

- Financial Management

- An Introduction

# FINANCE

Finance is the life-blood of business. Without finance neither any business can be started nor successfully run . Finance is needed to promote or establish business, acquire fixed assets, make necessary investigations, develop product keep man and machines at work ,encourage management to make progress and create values.

# FINANCIAL MANAGEMENT

Financial management is one the functional area of management. It refer to that part of the management activity which is concerned with the planning and controlling of firms financial resources.

# DEFINITION

“Financial management is the application of planning and control function of the finance function”

Howard and Upton

# NATURE AND SCOPE OF FINANCIAL MANAGEMENT

The nature of financial decisions would be clear when we try to understand the operation of a firm. At the very outset, the promoters makes an appraisal of various investment proposals and selects one or more of them ,depending upon the net benefits derived from each as well as on the availability of funds.

# PROCESS INVOLVE IN FINANCIAL DECISION

1. Selection of investment proposals ,known as the investment decision.
2. Determination of working capital requirements, known as the working capital decision.
3. Raising of funds to finance the assets, known as the financing decision.
4. Allocation of profit for dividend payment, known as the dividend decision.

# • What is Finance Anyway?

## What is this course all about?

- Accounting is the language of business.
- Finance uses accounting information together with other information to make decisions that affect the market value of the firm.
- There are three primary decision areas that are of concern.

# • Three decision areas in finance:

Investment decisions - What assets should the company hold? This determines the left-hand side of the balance sheet. These decisions are concerned with the effective utilization of funds in one activity or the other. The investment decision can be classified under two groups-

- (i) Long term investment decision
- (ii) Short term investment decision

The former are referred to as the capital budgeting and the latter as the working capital management.



# Financing decision

Financing decisions - How should the company pay for the investments it makes? This determines the right-hand side of the balance sheet. It is also known as capital structure decision. It involves the choosing the best source of raising funds and deciding optimal mix of various source of finance.

A company can not depend upon only one source of finance ,hence a varied financial structure is developed. but before using any particular source of capital ,its relative cost of capital ,degree of risk and control etc should be thoroughly examined by the financial manager. the major source of long-term capital as shares and debentures.

# DIVIDEND DECISION

Dividend decisions - What should be done with the profits of the business? The dividend decision is concerned with determining how much part of the earning should be distributed among the share holders by way of dividend and how much should be retained in the business for meeting the future needs of funds internally.

# Factors influencing financial decision

These factors are divided into two parts-

1. Micro economic factor
2. Macro economic factor

Micro economic factor- micro economic factor is related to the internal condition of the firm-

- (a) Nature and size of the firm
- (b) Level of risk and stability in earnings
- (c) Liquidity position
- (d) Asset structure and pattern of ownership
- (e) Attitude of the management

# Macro economic factor

These are the Environmental factor-

1. The state of the economy
2. Governmental policy

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• All management decisions should help to accomplish the goal of the firm!

• What should be the goal of the firm?

# Objectives of financial management

The objective of financial management are considered usually at two levels –at macro level and micro level. three primary objectives are commonly explained as the Objective of financial management-

1. Maximization of profits
2. Maximization of return
3. Maximization of wealth

# Maximization of profits

Profit earning is the main aim of every economic activity. Profit maximization simply means maximizing the income of the firm . Economist are of the view that profits can be maximized when the difference of total revenue over total cost is maximum, or in other words total revenue is greater than the total cost.



S.P MANDAL'S

# Maximization of return

Some authorities on financial management conclude that maximization of return provide a basic guideline by which financial decision should be evaluated .



# Maximization of wealth

According to prof solomon ezra of stand ford university , the ultimate goal of financial management should be the maximization of the owners wealth. The value of corporate wealth may be interpreted in terms of the value of the company's total assets. The finance should attempt to maximize the value of the enterprise to its shareholders. Value is represented by the market price of the company's common stock.

- What about risk? Isn't risk important as well as profits?

- How would the stockholders of a small business react if they were told that their manager canceled all casualty and liability insurance policies so that the money spent on premiums could go to profit instead.
- Even though the *expected* profits increased by this action, it is likely that stockholders would be dissatisfied because of the increased risk they would bear.

# The common stockholders are the owners of the corporation!

- Stockholders elect a board of directors who in turn hire managers to maximize the stockholders' well being.
- When stockholders perceive that management is not doing this, they might attempt to remove and replace the management, but this can be very difficult in a large corporation with many stockholders.

- More likely, when stockholders are dissatisfied they will simply sell their stock shares.
- This action by stockholders will cause the market price of the company's stock to fall.

- When stock price falls relative to the rest of the market (or relative to the rest of the industry) ...
- Management is failing in their job to increase the welfare (or wealth) of the stockholders (the owners).

- Conversely, when stock price is rising relative to the rest of the market (or industry), ...
- Management is accomplishing their goal of increasing the welfare (or wealth) of the stockholders (the owners).

- The goal of the firm should be to maximize the stock price!
- This is equivalent to saying the goal is to maximize **owners' wealth**.
- Note that the stock price is affected by management's decisions affecting **both** risk and profit.
- Stock price can be maintained or increased only when stockholders perceive that they are receiving profits that fully compensate them for bearing the risk they perceive.

- Important focal points in the study of finance:

- Accounting and Finance often focus on different things
- Finance is more focused on market values rather than book values.
- Finance is more focused on cash flows rather than accounting income.



- Why is market value more important than book value?

- Book values are often based on dated values. They consist of the original cost of the asset from some past time, minus accumulated depreciation (which may not represent the actual decline in the assets' value).
- Maximization of market value of the stockholders' shares is the goal of the firm.

# Why is cash flow more important than accounting income?

- Cash flow to stockholders (in the form of dividends) is the only basis for valuation of the common stock shares. Since the goal is to maximize stock price, cash flow is more directly related than accounting income.
- Accounting methods recognize income at times other than when cash is actually received or spent.

- One more reason that cash flow is important:
- When cash is actually received is important, because it determines when cash can be invested to earn a return.

[Also: When cash must be paid determines when we need to start paying interest on money borrowed.]

- Examples of when accounting income is different from cash flow:

- Credit sales are recognized as accounting income, yet cash has not been received.
- Depreciation expense is a legitimate accounting expense when calculating income, yet depreciation expense is not a cash outlay.
- A loan brings cash into a business, but is not income.

## • More examples:

- When new capital equipment is purchased, the entire cost is a cash outflow, but only the depreciation expense (a portion of the total cost) is an expense when computing accounting income.
- When dividends are paid, cash is paid out, though dividends are not included in the calculation of accounting income.

- **Definitions: Operating income vs. operating cash flow**

- Operating income = earnings before interest and taxes (EBIT). This is the total income that the company earned by operating during the period. It is income available to pay interest to creditors, taxes to the government, and dividends to stockholders.

# • Operating cash flow:

- Operating cash flow  
= EBIT + Depreciation - Taxes. This definition recognizes that depreciation expense is subtracted in computing EBIT, though it is not a cash outlay.
- It also recognizes that taxes paid is a cash outlay.