LESSON - 1

FINANCIAL MANAGEMENT: AN OVERVIEW

1.0 Objective :

After studying this lesson, you should be able to:

know the meaning and Scope of Financial Management

discuss the various financial objectives of a business firm

analyze the Financial goals of a company

familiarize the major decisions involved in Finance Function

explain the concept of time value of money

Structure :

1.1. Introduction

1.2. Meaning of Finance

1.3. Scope of Financial management

1.4. Role of Financial Manager

1.5. Finance Functions

1.6. Organization of Finance Function

1.7. Financial Goals of the company

1.8. Financial Decisions

1.9. Risk-Return Trade Off

1.10 Time value of Money

1.11 Summary

1.12. Keywords

1.13. Self assessment Questions

1.14. Further Readings

1.1. Introduction

Business is an economic activity, which involves the use of economic resources for the production of goods and services. These are sold at a price, which is more than the cost of producing them, resulting in a surplus or profit. When a business enterprise plans to do any activity, it has to make a market survey to estimate the demand for the product and to estimate the life of the business. The demand estimate helps in the finalization of plant capacity or scale of operations. Once the plant capacity is finalized, the area of the site

required to construct the business premises, number or personnel required, want of raw material are estimated. The enterprise finalizes its scale of operations and based on it, the capital requirement is estimated.

Depending upon the nature of business, the size of capital varies. A business with manufacturing activity requires more capital than what is required for trading or service organizations. Businesses, who are providing services like transportation, communication, banking, insurance, warehousing, etc. involves the need for estimating the capital requirement. Once the capital requirement is estimated, the enterprise has to find sources of mobilizing these funds. It has to identify sources for meeting the permanent capital requirement and short-term capital requirement. From among the various sources that provide long term or short term funds an enterprise has to choose.

A business enterprise strives to achieve a surplus and in order to achieve this goal, it has to invest funds in various income earning assets by obtaining funds from various sources. Thus, the financial function is all about the to determine the funds requirement assets to be acquired and the pattern of financing the assets.

1.2. Meaning of Finance

According to the Encyclopedia Britannica **Finance** is "the act of providing the means of payment"

Howard and Upton defines **Finance** as "the management of the flow of cash so that the organization will have the means to carry out its objectives and at the same time meet its obligations as they become due".

Wheeler defines **Business Finance** as "that business activity which is concerned with the acquisition and conservation of capital funds in meeting the financial needs and overall objectives of business enterprises".

According to Guthmann and Dougall, **Business Finance** can be broadly defined as "the activity concerned with the planning, raising, controlling and administering the funds used in the business".

1.3. Scope of Financial Management

Financial Management refers to that part of the management activity, which is concerned with the planning, and controlling of firm's financial resources. It is also a study about the process of procuring and judicious use of financial resources with a view to maximize the value of a business enterprise thereby the value of the owners is maximized. According to James C Van Horne financial management endeavors to make optimal investment, financing and dividend decisions.

1.4. Role of Financial Manager:

The functions of a financial manager of a company generally include the following:

* Estimation of capital requirements
* Provide funds for the selected projects.
* Maintain liquidity and solvency positions.

Acts as a liaison with stock exchanges, shareholders, bankers and financial institutions.

Estimate the risk in financial decisions and provide measures to minimize the risk.

Decide the credit policy of the company by taking into consideration the established practices.

Observe the various obligations under different legislations, like tax laws, SEBI Act, etc.

Takes - up internal audit to establish proper checks and controls.

Decides the dividend policy of the company.

All the above mentioned functions are supposed to be discharged by a Financial Manager within the frame work of laws in force, for the ultimate achievement of wealth maximization of shareholders.

1.5. Finance Functions.

Finance functions are very important activities in the total business management irrespective of the nature, size, age and structure of the organization. A business finance function expresses the relationship between value of a business enterprise and its various determinants. Value of a business enterprise is nothing but its net worth to the owners. Net worth is the difference between the market value of assets and the value of liabilities. If net worth of a business enterprise increases it can be interpreted that the value of a business enterprise is rising. The value of a business depends upon the internal and external factors, viz., state of the economy, capital market conditions, tax rates investment activities, financing mix and dividend policy.

