<u>INTRODUCTION TO FINANCIAL – MANAGEMENT</u>

Meaning of Financial Management

As we know finance is the lifeblood of every business, its management requires special attention. Financial management is that activity of management which is concerned with the planning, procuring and controlling of the firm's financial resources.

The scope and coverage of financial management have undergone fundamental changes over the last half a century. During 1930s and 1940s, it was concerned of raising adequate funds and maintaining liquidity and sound financial structure. This is known as the 'Traditional Approach' to procurement and utilization of funds required by a firm. Thus, it was regarded as an art and science of raising and spending of funds. In the words of **Paisco,** "In a modern money using economy, finance may be defined as the provision of money at the time it is wanted." The traditional approach emphasized the acquisition of funds and ignored efficient allocation and constructive use of funds. It does not give sufficient attention to the management of working capital.

During 1950s, the need for most profitable allocation of scarce capital resources was recognized. During 1960s and 1970s many analytical tools and concepts like funds flow statement, ratio analysis, cost of capital, earning per share, optimum capital structure, portfolio theory etc. were emphasized. As a result, a broader concept of finance began to be used. Thus, the modern approach to finance emphasizes the proper allocation and utilization of funds in addition to their economical procurement. Thus, business finance, in the words of **Authman** and **Dongall,** may broadly be defined as " the activity concerned with the planning, raising, controlling and administering of funds used in the business." Modern business finance includes - (i) determining the capital requirements of the firm. (ii) raisin of sufficient funds to make an ideal or optimum capital structure, (iii) allocating the funds among various types of assets and (iv) financial control so as to ensure efficient use of funds.

CorporationFinance

The most important area of business finance is the corporation finance because the big business firms require a huge capital which is procured from the market/public. So, an efficient use of funds is very essential. Huge business houses employ expertise to raise and utilize finance from various sources. The corporation finance refers to the planning, raising, administrating and controlling. Thus, it refers to planning, raising, administrating and financing of expansion of business and the financial adjustments.

SCOPE OF FINANCIAL MANAGEMENT

Scope of Functions of Financial Management

The finance department of an enterprise performs several functions in order to achieve the above objectives. The scope of finance function is very wide. It consists of the following activities:

Estimating the Requirement of Funds

The finance department must estimate the capital requirements of the firm accurately for long term and short term needs. In estimating the capital requirements of the business, the finance department must take help of the budgets of various activities of the business e.g. sales budget, production budget, expenses budget etc. prepared by the concerned departments. In the initial stage, the estimate is done by promoters but in a growing concern, it is done by the finance department. Unless the financial forecast is correct, business is likely to run into difficulties due to excess or shortage of funds. Correct estimates ensure the availability of funds as and when they are needed. In estimating the requirement of funds, nature and size of the business, modernization and expansion plan should be given due consideration.

Determining the Capital Structure

By capital structure we mean the kind and proportion of different securities for raising the required funds. Once the total requirement of funds is determined, a decision regarding the type of securities to be issued and the relative proportion between them is to be taken. The finance department must determine the proper mix of debt and equity. It should also decide the ratio between long term and short term debts. In determining these ratios, cost of raising finance from different sources, period for which funds are required and several other factors should be considered. A proper balance between risk and returns should be maintained.

Choice of Sources of Finance

A company can raise funds from different sources e.g. shareholders, debenture holders, banks, financial institutions, public deposits etc. Before raising the funds, it has to decide the source from which the funds are to be raised. The choice of the source of finance should be made very carefully by taking a number of factors into account such as cost of raising funds, conditions attached, charge on assets, burden of fixed charges, dilution of ownership and control etc. For example, if the company does not want to dilute the ownership, it will depend on any source of finance other than investment in shares.

Investment of Funds

The funds raised from different sources should be prudently invested in various assets -short term as well as long term to optimize the return on investment. In taking decisions for the investment of long term funds, a careful assessment of various alternatives should be made through capital budgeting, opportunity cost analysis and many other techniques used to evaluate the investment proposals. A part of the long term funds should be invested in working capital of the company. While taking decision for the investment of funds in long term assets, management should be guided by three basic principles, viz. safety, profitability and liquidity. In taking decisions for the investment of funds in working capital, the finance manager must seek cooperation of marketing and production departments in estimating the funds which are to be involved in carrying of inventories in finished product and credit policy of the marketing department and in raw material and factory supplies of the production department.

