Financial Management
Unit-1
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Financial Management

Introduction to Financial Management

- Let's define financial management as the first part of the introduction to financial management. For any business, it is important that the finance it procures is invested in a manner that the returns from the investment are higher than the cost of finance. In a nutshell, financial management –
  - Endeavors to reduce the cost of finance
  - Ensures sufficient availability of funds
  - Deals with the planning, organizing, and controlling of financial activities like the procurement and utilization of funds.

Definition-

- “Financial management is the activity concerned with planning, raising, controlling and administering of funds used in the business.” – **Guthman and Dougal**
- “Financial management is that area of business management devoted to a judicious use of capital and a careful selection of the source of capital in order to enable a spending unit to move in the direction of reaching the goals.” – **J.F. Brandley**
- “Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations.”- **Massie**

Nature, Significance, and Scope of Financial Management

Financial management is an organic function of any business. Any organization needs finances to obtain physical resources, carry out the production activities and other business operations, pay compensation to the suppliers, etc. There are many theories around financial management:

- Some experts believe that financial management is all about providing funds needed by a business on terms that are most favorable, keeping its objectives in mind. Therefore, this approach concerns primarily with the procurement of funds which may include instruments, institutions, and practices to raise funds. It also takes care of the legal and accounting relationship between an enterprise and its source of funds.
- Another set of experts believe that finance is all about cash. Since all business transactions involve cash, directly or indirectly, finance is concerned with everything done by the business.
- The third and more widely accepted point of view is that financial management includes the procurement of funds and their effective utilization. For example, in the case of a manufacturing company, financial management must ensure that funds are available for installing the production plant and machinery. Further, it must also ensure that the profits adequately compensate the costs and risks borne by the business.

In a developed market, most businesses can raise capital easily. However, the real problem is the efficient utilization of the capital through effective financial planning and control.

Further, the business must ensure that it deals with tasks like ensuring the availability of funds, allocating them, managing them, investing them, controlling costs, forecasting financial requirements, planning profits and estimating returns on investment, assessing working capital, etc.

The scope of Financial Mangement

- The introduction to financial management also requires you to understand the scope of financial management. It is important that financial decisions take care of the shareholders' interests.
- Further, they are upheld by the maximization of the wealth of the shareholders, which depends on the increase in net worth, capital invested in the business, and plowed-back profits for the growth and prosperity of the organization.
- The scope of financial management is explained in the diagram below:
- You can understand the nature of financial management by studying the nature of investment, financing, and dividend decisions.

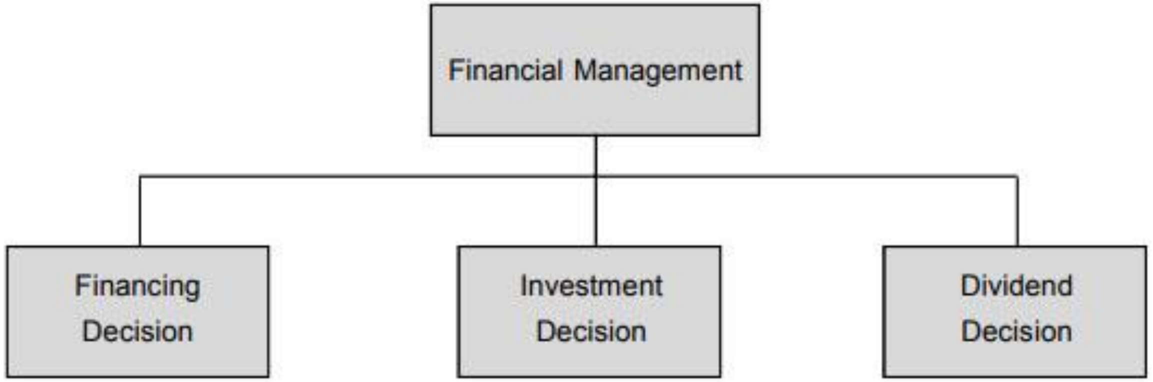


Fig. 1 - The scope of Financial Management

Core Financial Management Decisions

In organizations, managers in an effort to minimize the costs of procuring finance and using it in the most profitable manner, take the following decisions:

- **Investment Decisions:** Managers need to decide on the amount of investment available out of the existing finance, on a long-term and short-term basis. They are of two types:
  - Long-term investment decisions or Capital Budgeting mean committing funds for a long period of time like fixed assets. These decisions are irreversible and usually include the ones pertaining to investing in a building and/or land, acquiring new plants/machinery or replacing the old ones, etc. These decisions determine the financial pursuits and performance of a business.
  - Short-term investment decisions or Working Capital Management means committing funds for a short period of time like current assets. These involve decisions pertaining to the investment of funds in the inventory, cash, bank deposits, and other short-term investments. They directly affect the liquidity and performance of the business.