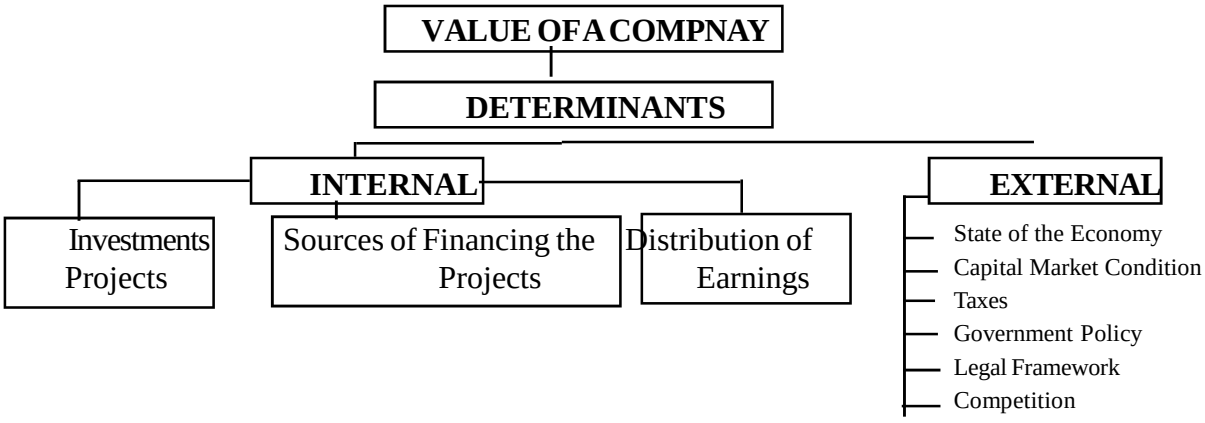
Among these factors some are controllable and others are uncontrollable. Assuming that the uncontrollable factors are held constant, the value of a business is a function of internal or controllable factors. Therefore, value of a business is a function of investment, financing mix and dividend policy. It can be expressed as:

