm, *i.e.*, the selling of goods and services to the customers. The marketing department is entrusted with the responsibility of framing marketing, selling, advertisement and other related policies to achieve the sales target. It is also required to frame credit and collection policies to maintain and increase the market share, creating a brand name, to acquire a competitive edge, *etc*. Different policy decisions all of which have financial implications are to be taken in this respect. The finance manager has to play an active role in interaction with the marketing department in the process of these decisions.

For example, the marketing department should not arbitrarily relax the credit terms (just in order to increase the sales figure) as it may affect the liquidity position of the firm. The financial implications of the proposed advertisement policy, price-war manoeuvers, liberalization of credit policy, *etc*., must be critically analyzed before these are adopted and implemented.

Thus, it is evident from the above analysis that financial management is closely linked with different functional areas of management. Since financial management is involved in overall planning and control of funds of the entire firm, it is related to each and every segment of operations of the firms. That is why it is generally said that finance department has more important place than others.

Principle/ Doctorine self evident truth

SOME BASIC TENETS AND AXIOMS OF FINANCIAL MANAGEMENT

The theory of financial management, as will be observed through out this text, is based upon 5 basis axioms as follows:

(*i*) **The Time Value of Money :** It refers to the fact that a rupee received today is worth more than a rupee receivable in future. The implications and applications of this axiom have been discussed in detail in Chapter 2.

(*ii*) **The Risk-Return Trade off:** This axiom has already been explained and refers to that no investor will take additional risk unless he expects to be compensated with additional return. This axiom has been extensively referred to through out the text.

(*iii*) **The Cash Flows and Accounting Profits:** This axiom refers to the difference between the accounting profit which is based upon the accounting concepts and conventions, and the cash flows which are based on the movement of cash. In financial management, the cash flow is the basic measuring tool. This has been discussed in detail in Chapter 3.

(*iv*) **Incremental Cash Flows:** In all financial decisions, the conscious effort is to think incrementally *i.e.,* what the cash flow will be if a particular decision is taken versus what they will be if the decision is taken otherwise. This axiom has also been explained in detail in Chapter 3.

PERFORMING THE FINANCE FUNCTION

In an organization, any member who is involved with one or the other decision, howsoever big or small the financial implications may be, is performing the finance function. Any manager who is participating in the planning and control process performs the finance function. A production engineer who proposes to replace the existing machinery by a new one, also contributes to the investment decision of the firm decides the inventory level and thus decides the investment required for the inventory.

However, in spite of so many persons performing the finance function at one or the other level, in one way or the other, there are two specific reasons which necessitate the constitution of a separate finance department in any firm. These reasons are :

1. There must be some person or department which is concerned with the financial planning and control of the firm as a whole, and
2. There must be some person or department to consolidate the proposals (having financial implications) from different departments and to take decisions keeping in view the objective of the firm.

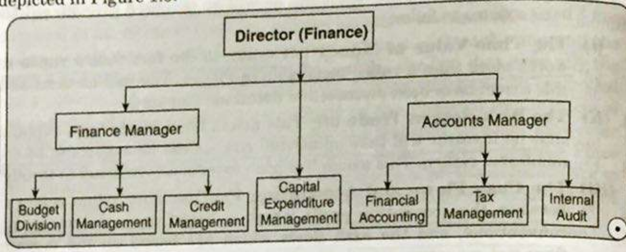
So, the firms usually have a separate managerial personnel, by whatever name called, who is entrusted with the responsibility of financial control of the firm. This person may be called the Financial Manager, Financial Controller, Finance Director, Controller, *etc*. The primary responsibility of this executive head of the finance function is to contribute and help achieving the objective of maximization of shareholders' wealth. For this purpose, he is required

(1) to undertake financial planning and analysis,

(2) to manage the asset structure of the firm, and

(3) to manage and balance the financial structure of the firm. In order to help him in this endeavors, a full fledged department consisting of a number of subordinates with pinpointed responsibilities should be provided. The organization of the finance function in a big firm may appear as depicted in Figure 1.3.

FIGURE 1.3 Organisation of Finance Function



FINANCIAL MANAGEMENT AND FINANCIAL ACCOUNTING

Financial Accounting is defined as the process of identifying, measuring and recording the economic transactions in any organizations with a purpose to provide information to various users for their decision making. This information is provided in the form of various accounting formats such as Income Statement, Balance Sheet, Funds Flow Statement, Cash Flow Statement, *etc.* These statements are prepared on the basis of standardized and generally accepted accounting principles. Further, these financial statements are prepared on the premise that the revenues should be recognized at the point of sale and expenses should be recognized when they are incurred. This is also referred to as accrual system of accounting. Financial Accounting provides the operating results of an organization for a particular period. It also helps in finding out the true and fair value or worth of the business at a point of time. The information given in the income statement and the balance sheet regarding the operating results and the worth of the business can be used for taking different types of decisions.

