Paper : Financial Management - I
UNIT 1: Introduction

MEANING OF FINANCIAL MANAGEMENT

Financial management is mainly concerned with procuring financial resources in the most economical and prudent manner, deploying these resources in most profitable way, planning future operations and controlling current and future performances and development through different tools.

Financial management which is an integral part of overall management is concerned with the application of general management principles to the areas of financial decision-making. In other words, it is the operational activity of a business firm which is responsible for obtaining and utilizing effectively the funds necessary for efficient operations.

CORE ELEMENTS OF FINANCIAL MANAGEMENT

There are three core elements of financial management. These elements are interrelated and interdependent. The elements are –

i) Mobilisation of financial resources

ii) Deployment of financial resources

iii) Generation and distribution of financial resources

i) Mobilisation of financial resources: Mobilisation of financial resources is the 'start up' financial variable of a business enterprise. It is concerned with raising of funds. There are a number of sources from which funds can be raised by a business enterprise, such as, issue of shares and debentures, loans from banks and non-bank financial institutions etc. A careful cost-benefit analysis is necessary in the matter of choosing the source of raising fund.

ii) Deployment of financial resources: Deployment of financial resources deals with the utilization aspect. Financial resources mobilized by the business firm may be utilized for various purposes such as, acquisition of fixed assets, meeting working capital needs etc. Financial resources are deployed in such a way that the benefits accruing from investments are more than the cost of

collection. So deployment of financial resources which acts as the 'intervening variable', influences the pattern of their mobilisation.

iii) Generation and distribution of financial resources: Generation of financial resources implies surplus generation. It is essential for every business enterprise. Distribution of financial resources means disposition of surplus. It is concerned with the dividend policy of the enterprise. Delicate judgements have to be made in formulating this policy. Distribution of financial resources is the 'end result' financial variable of the enterprise.

OBJECTIVES OF FINANCIAL MANAGEMENT

As an academic discipline, financial management has undergone significant changes over the years as regards its scope and coverage. As such, the role of finance manager has also changed tremendously over the years. However, the basic objective of an enterprise has not changed. The prime objective of a business entity is to maximize value for its owners. Therefore, the ultimate objective of financial management should be wealth maximization. Wealth maximization implies maximizing the net present value of a course of action. The net present value of a course of action is the difference between the present value of its benefits and that of its costs. A financial action having a positive net present value creates wealth and, therefore, is desirable. On the other hand, a financial action which yields a negative net present value should be rejected. The objective of wealth maximization can be achieved by a firm only if the firm follows this criterion in making financial decisions. Frequently, profit maximization is regarded as the proper objective of a business firm, but it is not as inclusive a goal as that of value maximization for its owners. Profit maximization implies maximizing total profits or earnings per share of the company. But total profit is an absolute measure of profitability of the concern while earnings per share is a relative measure. Thus, total profit figure is not as important as earnings per share. A firm could always raise its total profit by issuing stock and utilizing the proceeds to invest in treasury bills. Even maximizing earning per share, however, is not a fully appropriate objective, partly because it does not take into account the time pattern of returns. Thus, it ignores the time value of money and measures the value of benefits received in different time periods as the same. Moreover, it also does not consider the risk or uncertainty associated with the prospective earnings stream. There

may be two companies with the same expected earnings. However, the earning of one may be more fluctuating than the other and thus it will be more risky. The objective of profit maximization will treat both the companies at par whereas the owners of a company may prefer low earnings over high risky returns. But the objective of wealth maximization helps in resolving these two most troublesome problems connected with the flow of benefits. These problems are handled by selecting an appropriate rate for discounting the future stream of benefits. Keeping the above points in view, most of the thinkers of the subject have come to the conclusion that the aim of a business enterprise should be wealth maximization and not profit maximization. Professor Ezra Solomon has addressed the issue in a convincing manner. He argues that it is useful to draw a line of demarcation between profit and profitability. Profit maximization with a view to maximizing the wealth of owners is clearly an unreal motive. On the other hand, profitability maximization with a view to using resources to yield economic values higher than the joint values of inputs required is a useful goal. Thus, the proper goal of financial management is wealth maximization. It also implies maximization of the market value the firm/s shares. The value of the shares is represented by their market price which, in turn, is a reflection of the firm's financial decisions. In other words, the market value of the company's shares is a function of the financial decisions taken by it. Thus, in order to maximize market value of shares, the finance manager of the firm should take financial decisions most efficiently.