$$V = f [I, F, D]$$

Where,

V = value of a firm
I = Investment
F = Financing Mix
D = Dividend policy

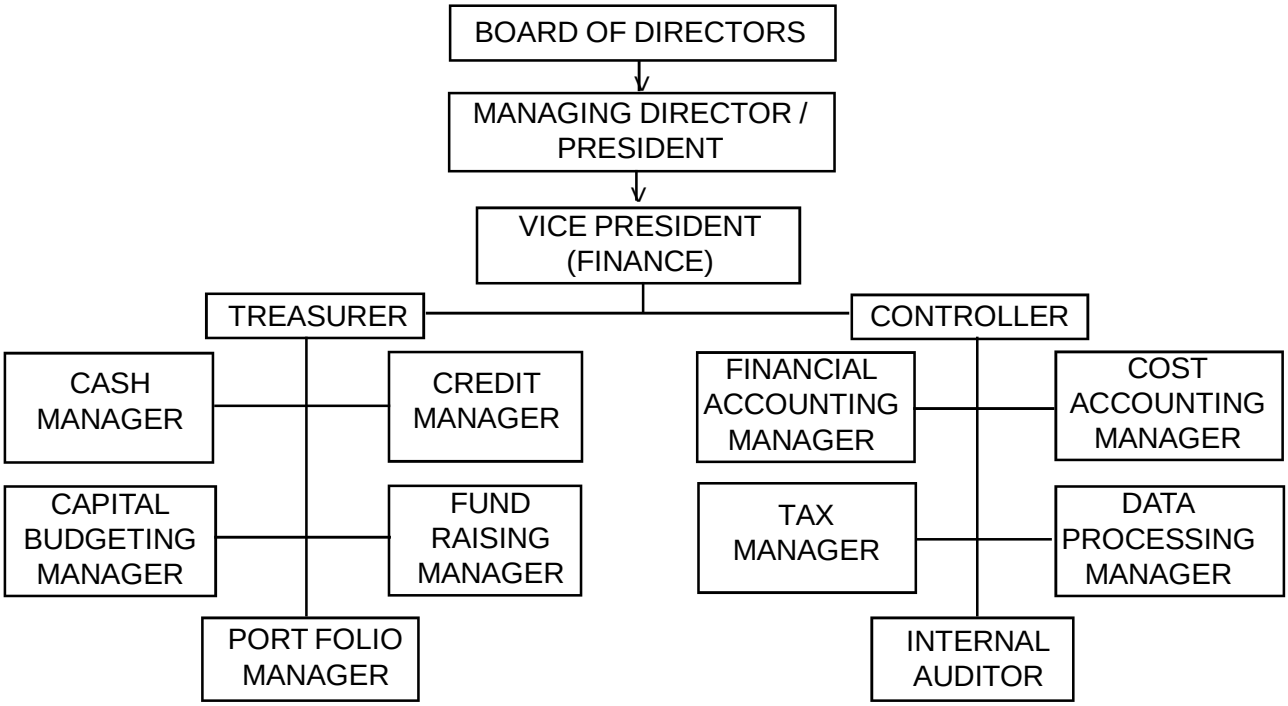
Figure 1.1 : Finance Function



1.6. Organization of Finance Function:

Finance function is an integral part of a company and all other functional areas are related to finance function. Production, marketing, human resource management functions are related to finance. In the area of finance specialists perform specific tasks. The organization of finance function can be better understood by the following figure 1.2.

Figure 1.2 : Organization of Finance Function



1.7. Financial Goals of a Company:

Company is a form of organization in which the ownership and management are separated. Shareholders are the owners and the boards of directors are the agents of the shareholders. The team of management takes various decisions involving the profitability and perpetuity of the company. When these strategic decisions are taken, what should be the goal of the firm? It is the fundamental question, which automatically leads us to the economic benefit to the shareholders. As shareholders provide capital and face maximum risk, they expect the company the company to provide them maximum return. There are two widely discussed approaches to achieve the above objective, which are: profit maximization and wealth maximization. Should the company be aim at maximizing profit or wealth?

1.7.1. Profit Maximization:

All business activities involve costs and revenues with which one can measure the efficiency in terms of surplus, i.e., the excess of revenues over costs, which is popularly known as profit. Therefore, a firm should aim at profit maximization, which is justified on the following grounds.

(i) Economic activity aims at utility maximization, which is measured in terms of profits.

(ii) Profit is a measure of economic efficiency, which leads to efficient allocation of resources

(iii) It ensures maximum social welfare with efficient use of important and scarce resources.

But, the profit maximization goal is having the following limitations**.**

(i) Ambiguity:

The goal of profit maximization is considered to be very vague and ambiguous. Profit has various connotations and amenable to different interpretations by various persons. For example, profit may be a short run or long run, total profit or it may be a rate, after tax profit or before tax profit, return on equity or return on total capital employed. There will be always a dilemma as to which of these variations of profits should a company try to maximize.

(ii) It ignores the timing of benefits:

The goal of profit maximization ignores the differences in the timing of benefits from investment. Between two alternative projects, which have different time pattern of profits, the goal makes no difference. For example, project A and project B have the following profits

Year	**Cash inflows pattern (Rs.)**	
	Project A	Project B
1	5000	15000
2	10000	10000
3	15000	5000
Total Profit	30000	30000
Average	10000	10000

Project B is providing high returns during the early period. The basic dictum of financial planning is "EARLIER THE BETTER". According to this principle, Project B is preferable.

iii) It ignores the Quality of benefits:

If the expected profits are more certain, with low range of variation, the quality is considered to be high. Goal of profit maximization ignores the quality of benefits. And it does not give weight age to the risk associated with the profits. The following table reveals the above the above concept.