Financial management on the other hand, is concerned with the financial decision making. In financial management, the stress is laid on the optimum utilization of funds and raising the funds at an optimum cost at an appropriate time. The financial management is concerned with the management of funds. The finance manager is more concerned with the maintenance of firm's solvency and liquidity by providing the cash flows necessary to met the requirements of the firm from time to time. Instead of recognizing revenues at the point of sales and expenses when they are incurred, the financial management recognizes the revenues and expenses only with respect to cash inflows and cash outflows. A firm may be profitable from accounting point of view but may not have sufficient cash to meet it's obligations. Financial management emphasizes the cash flows rather than profit.

So, on the face of it, the financial accounting and the financial management are different from each other. Financial accounting is concerned primarily with the recording of the facts and the transactions in monetary terms. But the financial management is concerned with taking decisions on the basis of different types of information (including that provided by the financial accounting) for the maximization of shareholders' wealth. The information collected in financial accounting is used by the financial manager in the decision making process. So, the financial accounting is basically information collection procedure whereas the financial management is the decision making process. The finance manager cannot proceed unless he gets sufficient information from the accounting department. So, these two are complementary and it can be said that the financial management starts where the financial accounting ends.

The relationship between financial accounting and financial management can be summarized as follows :

1. Financial Accounting provides the relevant information on the basis of which the earnings per share, the cash flows, *etc.*, can be ascertained for further use in financing decisions and investment decisions by a finance manager.
2. Necessary information for receivables management, liquidity management, payable's management, *etc.*, is all provided by the financial accounting to the finance manager.
3. Financial accounting provides the information about the available profits (after tax and other appropriations). This information is a necessary requisite for framing the dividend policy of the firm.
4. The objective of financial management is to maximize the shareholders' wealth as reflected in the market price of the share which is influenced to a large extent by the profit figure as shown in the financial statements.

To sum up, the financial management uses the information provided by the financial accounting to make decisions so that the firm can achieves its objective. Finance Managers need financial information to evaluate own decisions and for this, they must understand the financial consequences of their decisions. Only with financial information, a financial manager can plan and control the activities in the firm. The financial accounting and the financial management differ from each other as well as are complement to each other. The efficiency and the effectiveness of the decisions taken by a finance manager is largely determined by the accuracy of information provided by the financial accounting.

FINANCIAL SYSTEM : AN OVERVIEW

A financial system is consisting of a variety of financial assets, financial intermediaries, financial market, borrowers and investors. An efficient financial system is of critical importance for the economic development of any country. Indian financial system is consisting of two sectors: the unorganized sector and the organized sector. The unorganized sector, scattered particularly in rural India, is outside the purview of the regulations and control of the government authorities. The organized sector, on the other hand, is consisting of different elements *i.e.*, the financial assets, financial intermediaries and financial markets and is well regulated by a network of government authorities.

Financial Market

A financial market may be defined as the market of financial assets *i.e.*, the market in which the financial assets are transacted. Issue of shares and debentures by a company, issue of mutual fund units, working capital loans by commercial banks, long-term financial assistance by financial institutions, inter-bank call money transactions are a few examples of financial transactions which are undertaken in financial markets. The financial market in India may be divided into three parts *i.e.*, the money market, the capital market and the government securities market.

The **money market** is a term used to described the market for short-term debt transactions. The money market in India consists of informal money market and formal money market. The informal money market includes the indigenous money lenders, nidhis, chit funds, *etc*. Their operations are not covered by government regulations but by traditional practices. Usually their operations are restricted to a particular geographical area only. The basic characteristics of the informal money market are informal procedures, high rate of interest, flexible terms of loan as per mutual convenience of the parties, *etc*.

The formal money market is characterized by the presence of the Reserve Bank of India, Discount and Finance House of India Limited, Mutual Funds, Non-Banking Financial Companies, Commercial Banks, Financial Institutions, *etc*. These participants in the formal money market transact in Treasury Bills, Inter-Bank Call Money, Commercial Bills of Exchange, Inter-Corporate Deposits, *etc*. The basic characteristics of the formal money market are (*i*) regulated by the RBI by way of regulation of interest rate and reserve requirements of Commercial Banks, (*ii*) fairly strict and rigid rules of operations, and (*iii*) low rates of interests.