SCOPE OF FINANCIAL MANAGEMENT

With the increase in complexity of modern business environment, the role of a finance manager is not just confined to procurement of funds, but his area of functioning is extended to judicious and efficient use of funds available to the business enterprise, keeping in view the objectives of the enterprise and expectations of the providers of funds as well. The modern approach is an analytical way of looking at the financial problems of a firm. According to Prof. Ezra Solomon, these financial problems are associated with –

a) the total funds requirement of a firm;

b) the assets to be acquired by the firm and

c) the pattern of financing the assets to be adopted by the firm.

These three matters relate to four broad decision areas of financial management, namely, long-term investment or capital budgeting decision, financing or capital structure decision, dividend or profit allocation decision and liquidity or short-term asset-mix decision. These decisions comprise the scope of financial management. Let us make familiarity with these four decision areas of financial management.

i) Capital Budgeting Decision: Capital budgeting or long-term investment decision is the most crucial financial decision of a firm. This decision has a significant bearing on how capital fund is allocated in the firm. It involves the selection of an asset or investment proposal whose benefits are likely to be available in future over the life time of the project. Investment proposals are evaluated in term of both expected benefits to be derived in future from the projects and risk associated with them. The evaluation of the worth of a long-term investment proposal implies a certain standard against which the benefits are to be assessed. The standard is expressed in terms of the cost of capital. Cost of capital represents the opportunity cost of the funds to be invested in a project, where opportunity cost is quantified by the maximum expected rate of return from next best alternative foregone. Thus, another major aspect of the capital budgeting decision is the measurement of cost of capital.

ii) Capital Structure Decision: It is one of the major decisions involved in financial management. The term capital structure implies the combination of sources which have been used for creation of the pool of funds. A firm can make use of different sources of financing whose costs are different. Any source used for creating the pool of fund is an equity having an equitable claim on the fund created and also on the net inflow emanating from its use. The sources can be divided into two categories –

　　　a) External equities and

　　　b) Internal or owners' equities.

　　An external equity, when used, results in a fixed periodic contractual obligation. Contractual obligation implies payment of periodic interest / dividend and repayment of the principal. External equities are debentures, loans, deposits, preference share capital etc. But there is no contractual obligation in internal equity used in the capital structure.

　　Internal equities include equity share capital retained earnings etc. The finance manager strives to obtain the best combination of external and internal equities for his firm. Theoretically, the ideal combination exists when the market value of the firm is at its maximum and the overall

cost of capital for creating the pool of funds is at its minimum. Thus, the important aspect of the capital structure decision is the determination of an appropriate combination of internal and external equities taking into account the risk factor involved in a particular case.

iii) Dividend Decision: An appropriate dividend policy is yet another very important problem that is to be tackled by the finance manager. He has to decide whether all profits are to be distributed as dividend or retained in full or to distribute a portion of the profits and retain the balance. The proportion of earnings distributed by the company as dividend is called the dividend payout ratio and the portion of earnings retained by it is known as the retention ratio. The dividend policy is evaluated in terms of its impact on the shareholders' wealth. Thus, there should be such a dividend policy that has maximum positive impact on the wealth of the shareholders. The finance manager should consider the factors influencing dividend policy of a firm in practice and also the questions of dividend stability, bonus dividends and cash dividends.

iv) Liquidity Decision: The term 'liquidity' means proximity to cash. The liquidity of a firm implies the firm's ability to meet its short term obligations. Liquidity decision is concerned with the management of working capital. Management of working capital is an extremely important area of financial management. Investment and financing policies pursued must ensure adequate liquidity of the firm. Lack of it will seriously erode the credit standing and the firm may face the risk of technical insolvency. Excess of liquidity, on the other hand, jeopardizes the firm's capability to make profits. The crucial consideration in ensuring a trade-off between profitability and liquidity is one major aspect of working capital management. Moreover, the elements / components of working capital should be efficiently managed in order to ensure that neither inadequate nor excess funds are blocked up.