State of the economy	**Annual inflows (Rs.)**	
	Project A	Project B
Recession (pessimistic)	9000	0
Normal (most likely)	10000	10000
Boom (optimistic)	11000	20000
Average	10000	10000

Between these two projects, project A has high quality profits, as the range is low, i.e., 2000, whereas, Project B has higher range, i.e., 20000, which explains about the poor quality of profits. Thus, the profit

maximization goal fails to distinguish between these projects. Therefore, the profit maximization by itself cannot be an objective if it results in a disadvantage to the owners or shareholders. If a company invests in new projects by bringing in new capital through the issue of shares, the new profits may not result in the increase of earnings per share. If the return on the new project is less than what the company have been earnings, the earnings per share will decrease. Searching for high profits may result in collapse of the company, as it involves high degree of risk and goes against the interest of the shareholders who are bearing the maximum risk. Therefore, profit maximization is not considered to be an appropriate goal.

The goal of earnings per share maximization also suffers from the following limitations: (i) its does not specify the time of expected returns (ii) it does not consider risk associated with future earnings, and (iii) it does not take into account the financial risk.

1.7.2. Wealth Maximization:

Wealth maximization means maximization of market price of shares, which is the rational guide for running a business. Shareholders' wealth is represented by the market value of equity holdings. Market price of share acts, as an index of performance of a company. If the market price of share is a measure of efficiency, the goal of maximization of wealth helps in the efficient allocation of financial resources in a society.

(i) Implications of Wealth Maximization:

* The goal aims at prosperity and perpetuity of a company.
* The goal helps in measuring the performance of a company
* The goal helps in allocation / reallocation of scarce resources
* It helps the company in discharging its responsibilities effectively, such as:
    * Consumer protection
    * Payment of fair wages
    * Provision of safe working conditions.
    * Environmental protection.
    * Support to social problems.
* It leads to efficient use of scarce and precious resources
* It considers risks associated

(ii) What is Wealth Maximization?

Wealth maximization means maximizing the net present value of a course of business action. Net present value (NPV) is the difference between present value of expected benefits and present value of cash outflows.

If the cash inflows at end of the respective years are: $A_1, A_2, A_3, \ldots\ldots A_n$

the present value of these cash inflows can be calculated by discounting the future cash flows by using a discounting factor, i.e., k as under:

$$\frac{A_1}{(1+K)} + \frac{A_2}{(1+K)} + \frac{A_3}{(1+K)} \ldots\ldots\ldots\ldots\ldots\ldots \frac{A_n}{(1+K)}$$

Sum of these present values is the PV of future benefits .

If costs at the end the of each year, are :

C_0 , C_1 , C_2 , C_3 . . . . . C_n

Their present value the investments is calculated as under :

$$C_0 \quad \frac{C_1}{(1+K)^1} \quad \frac{C_2}{(1+K)^2} \quad \frac{C_3}{(1+K)^3} \quad \ldots\ldots\ldots\ldots\ldots\ldots \frac{C_n}{(1+K)^n}$$

Sum of these present values is the PV of costs of investment

NPV = [PV of Benefits - PV of costs]

$$= \left[\frac{A_1}{(1+K)} + \frac{A_2}{(1+K)^2} + \ldots\ldots\ldots + \frac{A_n}{(1+K)^n}\right] - \left[C_0 + \frac{C_1}{(1+K)^1} + \frac{C_2}{(1+K)^2} + \ldots\ldots\ldots + \frac{C_n}{(1+K)^n}\right]$$

$$\text{NPV} = \left[\sum_{t=1}^{n} \frac{A_t}{(1+K)^t}\right] - \left[\sum_{t=0}^{n} \frac{C_t}{(1+K)^t}\right]$$

In the above equation K refers to the discount rate and t refers to the time period.