- **Financing Decisions:** Managers also make decisions pertaining to raising finance from long-term sources (called Capital Structure) and short-term sources (called Working Capital). They are of two types:
  - **Financial Planning decisions** which relate to estimating the sources and application of funds. It means pre-estimating financial needs of an organization to ensure the availability of adequate finance. The primary objective of financial planning is to plan and ensure that the funds are available as and when required.
  - **Capital Structure decisions** which involve identifying sources of funds. They also involve decisions with respect to choosing external sources like issuing shares, bonds, borrowing from banks or internal sources like retained earnings for raising funds.

- **Dividend Decisions:** These involve decisions related to the portion of profits that will be distributed as dividend. Shareholders always demand a higher dividend, while the management would want to retain profits for business needs. Hence, this is a complex managerial decision.

Functions of Financial Management

- **Estimation of capital requirements:** A finance manager has to make estimation with regards to capital requirements of the company. This will depend upon expected costs and profits and future programmes and policies of a concern. Estimations have to be made in an adequate manner which increases earning capacity of enterprise.
- **Determination of capital composition:** Once the estimation have been made, the capital structure have to be decided. This involves short- term and long- term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.
- **Choice of sources of funds:** For additional funds to be procured, a company has many choices like-
  - Issue of shares and debentures
  - Loans to be taken from banks and financial institutions
  - Public deposits to be drawn like in form of bonds.

Choice of factor will depend on relative merits and demerits of each source and period of financing.

- **Investment of funds:** The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.
- **Disposal of surplus:** The net profits decision have to be made by the finance manager. This can be done in two ways:
  - Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
  - Retained profits - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.
- **Management of cash:** Finance manager has to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintainance of enough stock, purchase of raw materials, etc.
- **Financial controls:** The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.

Objectives of Financial Management

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

- To ensure regular and adequate supply of funds to the concern.
- To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
- To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
- To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
- To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

- **What is Profit Maximization?**
  - The process of increasing the profit earning capability of the company is referred to as Profit Maximization. It is mainly a short-term goal and is primarily restricted to the accounting analysis of the financial year. It ignores the risk and avoids the time value of money. It is primarily concerned as to how the company will survive and grow in the existing competitive business environment.
- **What is Wealth Maximization?**
  - The ability of a company to increase the value of its stock for all the stakeholders is referred to as Wealth Maximization. It is a long-term goal and involves multiple external factors like sales, products, services, market share, etc. It assumes the risk and recognizes the time value of money given the business environment of the operating entity. It is mainly concerned with the long-term growth of the company and hence is concerned more about fetching the maximum chunk of the market share to attain a leadership position.

Profit Maximization Vs Wealth Maximization

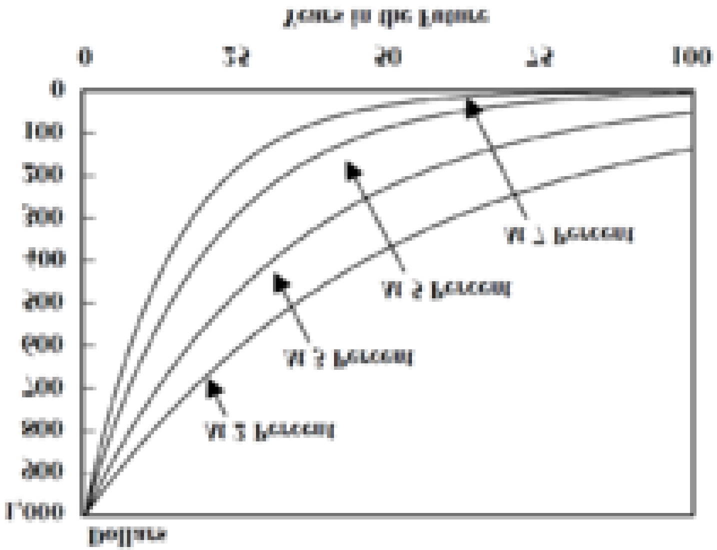
Profit Maximization	Wealth Maximization
It does take into account time value of money.	It takes into account time value of money
It does not take into consideration the uncertainty of future earnings	It takes into account the risk factor
It does not consider the effect of dividend policy on market price of shares	It takes into account the effect of dividend policy on Market Price of shares.
It does not differentiate between the short term and long term profits	It considers the different strategies for long term and short term profits.

chef Financial Officer

- A chief financial officer (CFO) is the senior executive responsible for managing the financial actions of a company. The CFO's duties include tracking cash flow and financial planning as well as analyzing the company's financial strengths and weaknesses and proposing corrective actions.
- The chief financial officer of a company is the top-level financial controller, handling everything relating to cash flow and financial planning.
- The meaning of CFO is simply the initials that stand for the title chief financial officer.
- Although the role of a CFO can be rewarding, there are legal considerations that must be strictly adhered to.
- CFOs oversee taxation issues for their companies.