The **capital market** is the market for long-term financial assets such as shares, bonds, debentures, mutual fund units, *etc*. It can be divided into New Issue Market (primary market) and Secondary Market. The New Issue Market provides a system wherein different companies, mutual funds and institutions issue (sell) their financial instruments *e.g.* shares, debentures, *etc*. and the investors (both individuals and institutional subscribe (buy) these instruments. The New Issue Market in India is well regulated by the Securities and Exchange Board of India (SEBI) which has issued guidelines for the issue of these instruments. The secondary market is the market in which the subsequent sale and purchase of these securities and instruments are undertaken. The secondary market is basically provided by the stock exchanges.

The **government securities market** is the market where the securities/loans of Central government, State governments and other government authorities are traded. These securities, primarily in the form of government loans, are known as Gilt-edged securities. The main participants in the government securities market are the commercial banks, provident funds *etc*. Interest rates on these securities are low.

Financial Assets

The financial assets are not the assets such as real assets, physical assets or tangible assets. Rather, financial assets represent a financial claim of the holder over the issuer of the financial assets. So, a financial asset is a liability of the issuer towards the holder. Besides the currency issued by the RBI or the Government of India, the other financial assets are usually classified into shares, mutual fund unit and debt instrument, deposits and loans.

The debt instruments are the loan instruments and hence repayable on the maturity. For the intervening period, the interest is payable as per terms and conditions of the issue. In India, debt instruments with diverse features have been issued by companies and financial institutions. Some of these are bonds, debentures, secured premium notes, partly-convertible debentures, deep discount bonds, zero-interest debentures, optionally convertible debentures *etc*. The companies in India can also avail long-term financial assistance from financial institutions and commercial banks. Recently, lease financing has also emerged as a variant of debt.

A share represents an ownership interest in the assets of a company. The companies in India are allowed to issue two types of shares *i.e.* the equity shares and the redeemable preference shares. The rate of dividend on the preference shares is fixed and therefore, a preference share may be called a hybrid security having features of debt as well as of a share. The equity shares represent a true ownership right. The rate of dividend is not fixed. Rather, it depends upon the earnings of the company.

A mutual fund unit is basically an instrument of channelizing the savings of individuals so that these collective savings can be utilized for meeting the financial requirements of the industry. The incomes on these units is distributed among the unit-holders. In 1964, the Unit Trust of India was established as the first mutual fund in India. Recently, many other mutual funds have been established in the public sector as well as the private sector. The UTI-Master Gain 1992 emerged as a popular mutual fund. These mutual fund units are listed and can be traded at stock exchanges. In case of close-ended mutual funds, units can be offered by the holder for the 'repurchase' at a price which is calculated on the basis of net assets value (NAV) of the unit.

There are different provisions contained in the Companies Act, 1956 and the Securities Contract (Regulation) Act, 1956 for the issue of shares and debentures. The SEBI, after it came into being in 1992, has issued a number of guidelines for the issue and transactions in different types of financial instruments. It has also framed guidelines for the credit rating of debt instruments and deposits invited by companies.

POINTS TO REMEMBER

- The term financial management is concerned with flow of funds in any firm. It is concerned with financial decision making and thereby deals with raising of funds and their optimum utilisation. Since all decisions have financial implications, the financial management is related to almost every aspect of business operations.
- Traditionally, financial management was concerned with raising of funds. Hence, it was episodic in nature and finance function was treated from the point of view of supplier of funds only. However, after 1950, finance has emerged as an integrated functional management. Now, the financial management is seen as a decision making process.

  The scope of the finance function has emerged to include :

  (*a*) What would be the size of the firm and how fast should it grow?

  (*b*) What are the various types of assets to be acquired?

  (*c*) What should be the pattern of raising funds from various sources?
- While performing these functions, a financial manager is required to take different decisions, which may be classified into : Investment decisions (relating to resource allocation) Financing decisions (relating to capital structure) and Dividend decisions (relating to distribution and retention of profits).
- The objective of financial decision making is defined as maximisation of wealth of shareholders as reflected in the market price of the share. This objective is considered superior to profit maximisation which is vague, ambiguous and ignores risk.
- Time Value of Money, Risk-Return trade-off, and Cash flows are some of the basic concepts of financial management.
- Financial Accounting and Financial Management are complementary in nature. The former provides data for the latter.