Every financial decision involves costs and benefits and result in NPV and maximization of this NPV is construed as maximizing wealth of financial decisions, which have a long-term impact on the firm. They are strategic, crucial and which involve risk are:

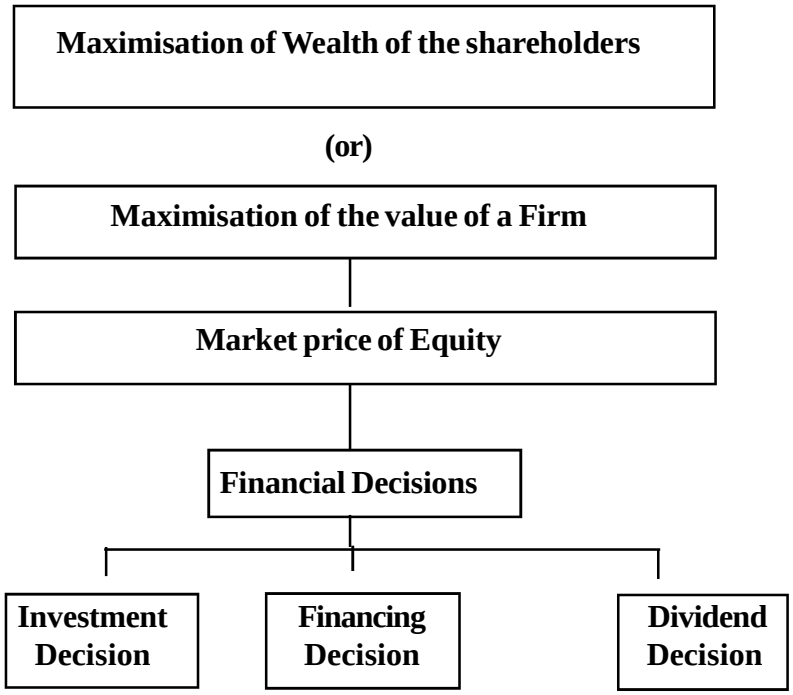
Investment decision

Financing decision

Dividend decision

These decisions are taken with an objective of maximizing Net Present Value which leads to value maximization of the company and in turn wealth maximization of shareholders.

Figure 1.3 Goal of a Firm



Value of a Firm = f [Investment, Financing, Dividend decision]

V = f [I, F, D]

1.8. Financial Decisions

The above said activities of Finance Functions are classified as three major Financial Decisions.

Three major decisions, which are strategic, crucial, which have long term impact and which cannot be reversed without abnormal losses are

(a) Investment decision

(b) Financing decision

(c) Dividend decision

1.8.1. Investment decision: Investment decision relate to the selection of projects or investment opportunities, which are financially viable. The process of investment decision involves the following steps— Generation of investment ideas or opportunities

— Defining the objective in quantitative terms

— Evaluation of each opportunity using techniques of evaluation

— Selection of the best alternative investment

— Implementation of the feasible investment

— Follow up or monitor the executed project whether it is providing expected return or not.

Decisions like (a) make or buy, (b) buy or lease, (c) outright purchase or hire purchase, (d) replacement of manual activities with mechanization, (e) replacement of outdated technology with latest technology (f) replacement of worn-out machinery with latest ones, (g) mergers (h) amalgamation (i) acquisitions, (j) launching of a new product (k) expansion activities (l) entering into foreign markets are some of the areas comes under the Investment decisions which are taken by the Financial Manager in the business organizations.

These decisions are based on financial estimates relating to the future. When future is uncertain, there is a chance that actual outcome may deviate from the estimated outcome. These changes amounts as risk and therefore measurement of risk in the investment decisions is essential and crucial.

1.8.2. Financing Decision:

Financing decision is related to judicious mix of debt and equity. It decides the capital structure of a company and also related to the mix of short and long term sources. When investment decision is a trade off between return and risk, financing decision is a trade off between cost and risk. Investment decision involves business or operating or investment risk. Financing decision involves financial risk.

Funds are required in business for financing fixed assets and for day-to-day business operations. Thus, the financing decision is related to the procurement of funds, which can be arranged in various forms and from different sources.

Equity share capital, preference share capital, debentures, company deposits, long term loans from financial institutions, inter corporate borrowings, bank overdraft, cash credit are some of the forms of funds, which are broadly divided into owners and outsiders money. Some of these sources involved fixed commitment on the part of the company.