Role of Chef financial officer

Time value of money



- The present value of $1,000, 100 years into the future. Curves represent constant discount rates of 2%, 3%, 5%, and 7%.
- The **time value of money** is the idea that there is greater benefit to receiving a sum of money now rather than an identical sum later. It is founded on time preference.
- The time value of money is the reason why interest is paid or earned: interest, whether it is on a bank deposit or debt, compensates the depositor or lender for the time value of money.
- It also underlies investment. Investors are willing to forgo spending their money now only if they expect a favorable return on their investment in the future, such that the increased value to be available later is sufficiently high to offset the preference to spending money now; see required rate of return.

How the Time Value of Money Works

A simple example can be used to show the time value of money. Assume that someone offers to pay you one of two ways for some work you are doing for them: They will either pay you $1,000 now or $1,100 one year from now.

Which pay option should you take? It depends on what kind of investment return you can earn on the money at the present time. Since $1,100 is 110% of $1,000, then if you believe you can make more than a 10% return on the money by investing it over the next year, you should opt to take the $1,000 now. On the other hand, if you don't think you could earn more than 9% in the next year by investing the money, then you should take the future payment of $1,100 – as long as you trust the person to pay you then.

- **Time Value of Money Formula**
- The time value of money is an important concept not just for individuals, but also for making business decisions. Companies consider the time value of money in making decisions about investing in new product development, acquiring new business equipment or facilities, and establishing credit terms for the sale of their products or services.
- A specific formula can be used for calculating the **future value** of money so that it can be compared to the present value:

$$FV = PV \times [1 + (i / n)]^{(n \times t)}$$

- Where:
- **FV** = the future value of money
  PV = the present value
  i = the interest rate or other return that can be earned on the money
  t = the number of years to take into consideration
  n = the number of compounding periods of interest per year
- Using the formula above, let's look at an example where you have $5,000 and can expect to earn 5% interest on that sum each year for the next two years. Assuming the interest is only compounded annually, the future value of your $5,000 today can be calculated as follows:
- **FV = $5,000 x (1 + (5% / 1) ^ (1 x 2) = $5,512.50**

Significance of time value Of money

The time value of money is the idea that money available at the present time is worth more than the same amount in the future due to its potential earning capacity. Time value of money is a widely used concept in the literature of finance. Financial decision models based on finance theories basically deal with the maximization of the economic welfare of shareholders. A fundamental idea in finance that money that one has now is worth more than money one will receive in the future.

The concept of time value of money contributes to this aspect to a greater extent. The significance of the concept of time value of money could be stated as below:

- ***Investment Decision***

  The investment decision is concerned with the allocation of capital into long-term investment projects. The cash flow from long-term investment occurs at a different point in time in the future. In other words, investment decisions are concerned with the question of whether adding to capital assets today will increase the revenues of tomorrow to cover costs. They are not comparable to each other and against the cost of the project spent at present. To make them comparable, the future cash flows are discounted back to present value. As such investment decisions are concerned with the choice of acquiring real assets over the time period in a productive process.

The concept of time value of money is useful to securities investors. They use valuation models while making an investment in securities such as stock and bonds. These security valuation models consider the time value of cash flows from securities.

- ***Financing Decision***

  Financing decision is concerned with designing optimum capital structure and raising funds from the least cost sources. The concept of time value of money is equally useful in financing decision, especially when we deal with comparing the cost of different sources of financing. It is concerned with the borrowing and allocation of funds required for the investment decisions. The effective rate of interest of each source of financing is calculated based on the time value of money concept. Similarly, in leasing versus buying decision, we calculate the present value of the cost of leasing and the cost of buying. The present value of costs of two alternatives is compared against each other to decide on an appropriate source of financing. The objective of financial decision is to maintain an optimum capital structure, i.e. a proper mix of debt and equity, to ensure the trade-off between the risk and return to the shareholders.

- Besides, the concept of time value of money is also used in evaluating proposed credit policies and the firm's efficiency in managing cash collection under current assets management.

Compounding and discounting Techniques

- **COMPOUNDING TECHNIQUE** is the method of calculating the future values of cash flows and involves calculating **compound** interest. Under this process, interest is **compounded** when the amount earned on an initial deposit (the initial principal) becomes part of the principal at the end of the first **compounding** period.
- **Discounting** is the process of determining the present value of a payment or a stream of payments that is to be received in the future. Given the time value of money, a dollar is worth more today than it would be worth tomorrow. **Discounting** is the primary factor used in pricing a stream of tomorrow's cash flows.

COMPOUNDING VERSUS DISCOUNTING

INFOGRAPHIC FOR QUICK REFERENCE

	Compounding	Discounting
Definition	Process of calculating the future value of a present investment	Process of calculating the present value of a future cash flow
Rate	Compound interest rate	Discount Rate
Formula	A = P (1+ r/n)nt	Dn = 1/(1+r)n
Used To	Determine the amount of earnings to be gained by making an investment	Determine how much should be invested to make maximum returns in the future