Management of Cash

It is the prime responsibility of the finance manager to see that an adequate supply of cash is available at proper time for the smooth running of the business. Cash is needed to purchase raw materials, pay off creditors, to pay to workers and to meet the day to day expenses of the business. Availability of cash is necessary to maintain liquidity and credit- worthiness of the business. Excess cash must be avoided as it costs money. It there is any cash in excess, it should be invested in near cash assets such as investments etc. which may be converted into cash within no time. A cash flow statement should be prepared by the department to know the correct need of cash is essential to achieve the goal of profitability and liquidity. The finance manager should decide in advance how much cash he should retain to meet current obligations of the company.

Disposal of Surplus
One of the prime function of the finance department is to allocate the surplus. After paying all taxes, the available surplus of the business can be allocated for three purposes -(a) for paying dividend to the shareholders as a return on their investment, (b) for distributing bonus to workmen and company's contribution to other profit sharing plans, and (c) for ploughing back of profits for the expansion of business. As far as the second alternative is concerned, the amount to be paid to workers is generally fixed either by statute or by agreement and therefore, there is no problem in allocating surplus for this purpose. But a considerable, attention is to be paid in so far as first and third alternatives are concerned i.e., how much to be paid to shareholders as dividend and how much to be retained in the business. For this purpose factors like the trend of the earning of the company, trend of the market price of its shares; the requirement of funds for the purpose of expansion and future prospects should be considered.

Financial Controls
The financial manager is under an obligation to check the financial performance of the funds invested in the business. There are a number of techniques to evaluate the performance viz. Return on Investment (ROI), budgetary control, cost control, internal audit, ratio analysis and break-even point analysis. The financial manager must lay emphasis on financial planning as well.

OBJECTIVES OF FINANCIAL MANAGEMENT

Objectives of Financial management
For optimum financial decisions, the objectives of financial management shall be clearly defined. They should be so laid down that they contribute directly towards the achievement of overall business objectives. Objectives provide a normative framework within which a firm is to take decisions. Financing is the functional area of objective of the business and contribute directly towards it. The main objectives of a business are survival and growth. In order to survive ups and downs in the business, the business must earn sufficient profits and it should also maintain proper relations with shareholders, customers, suppliers

and other social groups. The financial management of an organisation must seek to achieve the following objectives:

- To ensure adequate and regular supply of funds.
- To provide a fair rate of return to the suppliers of capital viz. shareholders.
- To ensure effective utilization of funds by maintaining proper balance between profitability, liquidity and safety.
- to generate and build up sufficient surplus for expansion and growth through ploughing back of profits.
- To minimize cost of capital by developing a sound capital between various securities issued by the company.
- To coordinate the activities of the finance department with the activities of other departments in the organisation.

PROFIT V/S WEALTH MAXIMIZATION

Financial management is an academic discipline which is concerned with decision-making. This decision is concerned with the size and composition of assets and the level and structure of financing. In order to make right decision, it is necessary to have a clear understanding of the objectives. Such an objective provides a framework for right kind of financial decision making. The objectives are concerned with designing a method of operating the Internal Investment and financing of a firm. There are two widely applied approaches, viz.

(a) profit maximization and

(b) wealth maximization.

The term '**objective'** is used in the sense of an object, a goal or decision criterion. The three decisions – Investment decision, financing decision and dividend policy decision are guided by the objective. Therefore, what is relevant – is not the over-all objective but an operationally useful criterion: It should also be noted that the term objective provides a normative framework. Therefore, a firm should try to achieve and on policies which should be followed so that certain goals are to be achieved. It should be noted that the firms do not necessarily follow them.

Profit Maximization as a Decision Criterion

Profit maximization is considered as the goal of financial management. In this approach, actions that Increase profits should be undertaken and the actions that decrease the profits are avoided. Thus, the Investment, financing and dividend also be noted that the term objective provides a normative framework decisions should be oriented to the maximization of profits. The term 'profit' is used in two senses. In one sense it is used as an owner-oriented.

In this concept it refers to the amount and share of national Income that is paid to the owners of business. The second way is an operational concept i.e. profitability. This concept signifies economic efficiency. It means profitability refers to a situation where output exceeds Input. It means, the value created by the use of resources is greater that the Input resources. Thus in all the decisions, one test is used I.e. select asset, projects and decisions that are profitable and reject those which are not profitable.