ROLE / FUNCTIONS OF FINANCIAL MANAGER

A financial manger is a person who takes care of all the important financial functions of an organization. Following are the main functions of a Financial Manager –

i) Estimating the Amount of Capital Required: This is the foremost function of the financial manager. The financial manager makes estimates of funds required for both short-term and long-term.

ii) Determining Capital Structure: Financial manager has to determine the proper mix of equity and debt and short-term and long-term debt ratio. This is done to achieve minimum cost of capital and maximise shareholders wealth.

iii) Choice of Sources of Funds: Before the actual procurement of funds, the finance manager has to decide the sources from which the funds are to be raised. The management can raise finance from various sources like equity shareholders, preference shareholders, debenture- holders, banks and other financial institutions, public deposits, etc.

iv) Procurement of Funds: The financial manager takes steps to procure the funds required for the business. It might require negotiation with creditors and financial institutions, issue of prospectus, etc.

v) Utilisation of Funds: The funds procured by the financial manager are to be prudently invested in various assets so as to maximise the return on investment: While taking investment decisions, management should be guided by three important principles, viz., safety, profitability, and liquidity.

vi) Disposal of Profits or Surplus: The financial manager has to decide how much to retain for ploughing back and how much to distribute as dividend to shareholders out of the profits of the company.

vii) Management of Cash: Management of cash and other current assets is an important task of financial manager. It involves forecasting the cash inflows and outflows to ensure that there is neither shortage nor surplus of cash with the firm.

viii) Financial Control: Evaluation of financial performance is also an important function of financial manager. The overall measure of evaluation is Return on Investment (ROI). The other techniques of financial control and evaluation include budgetary control, cost control, internal audit, break-even analysis and ratio analysis.

CONCEPT OF TIME VALUE OF MONEY

The wealth maximization objective of financial management makes an explicit distinction between returns received in different time periods. It gives due consideration to the timing of returns received. One rupee today is more valuable than one rupee one year hence. Similarly, one rupee one year from now is more valuable than one rupee two years from now. This concept is known as the time value of money. The recognition of this concept is extremely important in every financial decision. The logic behind the concept of time value of money is as follows –

i) Rational individuals prefer current consumption to future consumption.

ii) Money can be invested productively to obtain positive return. An investment of one rupee today would increase to (1+r) rupees one year hence where r is the rate of return earned on the investment.

iii) In an inflationary situation, the value of money / purchasing power of money reduces.

Many financial problems involve cash flows that accrue at different points of time. In order to have a logical and meaningful comparison between such cash flows it is necessary to convert the sums of money to a common point of time. So, for doing this, the concept of time value of money is taken into consideration.

TECHNIQUES FOR DEALING WITH TIME VALUE OF MONEY

There are different techniques for dealing with time value of money, these are –

i) Future Value of a Single Cash Flow

ii) Future Value of an Annuity

iii) Present Value of a Single Cash Flow

iv) Present Value of an Annuity

i) Future Value of a Single Cash Flow: The general formula for the future value of a single cash flow is –

$$F_{n(c)} = P(1 + i)^n$$

where $F_{n(c)}$ = future value or compound value of cash flow n year hence

P = principal cash flow today (present value)

i = rate of interest per year

n = number of years before pay-off

This formula is developed in the following way –

Year	Amount at the beginning of the year	Interest for the year	Amount at the end of the year
1	P	P.i	$F_1 = P(1+i)$
2	$P(1+i)$	$P(1+i)\,.i$	$F_2 = P(1+i)^2$
3	$P(1+i)^2$	$P(1+i)^2.i$	$F_3 = P(1+i)^3$
4	$P(1+i)^3$	$P(1+i)^3.i$	$F_4 = P(1+i)^4$
.	.	.	.
.	.	.	.
N	$P(1+i)^{n-1}$	$P(1+i)^{n-1}.i$	$F_n = P(1+i)^n$

Illustration 1

Suppose that an amount of Rs.20,000 is deposited in the fixed deposit account of a bank at 8% interest rate. How much shall the deposit grow at the end of 5th year?

Solution:

$F_{n(c)} = P(1+i)^n$ here, P = Rs.20,000; i = 8% and n = 5

At the end of 5th year, the deposit will grow as follows –

$F_5 = 20,000 \times (1+8\%)^5$

$= 20,000 \times (1.08)^5$

$= 20,000 \times 1.469328$

= Rs.29,386.56 or Rs.29,387 (approx.)

ii) Future Value of an Annuity: An annuity is a series of periodic cash flows (payments or receipts) of equal amounts. If a person rents a motor car and promises to make a series of payments over an agreed period, then an annuity is created.

