

FINANCIAL MANAGEMENT-I

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CHAPTER ONE:

AN OVERVIEW OF FINANCIAL MANAGEMENT

INTRODUCTION:

MEANING OF FINANCIAL MANAGEMENT

- ❑ **Financial Management:** Is nothing but management of the limited financial resources the organization has to its utmost advantage.
- ❑ It refers to that part of management activity, which is concerned with the *planning* and *controlling* of firm's financial resources.
- ❑ **Financial Management:** is a combination of two disciplines, management and finance.

❑ **Management**: Is defined as the acts of getting people together to accomplish desired **goals and objectives** of any business areas and organizational activities.

❑ I.e. **Management** consists of the activities of **planning, organizing, staffing, leading, or directing, and controlling** an organization (a group of one or more people or entities) for the purpose of accomplishing a goal or objectives using the **available resources**.

❑ **Finance:** is defined as the art and science of managing money.

❑ **Finance** is concerned with the process, institutions, markets, and instruments involved in the transfer of money among individuals, businesses, and governments.

Finance as an area of study

□ **Finance**, in general, consists of **three** interrelated areas:

I. Money and capital markets: which deal with securities markets and financial institutions.

□ Factors that cause **interest rates** to **rise** and **fall**, the **regulations** to which financial institutions are subjected, and the various types of **financial instruments** such as **bonds**, **shares**, **mortgages**, **certificates of deposits**, and so on.

II. Investments: Which focus on the decision of investors, both individuals and institutions.

□ The **three** major functions in the investment area are:

- (i) Sales of securities,
- (ii) Analysis of individual securities, and
- (iii) Determination of the optimal (best) mix of securities for a given investor.

III. Financial management, (or "*business finance*", "*corporate finance*", or "*managerial finance*"): involves the actual management of business firms.

□ **FM** is concerned with the creation, maintenance and maximization of economic value or wealth through the application of accounting theories and concepts in management decision making.

❑ The **decisions involved are financial decisions** such as:

- ❖ when to introduce a new product,
- ❖ when to invest in new assets,
- ❖ when to replace existing assets
- ❖ when to borrow from banks,
- ❖ when to issue stocks or bonds,
- ❖ when to extend credit to a customer and how much cash to maintain.

❑ **Financial management** is the broadest area in finance and it is important in all types of businesses.

Financial services vs Financial Management:

- i. **Financial services:** is concerned with the design and delivery of advice and financial products (assets) to individuals, businesses and governments within the areas of banking and related institutions, personal financial planning, investments, insurance and so on.

ii. Financial management (managerial finance/ corporate finance): is the management of **capital sources** and **their uses** so as to attain the desired goal and objectives of the firm.

❖ It involves **sourcing of funds, making appropriate investments and promulgating the best mix of financial resources** in relation to the value of the firm.

KEY ACTIVITIES OF THE FINANCIAL MANAGER

The primary activities of a financial manager are:

1. Performing financial analysis and planning:

❖ **Financial planning (forecasting):** Evaluate productive capacity and determine financing requirement.

✓ **Techniques (Financial ratios) and Interpretations**

❑ The basis to calculate ratios are **historical financial statements.**

❑ However, using the historical data and equipped with the knowledge of future plans and constraints to achieve, management is in a better position to predict future happening to a certain reasonable extent.

❖ **Financial analysis:** Is the process of identifying the **financial strengths** and **weaknesses** of the firm, by properly establishing the **relationships** between the **items** contained in **balance sheet** and **profit and loss account**.

□ **Ratios** are the symptoms of health of an organization like blood pressure, pulse or temperature of an individual.

❑ Transforming financial data into usable form to monitor financial condition (Increase or Decrease capacity; additional funds or reduction of funds).

2. Making investment and financing decisions:

- **Investment decisions:** Short-term and long-term investments (*Capital budgeting and measurement of expected rate of return*).
- **Financing decisions** "Capital structure and Financing policy (Financial leverage and credit policy plus retention).

3. Managing financial resources:

- ❖ **Management of Current Assets:** (management of working capital, cash, receivable, inventory).
- ❖ **Multi-national financial management considerations**
(Currency Valuation).

❑ **Financial managers also have the responsibility for deciding:**

- The credit terms under **which customers** may buy,
- How much **inventory the company should carry**,
- How much **cash to keep on hand**,
- Whether to acquire other company (merger analysis), and
- How much of the firm's **earnings to retain** in the business versus **payout as dividends**.

