UNIT 1: THE NATURE AND SCOPE OF FINANCIAL MANAGEMENT

1.1 INTRODUCTION

To have a good understanding of financial management, you need to understand first what finance is. Literally, finance means the money used in day-to-day activities of an individual or a business for exchange of goods and services. But here our focus rather should be to consider finance as a separate and distinct field of study like accounting, economics, mathematics, history, geography etc..

1.1.1 What Is Finance?

Finance is a distinct area of study that comprises facts, theories, concepts, principles, techniques and practices related with raising and utilizing of funds (money) by individuals, businesses, and governments.

Finance is a very wide and dynamic field of study. It directly affects the decisions of all individuals and organizations that earn or raise money and spend or invest it. Therefore, finance is also an area of study that deals with how, where, by whom, why, and through what money is transferred among and between individuals, businesses, and governments. It is concerned with the processes, institutions, markets, and instruments involved in the transfer of funds.

In addition to principles and techniques, finance requires individual judgment of the person making the financial decision. Hence, finance can also be defined as the art and science of managing money.

1.1.2 Major Areas of Finance

Since the concepts and areas of finance are very broad, the academic discipline of finance can be viewed as made of specialized areas. There are several ways to summarize the major areas of finance. One way is to review the career opportunities under it. Another way is based on the differences in the objectives of different organizations. For the sake of simplifying our discussion, we summarize the major fields of finance based on career opportunities in finance.

The career opportunities again can be divided into different categories. For our convenience, these opportunities can be categorized into two broad areas.

i) Financial Services

This is a part of finance which involves personal career opportunities as a loan officer, financial planner, stockbroker, real estate agent, and insurance broker. It is generally concerned with the design, development, and delivery of these financial services to individuals, business organizations, and governments.

ii) Financial Management

Financial management is concerned with the financial decisions of a business firm. This firm can be large or small, private or public, financial or non-financial, profit – seeking or not-for-profit. It involves specific financial functions of the firm.

1.1.3 Meaning of Financial Management

Financial Management can be clearly defined by viewing it as a subject, a process, or a function.

Financial management is one major area of study under finance. It deals with decisions made by a business firm that affect its finances. Financial management is sometimes called corporate finance, business finance, and managerial finance. These terms are used interchangeably in this material.

Financial management can also be defined as a decision making process concerned with planning for raising, and utilizing funds in a manner that achieves the goal of a firm.

There are many specified business functions performed by a business unit. These include marketing, production, human resource management, and financial management. Financial management is one of the important functions of a firm. It is a specified business function that deals with the management of capital sources and uses of a firm.

1.1.4 Why Study Financial Management?

If you are approaching financial management for the first time, you might wonder why students like you study the field of financial management and what career opportunities exist.

Many business decisions made by firms have financial implications. Accordingly, financial management plays a significant role in the operation of the firm. People in all functional areas of a firm need to understand the basics of financial management. Accountants, information systems analysts, marketing personnel and people in operations, all need to be equipped with the basic theories, concepts, techniques, and practices of managerial finance if they have to make their jobs more efficient and achieve their goals. That is why the course Financial Management is offered to students in the fields of accounting, management, business administration, and management informations systems.

If you develop the necessary training and skills in financial management, you have career opportunities in a good deal of positions as a financial analyst, capital budgeting, project finance, cash, and credit manager, financial manager, banker, financial consultant, and even as a general manager. The author hopes you will appreciate the importance of financial management as you learn it more.

1.2 HISTORICAL DEVELOPMENT OF FINANCIAL MANAGEMENT

Finance emerged as a field separate and distinct from economics around 1900. The first major focus of financial management during its early years of development was the meanses how large corporations of the time could raise capital. This was a period when the establishment of very large companies like the Rockefeller oil and Morgan steel was marked.

The economic depression of the 1930s made financial management to shift to topics like preservation of capital, maintenance of liquidity, reorganization of financially troubled companies, and the bankruptcy process.

Until 1950s, the study of financial management had been descriptive or definitional in nature. But in the mid 1950s, more analytical, decision – oriented approach began to evolve. These include capital budgeting, cash and inventory management, capital structure formulation, and allocation of income as dividends and retained earnings.

Starting the late 1960s, the primary focus of financial management has been on the relationships between risk and return of a firm's financial decision. That is financial management has focused on the maximization of earnings (return) for a given level of risk; or minimization of risk for a given level of return.

1.3 FINANCE AND RELATED FIELDS

Though finance had ceded itself from economics, it is not totally an independent field of study. It is an integral part of the firm's overall management. Finance heavily draws theories, concepts, and techniques from related disciplines such as economics, accounting, marketing, operations, mathematics, statistics, and computer science. Among these disciplines, the field of finance is closely related to economics and accounting.