The general formula for the future value of an annuity is –

$$F_{n(A)} = A\left[\frac{(1+i)^n - 1}{i}\right]$$ where $F_{n(A)}$ = future of an annuity having a duration of n periods

A = constant periodic cash flow

i = rate of interest per period

n = duration of the annuity

Illustration 2

Mr. Kishore deposits Rs.40,000 at the end of every year for 6 years in his saving account paying 6% interest computed annually. What is the future value of this annuity at the end of 6th year?

Solution:

$$F_{n(A)} = A\left[\frac{(1+i)^n - 1}{i}\right]$$ here, A = Rs.40,000; i = 6%; n = 6

At the end of 6th year, the future value of the annuity is –

$$F_{6(A)} = Rs.40,000\left[\frac{(1+6\%)^6 - 1}{6\%}\right]$$

= Rs.40,000 x 6.9753166

= Rs.279,013 (approx).

iii) Present Value of a Single Cash Flow: The concept of the present value is the exact opposite of the compound value concept. According to the compound value concept, the amount of present cash flow is converted into an amount of cash flow of equivalent value in future. However, the present value of a future cash flow is the amount of current cash that is of equivalent value to the decision maker. In other words, the present value of one rupee that will be received in the future will be less than the value of one rupee in hand today. The process of ascertaining present value is known as the discounting and the compound interest rate used in this process in called the discount rate.

The general formula for determining the present value of a single cash flow is –

$$P_c = F_{n(c)} \left[\frac{1}{(1+i)^n} \right]$$ where   P = present value of a single cash flow,

$F_{n(c)}$ = future value of cash flow n years hence

i = discount rate

n = number of years

The factor $\left[\dfrac{1}{(1+i)^n} \right]$ is known as the discounting factor.

Illustration 3

Obtain the present value of Rs.50,000 receivable 5 years hence if the discounting rate is 5%.

Solution:

$$P_c = F_{n(c)} \left[\frac{1}{(1+i)^n} \right]$$ here, $F_{n(c)}$ = Rs.50,000; i = 5%; n = 5

$$P_c = 50,000 \times \left[\frac{1}{(1+5\%)^5} \right]$$

= Rs.50,000 x 0.7835262

= Rs.39,176 (approx)

iv) Present Value of an Annuity: The computation of the present value of an annuity can be made with the help of the following formula –

$$P_A = \frac{A}{(1-i)} + \frac{A}{(1+i)^2} + \frac{A}{(1+i)^3} + \text{........} + \frac{A}{(1+i)^n}$$

$$= A \left[\frac{1}{(1-i)} + \frac{1}{(1+i)^2} + \frac{1}{(1+i)^3} + \text{........} + \frac{1}{(1+i)^n} \right]$$

$$= A \left[\frac{(1+i)^n - 1}{i(1+i)^n} \right]$$ Where P_A = present value of annuity having a
duration of n periods

$$= A \left[\frac{1}{i} - \frac{1}{i(1+i)^n} \right]$$ A = constant periodic cash flow

i = discount rate

The factor $\left[\dfrac{(1+i)^n-1}{i(1+i)^n}\right]$ or $\left[\dfrac{1}{i}-\dfrac{1}{i\,(1+i)^n}\right]$ is known as the present value factor of an annuity of rupee one.

Illustration 4

Mr. Rahul receives an annuity of Rs.25,000 for 6 years. If the interest rate is 5%, what will be the present value of Rs.25,000?

Solution:

$$P_A = A\left[\frac{1}{i}-\frac{1}{i\,(1+i)^n}\right] \qquad \text{Here, A = Rs.25,000; i = 5%; n = 6}$$

$$P_A = 25000\left[\frac{1}{5\%}-\frac{1}{5\%\,(1+5\%)^6}\right]$$

$$P_A = 25000\left[\frac{1}{0.05}-\frac{1}{0.05\,(1+0.05)^6}\right]$$

$$P_A = 25000\left[20-14.924326\right]$$

$$P_A = 25,000 \times 5.075674$$

$$P_A = \text{Rs.126,892 (approx)}$$