FUNCTIONS OF FINANCIAL MANAGEMENT

❑ **Financial management** is concerned with **two** distinct **functions**. These are:

1. **Financing function:-** Describes the management of the *sources of capital*
2. **Investing function:-** Concentrates on the **type, size, and** percentage composition of *capital uses*.

SCOPE OF FINANCIAL MANAGEMENT:-
IN TERMS OF APPROACH

- ❑ The **scope** and **complexity** of financial management has been **widening, with the growth of business** in different diverse directions.
- ❑ It has undergone significant changes, over the years in its scope and coverage:

Approaches: Broadly, it has two approaches:

- **Traditional Approach-Procurement of Funds**
- **Modern Approach-Effective Utilization of Funds**

1) Traditional Approach:- Procurement of funds

- ❑ The scope of finance function was treated in the narrow sense of procurement or arrangement of funds.**
- ❑ The finance manager was treated as just provider of funds, when organization was in need of them.**
- ❑ The utilization or administration of resources was considered outside the purview of the finance function (Finance Manager).**

❑ As per this approach, the following aspects only were included in the scope of financial management:

- i. Estimation of required finance,
- ii. Arrangement of funds from financial institutions,
- iii. Arrangement of funds through financial instruments such as shares, debentures, bonds and loans, and
- iv. Looking after the accounting and legal work connected with the raising of funds.

Limitations of Traditional Approach:

- No Involvement of financial manager in Allocation of Funds.
- Financial manager was not Associated in Application of Funds.
- No Involvement of financial manager in day to day Management of funds.

2. Modern Approach:- Effective utilization of funds

- ❑ Since 1950s, the emphasis of Financial Management has been shifted from **raising of funds to the effective and judicious (careful) utilization of funds.**
- ❑ **Financial management** is considered as **vital** and an **integral part of overall management.**
- ❑ The **modern approach** is **analytical, logical and systematic** way of looking into the financial problems of the firm.

- ❑ Advice of finance manager is required at every moment, whenever any decision with involvement of funds is taken.
- ❑ Nowadays, the finance manager is required to look into the financial implications of every decision to be taken by the firm.
- ❑ The involvement of finance manager has been; before taking the decision, during its review and, finally, when the final outcome is judged.

SCOPE OF FINANCIAL MANAGEMENT:- **IN TERMS OF PERSPECTIVE (VIEWPOINT)**

I. Balance sheet perspective (how large should an enterprise be?)

- **Uses of funds** (in what form should it hold its Assets?)
- **Sources of funds** (what should be the composition of its claims?)

II. **Income statement perspective** (how fast should it grow?)

- **Sustainable sales growth rate** with out increasing leverage or issuing new shares.
- **Target capital structure:** is the mix of liability and equity (leverage, retention and dividend policy)
- **Capital intensity:** Sales per invested capital, Investment turnover (return).

OBJECTIVES OF FINANCIAL MANAGEMENT

❑ The term **objective** is used in the sense of a **goal or decision criterion** for the **four decisions**:

- ❖ **Investment decision**: deal with allocation of the firm's scarce financial resources among competing uses.
- ❖ **Dividend policy decision**: address the question how much of the cash a firm generates from operations should be distributed to owners in the form of dividends and how much should be retained by the business for further expansion.
- ❖ **Financial decision**: deal with the financing of the firm's investments, i.e., decisions whether the firm should use **equity** or **debt** funds in order to finance its assets.

❖ Asset management decision

- ***Determining the asset mix or composition:*** - determining the total amount of the firm's finance to be invested in current and fixed assets.
- ***Determining the asset type:*** - determining which specific assets to maintain within the categories of current and fixed assets.
- ***Managing the asset structure,*** i.e., maintaining the composition of current and fixed assets and the type of specific assets under each category

❑ The financial manager uses the overall company's **goal** of *shareholders' wealth maximization* which is reflected through:

- The **increased dividend per share**, and
- The **appreciations of the prices of shares**

THE FOLLOWING ARE **SPECIFIC OBJECTIVES** OF FINANCIAL MANAGEMENT:

I. Determining the Size and Growth Rate of firm:

- The size of the firm is equal to the total assets as indicated in the balance sheet and measured by the yearly percentage change.

II. Determining Assets Composition (Portfolio):

- Real assets (Current assets and fixed assets) Or Financial assets (Bonds, stocks, loans, advances, and negotiable securities....etc)
- ☐ The percentage composition of the assets of the firm is computed as ratio of the book value of each asset to total book values of all assets.