1.3.1 Finance versus Economics

Finance and economics are closely related in many aspects. First, economics is the mother field of finance. Second, the economic environment within which a firm operates influences the decisions of a financial manger. A financial manger must understand the interrelationships between the various sectors of the economy. He must also understand such economic variables as a gross domestic product, unemployment, inflation, interests, and taxes in making financial decisions.

Financial mangers must also be able to use the structure of decision-making provided by economics. They must use economic theories as guidelines for their efficient financial decision making. These theories include pricing theory through the relationships between demand and supply, return analysis, profit maximization strategies, and marginal analysis. The last one, particularly, is the primary economic principle used in financial management.

Basic Differences between Finance and Economics

i) Finance is less concerned with theory than is economics. Finance is basically concerned with the application of theories and principles.
ii) Finance deals with an individual firm; but economics deals with the industry and the overall level of the economic activity.

1.3.2 Finance Versus Accounting

Accounting provides financial information through financial statements. Therefore, these two fields are closely linked as accounting is an important input for financial decision-making. Besides, the accounting and finance functions generally overlap; and usually it is difficult to distinguish them. In many situations, the accounting and finance activities are within the control of the financial manager of a firm.

Basic Differences between Finance and Accounting

i) ***Treatment of income: -*** in accounting income measurement is on accrual basis. Under this method revenues are recognized as earned and expenses as incurred. In finance, however, the cash method is employed to recognize the revenue and expenses.
ii) ***Decision-making: -*** the primary function of accounting is to gather and present financial data. Finance, on the other hand, is primarily concerned with financial planning, controlling and decision-making. The

financial manger evaluates the financial statements provided by the accountant by applying additional data and then makes decisions accordingly.

iii) Accounting is highly governed by generally accepted accounting principles.

1.4 THE SCOPE OF FINANCIAL MANAGEMENT

The scope of financial management refers to the range or extent of matters being dealt with in financial management.

Traditionally, financial management was viewed as a field of study limited to only raising of money. Under the traditional approach, the scope and role of financial management was considered in a very narrow sense of procurement of funds from external sources. The subject of finance was limited to the discussion of only financial institutions, financial instruments, and the legal and accounting relationships between a firm and its external sources of funds. Internal financial decision makings as cash and credit management, inventory control, capital budgeting were ignored. Simply stating, the old approach treated financial management in a narrow sense and the financial manager as a less important person in the overall corporate management.

However, the modern or contemporary approach views financial management in a broad sense. Corporate finance is defined much more broadly to include any business decisions made by a firm that affect its finance. According to the modern approach, financial management provides a conceptual and analytical framework for the three major financial decision making functions of a firm. Accordingly, the scope of managerial finance involves the solution to investing, financing, and dividend policy problems of a firm. Besides, unlike the old approach, here, the financial manager's role includes both acquiring of funds from external sources and allocating of the funds efficiently within the firm thereby making internal decisions.

The increased globalization of business has expanded the scope of financial management further to include financial decisions pertaining to the international financial environment.

1.5 THE FUNCTIONS OF FINANCIAL MANAGEMENT

This refers to the special activities or purposes of financial management. The functions of financial management are planning for acquiring and utilizing funds by a firm as well as distributing funds to the owners in ways that achieve goal of the firm.

In general, the functions of financial management include three major decisions a firm must make. These are:
Investment decisions
Financing decisions
Dividend decisions

1.5.1 Investment Decisions

They deal with allocation of the firm's scarce financial resources among competing uses. These decisions are concerned with the management of assets by allocating and utilizing funds within the firm. Specifically, the investment decisions include:

i) ***Determining the asset mix or composition:*** **-** determining the total amount of the firm's finance to be invested in current and fixed assets.

ii) ***Determining the asset type:*** **-** determining which specific assets to maintain within the categories of current and fixed assets.

iii) ***Managing the asset structure***, i.e., maintaining the composition of current and fixed assets and the type of specific assets under each category.

The investment decisions of a firm also involve working capital management and capital budgeting decisions. The former refers to those decisions of a firm affecting its current assets and short – term liabilities. The later, on the other hand, involves long – term investment decisions like acquisition, modification, and replacement of fixed assets.

Generally, the investment decisions of a firm deal with the left side of the basic accounting equation: A = L + OE (Assets = Liabilities + Owners' Equity).

1.5.2 Financing Decisions

The financing decisions 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. They are also concerned with determining the most appropriate composition of short – term and long – term financing. In simple terms, the financing decisions deal with determining the best financing mix or capital structure of the firm.