The profit maximization criterion is criticized on several grounds. Firstly, the reasons for the opposition that are based on misapprehensions about the workability and fairness of the private enterprise itself. Secondly, profit maximization suffers from the difficulty of applying this criterion in the actual real-world situations. The term ‘objective’ refers to an explicit operational guide for the internal investment and financing of a firm and not the overall business operations. We shall now discuss the limitations of profit maximization objective of financial management.

1) <u>Ambiguity:</u>

The term ‘profit maximization’ as a criterion for financial decision is vague and ambiguous concept. It lacks precise connotation. The term ‘profit’ is amenable to different interpretations by different people. For example, profit may be long-term or short-term. It may be total profit or rate of profit. It may be net profit before tax or net profit after tax. It may be return on total capital employed or total assets or shareholders equity and so on.

2) <u>Timing of Benefits:</u>

Another technical objection to the profit maximization criterion is that It Ignores the differences in the time pattern of the benefits received from Investment proposals or courses of action. When the profitability is worked out **the bigger the better principle**is adopted as the decision is based on the total benefits received over the working life of the asset, Irrespective of when they were received. The following table can be considered to explain this limitation.

3) <u>Quality of Benefits</u>

Another Important technical limitation of profit maximization criterion is that it ignores the quality aspects of benefits which are associated with the financial course of action. The term ‘quality’ means the degree of certainty associated with which benefits can be expected. Therefore, the more certain the expected return, the higher the quality of benefits. As against this, the more uncertain or fluctuating the expected benefits, the lower the quality of benefits.

The profit maximization criterion is not appropriate and suitable as an operational objective. It is unsuitable and inappropriate as an operational objective of Investment financing and dividend decisions of a firm. It is vague and ambiguous. It ignores important dimensions of financial analysis viz. risk and time value of money.

An appropriate operational decision criterion **for** financial management should possess the following quality.

a) It should be precise and exact.

b) It should be based on bigger the better principle.

c) It should consider both quantity and quality dimensions of benefits.

d) It should recognize time value of money.

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Wealth Maximization Decision Criterion

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Wealth maximization decision criterion is also known as Value Maximization or Net Present-Worth maximization. In the current academic literature value maximization is widely accepted as an appropriate operational decision criterion for financial management decision. It removes the technical limitations of the profit maximization criterion. It posses the three requirements of a suitable operational objective of financial courses of action. These three features are exactness, quality of benefits and the time value of money.

i) Exactness: The value of an asset should be determined In terms of returns it can produce. Thus, the worth of a course of action should be valued In terms of the returns less the cost of undertaking the particular course of action. Important element in computing the value of a financial course of action is the exactness in computing the benefits associated with the course of action. The wealth maximization criterion is based on cash flows generated and not on accounting profit. The computation of cash inflows and cash outflows is precise. As against this the computation of accounting is not exact.

ii) Quality and Quantity and Benefit and Time Value of Money:

The second feature of wealth maximization criterion is that. It considers both the quality and quantity dimensions of benefits. Moreover, it also incorporates the time value of money. As stated earlier the quality of benefits refers to certainty with which benefits are received In future.

The more certain the expected cash in flows the better the quality of benefits and higher the value. On the contrary the less certain the flows the lower the quality and hence, value of benefits. It should also be noted that money has time value. It should also be noted that benefits received in earlier years should be valued highly than benefits received later.

The operational implication of the uncertainty and timing dimensions of the benefits associated with a financial decision is that adjustments need to be made in the cash flow pattern. It should be made to incorporate risk and to make an allowance for differences in the timing of benefits. Net present value maximization is superior to the profit maximization as an operational objective.

It involves a comparison of value of cost. The action that has a discounted value reflecting both time and risk that exceeds cost is said to create value. Such actions are to be undertaken. Contrary to this actions with less value than cost, reduce wealth should be rejected. It is for these reasons that the Net Present Value Maximization is superior to the profit maximization as an operational objective.

PROFIT MAXIMIZATION VS WEALTH MAXIMIZATION

PROFIT MAXIMISATION – It is one of the basic objectives of financial management. Profit maximization aims at improving profitability, maintaining the stability and reducing losses and inefficiencies.

Profit in this context can be seen in 2 senses.