More specifically the following business activities are belongs to financial decisions:

??determination of degree of leverage;

- ➔ Raising funds through equity and debt and also raising funds from long term and short term sources;
- ➔ Consideration of tax benefit of usage of debt

1.8.3. Dividend Decision:

Dividend decision is indirectly a financing decision. If sources of funds are classified as internal and external sources, all the sources discussed under the ‘financing decision’ are external sources. Dividend decision relates to the distribution of profits after meeting all the expenses among the equity shareholders.

No business enterprise will distribute all the profits to its owners. Some of the profits are retained in the business for future purposes for expansion or diversification of the business. These retained profits are considered as internal generated funds, which are belonging to the existing shareholders of the firm. Net worth of the shareholders is a sum of equity share capital plus retained earnings. If the net worth increases, the book value of the share increases, which will have a favourable impact on the market price of the shares.

Dividend decision is concerned with the determination of dividend payout ratio Dividends provide current earnings to the shareholders, whereas retained earnings increase the scope for more earnings in the future period. Taking into consideration of the company's future investment opportunities and its ability to tap the capital market, tax effect, shareholders' expectations, etc, a dividend decision has to be taken.

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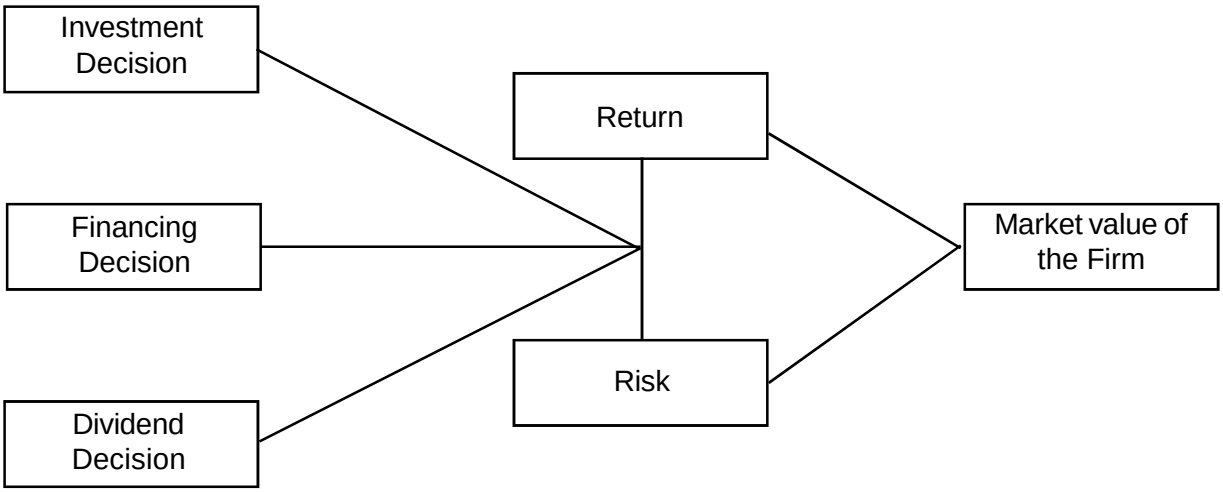
Thus, the investment, financing and dividend decision are interrelated. Their impact on the value of the company should be taken into consideration, as they affect the market value of the share.

1.9. Risk - Return Trade off:

Investment decisions involve two aspects i.e. the risk and the return. Finance managers have to select those investment projects by balancing the rerun. When future is uncertain, these are a chance of variability in the expected return, which is called business risk or operating risk or investment risk. Any attempt to increase the forces of risk element. There fore, a finance manager has to optimize the forces of risk and return Selection of investment opportunities where risk and return are optimized is known as risk-return trade-off.

Financing decisions also involve return and risk. When the decision related to the capital structure or debt-equity mix or financial leverage is taken, it is quite possible that a company may attempt to use more debt, as purpose. Increasing use of debt reduces the cost of capital to the company. But, it increases the variability of the shareholders' return. There fore, finance manager has by increasing risk and return and arrive at an optimum capital structure. Selection of optimum capital structure where return and risk are optimized is known as risk-trade-off which is shown in figure 1.4.