The financing decisions of a firm are generally concerned with the right side of the basic accounting equation.

1.5.3 Dividend Decisions

The dividend decisions 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. There are trade offs on the dividend policy of a firm. On the one hand, paying out more dividends will make the firm to be perceived strong and healthy by investors ; on the other hand, it will affect the future growth of the firm. So the dividend decision of a firm should be analyzed in relation to its financing decisions.

1.6 JOBS OF THE FINANCIAL STAFF

Key activities of the finance people can be related to the firm's basic financial statements. The primary jobs of the financial staff are:

i) ***Performing Financial Analysis:*** **-** financial analysis is concerned with obtaining of the basic financial statements, applying some tools and techniques, and converting the raw information into a standardized form. The purpose here is to give the finance person a better opportunity to understand the firm's financial affairs, the results of its operations, and its cash flows.

ii) ***Performing Financial Forecasting:*** **-** financial forecasting is concerned with forecasting of the firm's sales for a given future period upon which the firm projects its assets needs, and finally, it will evaluate whether additional finance is required.

iii) ***Making Investment Decisions:*** **-** include credit management, inventory control, cash management, capital budgeting and other investment activities of a firm.

iv) ***Making Financing Decision: -*** include any activities associated with procurement or acquisition of funds. Examples include borrowing decisions, decisions to issue shares of common stock and preferred stock, bonds, and other securities.

1.2 The goals of financial management

The goals of managerial finance are:

1. *Profit maximization*
2. *Stockholder wealth maximization*
3. *Managerial reward maximization*: when the firms make a profit management give a bonus for their employees.
4. *Behavioral goal*: change employees mind to think for the advancement of the organization.
5. *Social responsibility*: keep the environment in well manner. Avoid environmental pollutions.

1. ***Profit maximization***.

Objective: - to get large amount of profits in short period of time.

- It is short term goal
- A firm may maximize its short-term profits at the expense of its long term profitability and still realize this goal. In contrast, stockholder wealth maximization is a long term goal, since stockholders are interested in future as well as present profits.
- You can attain maximum profit through selling a portion of your assets but you are endangering the existence of the business.

Advantages

- easy to calculate profits
- easy to determine the link between financial decisions and profits.

Disadvantages

- emphasis only on short-term
- ignores risk and uncertainty

2. Stockholder wealth maximization

Objective: is attained when highest market value of common stock is maintained.

Advantages

Wealth maximization is generally preferred because:

- emphasis on long-term
- recognizes risks and uncertainty

Disadvantages

- offers no clear link between financial decisions and stock price
- Leads to anxiety of management and frustrations.

2.5 CONFLICT OF GOALS BETWEEN MANAGEMENT AND OWNERS AND AGENCY PROBLEM

As you understand, in a corporate form of business organization owners (stockholders) do not run the activities of the firm. Rather, the stockholders elect the board of directors, who in turn assign the management on behalf of the owners. So, basically, managers are agents of the owners of the corporation and they undertake all activities of the firm on behalf of these owners. Managers are agents in a corporation to maximize the common stockholders' well-being.

However, there is a conflict of goals between mangers and owners of a corporation and mangers may act to maximize their interest instead of maximizing the wealth of owners. Managers are interested to maximize their personal wealth, job security, life style and fringe benefits.

The natural conflict of interest between stockholders and managerial interest create agency problems. Agency problems are the likelihood that mangers may place their personal goals a head of corporate goals. Theoretically, agency problems are always there as long as mangers are agents of owners.

Corporations (owners) are aware of these agency problems and they incur some costs as a result of agency. These costs are called agency cost and include:

1. ***Monitoring expenditures*** – are expenditures incurred by corporations to monitor or control the activities of managers. A very good example of a monitoring expenditure is fees paid by corporations to external auditors.
2. ***Bonding expenditures*** – are cost incurred to protect dishonesty of mangers and other employees of a firm. Example: fidelity guarantee insurance premium.
3. ***Structuring expenditures*** – expenditures made to make managers fell sense of ownership to the corporation. These include stock options, performance shares, cash bonus etc.
4. ***Opportunity costs*** – unlike the previous three, these costs are not explicit expenditures.

Opportunity costs are assumed by corporations due to hindrances of decisions by them as a result of their organizational structure and hierarchy.

On top of the above costs assumed by corporations, there are also other ways to motivate managers to act in the best interest of owners. These ways include to make know managers that they would be fired if they do not act to maximize shareholders wealth and that the corporation could be overtaken by others if its value is very much lower than other firms.