1. Profit maximization for the owner.

2. Profit maximization is for others.

Normally profit is linked with efficiency and so it is the test of efficiency.

However this concept has certain limitations like ambiguity i.e. the term is not clear as it is nowhere defined, it changes from person to person.

2. Quality of profit – normally profit is counted in terms of rupees. Normally amt earned is called as profit but it ignores certain basic ideas like wastage, efficiency, employee skill, employee's turnover, product mix, manufacturing process, administrative setup.

3. Timing of benefit / time value of profit – in inflationary conditions the value of profit will decrease and hence the profits may not be comparable over a longer period span.

4. Some economists argue that profit maximization is sometimes leads to unhealthy trends and is harmful to the society and may result into exploitation, unhealthy competition and taking undue advantage of the position.

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WEALTH MAXIMISATION – One of the traditional

approaches of financial management , by wealth maximization we mean the accumulation and creation of wealth , property and assets over a period of time thus if profit maximization is aimed after taking care , of its limitations it will lead to wealth maximization in real sense, it is a long term concept based on the cash flows rather than profits an hence there can be a situation where a business makes losses every year but there are cash profits because of heavy depreciation which indirectly suggests heavy investment in fixed assets and that is the real wealth and it takes into account the time value of money and so is universally accepted

TIME VALUE OF MONEY

Introduction

Time Value of Money (TVM) is an important concept in financial management. It can be used to compare investment alternatives and to solve problems involving loans, mortgages, leases, savings, and annuities.

TVM is based on the concept that a dollar that you have today is worth more than the promise or expectation that you will receive a dollar in the future. Money that you hold today is worth more because you can invest it and earn interest. After all, you should receive some compensation for foregoing spending. For instance, you can invest your dollar for one year at a 6% annual interest rate and accumulate $1.06 at the end of the year. You can say that the **future value** of the dollar is $1.06 given a 6% **interest rate** and a one-year **period**. It follows that the **present value** of the $1.06 you expect to receive in one year is only $1.

A key concept of TVM is that a single sum of money or a series of equal, evenly-spaced payments or receipts promised in the future can be converted to an equivalent value today. Conversely, you can determine the value to which a single sum or a series of future payments will grow to at some future date.

You can calculate the fifth value if you are given any four of: Interest Rate, Number of Periods, Payments, Present Value, and Future Value. Each of these factors is very briefly defined in the right-hand column below. The left column has references to more detailed explanations, formulas, and examples.

Interest • **Simple** • **Compound**	Interest is a charge for borrowing money, usually stated as a percentage of the amount borrowed over a specific period of time. **Simple interest** is computed only on the original amount borrowed. It is the return on that principal for one time period. In contrast, **compound interest** is calculated each period on the original amount borrowed **plus** all unpaid interest accumulated to date. Compound interest is always assumed in TVM problems.
Number of Periods	Periods are evenly-spaced intervals of time. They are intentionally not stated in years since each interval must correspond to a compounding period for a single amount or a payment period for an annuity.
Payments	Payments are a series of equal, evenly-spaced cash flows. In TVM applications, payments must represent all outflows (negative amount)

	or all inflows (positive amount).
[Present Value] • [Single Amount] • [Annuity]	**Present Value** is an amount today that is equivalent to a future payment, or series of payments, that has been discounted by an appropriate interest rate. The future amount can be a single sum that will be received at the end of the last period, as a series of equally-spaced payments (an annuity), or both. Since money has time value, the present value of a promised future amount is worth less the longer you have to wait to receive it.
[Future Value] • [Single Amount] • [Annuity]	**Future Value** is the amount of money that an investment with a fixed, compounded interest rate will grow to by some future date. The investment can be a single sum deposited at the beginning of the first period, a series of equally-spaced payments (an annuity), or both. Since money has time value, we naturally expect the future value to be greater than the present value. The difference between the two depends on the number of compounding periods involved and the going interest rate.
[Loan Amortization]	A method for repaying a loan in equal installments. Part of each payment goes toward interest and any remainder is used to reduce the principal. As the balance of the

	loan is gradually reduced, a progressively larger portion of each payment goes toward reducing principal.
Cash Flow Diagram	A cash flow diagram is a picture of a financial problem that shows all cash inflows and outflows along a time line. It can help you to visualize a problem and to determine if it can be solved by TVM methods.

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