Figure 12.4. : Trade - off between Return and Risk



1.10. Time Value of Money

An important principle in finance is that the value of money is dependent on time. The value of money received today is different from the value of money received after sometime in the future. The principle is based on the fact that what we receive today can be invested and a return can be earned on it. For example, between Rs 100 now or Rs 100 after one year, Rs 100 now will have more time value because if it is invested in any opportunity, for example at 10% rate of interest, and a return of Rs 10 can be earned and therefore the amount of Rs 100 becomes Rs 110 a year after.

In business situations, various decisions involve outflow and inflow of funds, which do not take place at the same time. For example, in the case of investment decision outflows in the form of cost of the project takes place first and it is followed by inflows in the form of profits or returns in future.

Time	Outflows	Inflows			
	t_0	t_1	t_2	t_3 . . . . . t_n	
	(Cost of the project)	Returns (or) profit	Returns (or) profit	Returns (or) profit	Returns (or) profit

The difference in their timing makes it difficult to compare the costs and benefits. Therefore, there is a need to equalize the time value of inflows and outflows. For this Time value can be incorporated into the financial decisions either by compounding or by discounting.

Let us try to understand these methods.

1.10.1. Compounding: Compounding is the process of finding the Future Value of an amount at the end of a period using an interest rate. For example, if we want to find the future value of Rs 100(PV) at the end of one year when interest rate (r) is 12 percent per annum:

FV = Present value + Interest for one year at 12%

$FV_1 = PV + PV\ (r) = PV\ (1+ r)$

FV_1 = Rs 100 + 100 (12%) = Rs 100 + Rs 12 = Rs 112.

If we wish to find FV at the end of second year

$FV_2 = FV_1$ + Interest of second year at 12 %

$= FV_1 + FV_1$ (interest rate)

$= FV_1 + FV_1\ (r)$

$= FV_1\ (1 + r)$

We know that $FV_1 = PV\ (1 + r)$

$FV_2 = PV\ (1 + r)\ (1 + r) = PV\ (1 + r)^2$

Future value at the end of n years can be taken as: $FVn = PV\ (1 + r)^n$

Continuous compounding results in the maximum possible future value at the end of 'n' periods for a given rate of interest (r).

1.10.2. Discounting - Discounting is the process of finding the present value of the expected benefits at the end of a period (n) using a rate of interest (called the discount rate). If we want to find the present value of Rs 100 to be received at the end of one year, when the rate of interest is 12 per cent, the present value is:

PV = FV/(1+r)

= 100/1+.12 = Rs. 89.29

It means that the present value of Rs 100 to be received at the end of one year, when discounted at 12%, it is equivalent to Rs 89.29.

PV of Rs 100 to be received at the end or n' years

$PV = FV/(1+r)^n$

For these calculations, you are required to provide two types of Tables, which are given in the Appendix. They areCompound Value Tables andPresent Value Tables.

1.10.3. Annuity: An Annuity is a stream of constant cash flows (payment or receipt) occurring at regular intervals of time. When cash flows occur at the end of each period we can find the future value by compounding and present value by discounting.

Compound value of annuity. Future or compound value of an annuity (FVA) can be calculated by using the following formula.

$$FVA = \text{Annuity amount } X \frac{(1+r)^n - 1}{r}$$

In the above equation, $\left[\frac{(1+r)^n - 1}{r}\right]$ expression is compound factor for one rupee annuity received at the end of each year for n years with 'r' compound interest rate.

Having understood the methods of incorporating time value of money, through compounding and discounting, let us now see, how these methods are relevant in financial decision making

1.10.4 Financial Decisions:

Time value of Money :

(a) Investment Decision: Investment decision involves current cash outlay for expected stream of cash inflows in future.