- ❑ The choice of the percentage composition of asset items affects the level of business risk.
- ❑ The **wealth maximizing assets structure** can be described in either of the following ways:
 - ✓ The *asset structure that yields the large profit for a given level of exposure to business risk,* or
 - ✓ The *asset structure that minimizes exposure to business risk that is needed to generate the desired profit.*

III. Determining the Composition of Liabilities and Equity:

- ❑ liabilities and equity are the **sources of capital** for business firms.
- ❑ The **mix of liabilities and equity** of the business is what is known as the **capital structure**.
- ❑ The **liability and equity percentage compositions** of the business firm is measured by **dividing the book value of each liability or equity item** by the **total book values of all liabilities and equity**.

□ When the business firm **finances its investment by using debt capital**, (*"leverage" being the jargon used in Finance to refer this*), the business firm and its shareholders face **added risks** along with the possibility of **added returns**.

➤ The **added risk** is the possibility that the firm may face **difficulty to repay its debts** as they mature. (*This is referred to as a negative leverage*)

➤ The **added returns** come from the ability of the firm to **earn the rate of return higher than the interest payments and related financing costs** of using liabilities. (*This is referred to as a positive leverage*)

❑ The added returns may be paid as dividends and/or re-invested in the firm to generate more profit.

❑ This, in effect, would **maximize the wealth of shareholders of the business firm.**

GOAL OF THE FIRM:
Profit vs Wealth Maximization

- ❑ The **business decisions** that financial managers are required to make **entirely depend on the purposes or goals** of their respective organizations.
- ❑ So, it is very important to distinguish between *wealth maximization and profit maximization* as goals of business firms.

1. Profit Maximization:

- ❑ Profit-maximization is a **traditional micro-economics theory** of business firm, which was historically considered as the goal of the firm.
- ❑ It stresses on the efficient use of financial/capital resources of the firm.
- ❑ However, as a goal of the business firm ignores many of the real world complexities that financial managers try to address in their decisions.

- ✓ **Profit maximization** looks at the total company profit rather than profit per share.
- ✓ **Profit maximization** does not speak about the company's dividends as either a return to shareholders or the impact of dividend policy on stock prices.

□ In the more applied discipline of financial management, however, firms must deal every day with two major factors: These are **uncertainty and timing**.

A. Uncertainty of Returns/Risk

- ❑ Profit maximization as the goal of business firms ignores uncertainty and risks.
 - ✓ Projects and investment alternatives are compared by examining their expected values or weighted average profits.
 - ✓ Whether or not one project is riskier than another, doesn't enter these calculations; economists do discuss risk, but tangentially (or imaginatively).
- ❑ **In reality**, however, projects differ in a great deal with respect to the risk characteristics, and ignoring these differences can result in incorrect decisions.

B. Timing of Returns

- ❑ Another problem with profit maximization as the goal of business firm is that it ignores the timing of the returns from projects.
- ❑ From the concept of "Time Value of Money ", money has a definite time value as people have definite preference for current benefits over future benefits.

- ❑ The returns obtained can be re-invested at the prevailing rate of return.
- ❑ The financial manager must always consider the possible timing of returns (profits) in financial decision-making.
- ❖ These limitations of profit maximization as the goal of business firms lead us to the maximization of the more robust goal of the business firm, that is, shareholders' wealth.

2. Wealth Maximization

- ❑ Wealth maximization, on the other hand, is a more *comprehensive model dealing* with the goal of the firm.
- ❑ According to this model, it is made clear that there are two ways in which the wealth of shareholders changes. These are:
 - Through *changing dividend payments*, and
 - Through *the change in the market price of common shares*

□ Hence, the change in shareholders' wealth, or change in the value of business firms, may be calculated as follows:

- 1) Multiply the dividend per share paid during the period by the number of shares owned.
- 2) Multiply the change in shares price during the period by the number of shares owned.
- 3) Add the dividends and the change in the market value of shares, computed in step 1 and 2 above, to obtain the change in the shareholders' wealth during the period.

□ In order to maximize the wealth of shareholders, a business firm must seek to provide the largest attainable combination of **dividends per share and stock price appreciation.**

THE AGENCY PROBLEM

- ❑ While the goal of the business firm is the maximization of shareholders' wealth, in reality the agency problem may interfere with the implementation of this goal.
- ❑ The agency problem is the result of a separation of the management and the ownership of the firm.

□ Because of the separation between the decision makers and owners, managers may make decisions that are not in line with the goal of the business firm, or not consistent with the interests of owners, that is outlined as maximization of shareholders' wealth.

END OF CHAPTER 1

THANK YOU!