Time	t_o	t_1	t_2 . . . . . t_n
Cash flows	Cash outlay (Co)	Cash inflow	Cash inflow Cash inflow

The cash flows (outflows and inflows) occur at different time periods. Therefore, they are not comparable and hence to equate them, Time value of money is taken into consideration by discounting the cash inflows to find the present value of all cash inflows. Then the PV of cash inflows is compared with cash outlay or cost of the investment project.

For example: A project costs Rs.1, 00,000 on which the expected to provide cash inflows as follows for 3 years. The company's cost of capital or required rate of return is 15%. Whether the project is acceptable?

Year	1	2	3
Cash Inflows	Rs 40000	Rs 50000	Rs 30000

Solution:

PV of cash inflows = PV of Rs 40000 + PV of Rs 50000 + PV of Rs 30000

= [40000 X 0.870] + [50000 X 0.756] + [30000 X 0.658]

= Rs 34800 + Rs 37800 + Rs. 19740

= Rs. 92340

In this example, the present value of cash inflows is Rs 92,340, whereas, the cost of the project is Rs 1 lakh. As the benefits are less than the cost the project, hence it is not acceptable.

(b) Financing Decision: When a company issues debentures, it receives cash flows now. Interest payments are to be made at the end of each year. At the end of the period the debenture amount is redeemed. Therefore, the financing decision involves cash inflows first, followed by cash outflows:

Time	t_o	t_1	$t_2 . . . . . t_n$	
Cash flows	Sale value of Debentures	Interest	Interest	Interest and redemption value

As these cash flows takes place at different times, they cannot be compared. Time value of payment is taken into consideration by finding the present value of interest payments and redemption value. The present value of cash outflows is compared with sale value of debentures and takes the financing decision whether to take-up the issue of debentures.

1.11. Summary

This lesson has provided you an overview of Finance Function in a business firm. The scope and the significance of financial management and finance functions in a business firm have been covered. The primary financial objective of a company and the broad goal has been discussed. Profit maximization vis-à-vis wealth maximization revealed that profit maximization goal has certain limitations, which can be overcome with wealth maximization goal. The organization of finance function and role of finance manager provide an insight into organizational chart and various functions of financial manager.

There are three major financial decisions, viz., Investment, Financing and Dividend decisions. Investment decision relates to the selection of viable projects and estimating their returns. Financing decision is concerned with the ways of finding funds to meet the capital budget requirement. Dividend decision is about how the earnings of the company are to be used i.e., a break-up between dividends and retention. Finally, the time value of money has been presented.

1.12. Key words

Financial Management : Concerns the acquisition, financing, and management of assets with some overall goal.

Future Value : The value at some future time of a present amount of money, or a series of payment, evaluated at a given interest rate.

Net Present Value : The Present Value of an investment projects net cash flows minus the projects initial cash outflow.

Present Value : The current value of a future amount of money, or a series of payments, evaluated at a given interest rate.

Price / earning ratio (P / O): The market price per share of a firm's common stock dividend by the most recent 12 months of earnings per share.

Risk : The variability of returns from those that are expected.

Capital structure : The mix of a firm's permanent long - term financing represented by debt, preferred stock, and common stock equity.

Compound Interest : Interest paid on any previous interest earned, as well as on the principal borrowed.

Profit Maximization : It is a criterion for economic efficiency as profits provide a yard stick by which economic performances can be judged under condition of perfect competition.

Wealth Maximization : It stands that the management should seek to maximize the present value of the expected returns of the firm.

Discounting : A reduction of some future amount of money to a present value at some appropriate rate in accordance with the concept of the time value of money.

1.13 Self - Assessment questions.

1. What do you mean by "Finance Function"? Explain the scope of finance Function.
2. What is Financial Management? What role a Financial Manager plays in a corporate enterprise?
3. Do you think Wealth Maximization as a goal of a company is superior to Profit Maximization? Explain.
4. What are the major Financial Decisions? How do you trade - off risk and return?
5. How is Finance Function organized? What are the functions that finance officers perform in a large firm?
6. What do you mean by Time Value of Money? Explain its relevance in financial decision-making.

1.14. Further Readings

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