Chapter 1

Scope and Objectives of Financial Management

"DO NOT LOWER YOUR GOALS TO THE LEVEL OF YOUR ABILITIES. INSTEAD, RAISE YOUR ABILITIES TO THE HEIGHT OF YOUR GOALS."

Financial management

Imagine you are planning to start a business. What comes at first in your mind? It must be what business you want to be in? that simply means you must define the business. This is basically Strategic planning, and it has a considerable impact on how capital is allocated in the firm.

In organizing your business, you will have to address some prominent questions here, like:

- ***How will you raise money to pay for the proposed capital investment?***
- ***What capital investment should you make?***
- ***How will you handle the day-to-day financial activities?***

These are the central issues dealt in financial management.

Financial management is also referred to as "corporate finance" or "managerial finance.

DEFINITION:

By Phillippatus;

"Financial management is concerned with managerial decisions that result in the acquisition and financing of short term and long-term credits for the firm"

In nutshell we can say,

"Financial management is the managerial activity which is connected with planning and controlling of firm's financial resources."

Basic aspects:

So, you can conclude here that two most basic aspects of financial management are:

A. Procurement of funds
B. Utilization of funds

A. Procurement of Fund:

Some of the sources of funds are:

a. Equity
b. Debentures
c. Funding from banks
d. International funding
e. Angel financing

B. Effective utilization of funds:

Some aspects of fund utilization are:

a. Utilization for fixed assets
b. Utilization for working capital

EVOLUTION OF FINANCIAL MANGEMENT:

Evolution of financial management is divided into three phases:

1. Traditional phase	2. Transitional phase	3. Modern phase
• *This was the phase when financial management used considered only during some occasional events like mergers, liquidation, expansions etc.,* • *During this phase, while taking financial decisions needs of outsiders like lenders, bankers etc., was kept in mind.*	• *In this phase day to day operations were given importance.* • *General problems related to funds analysis, planning and control were given more attention.*	• *Now-a-days financial management became vital for any business.* • *During this phase various theories have been developed regarding efficient markers, capital budgeting, option pricing, valuation models etc.,*

FINANCE FUNCTIONS/DECISION

Finance functions are divided into long term and short-term functions/decisions.

Long Term finance function decisions:

a. **Investment Decisions (I):**

- Strategic planning Defines what business, you want to be in?
- Strategic planning involves evaluating cost and benefits spread out over time, so you can see here that it is essentially a financial decision-making process.
- Once business is defined, the manager need to develop a plan for investing in machines, buildings, equipment, information system, brands etc,. This process is called as capital budgeting.
- If you must see an investment project from financial point of view, wouldn't you focus on magnitude, timing and riskiness of cashflow associated with it? Your answer must be 'YES'.
- So, income generated from funds invested must be higher than the cost incurred in procuring those funds. And hence we say that investment of funds in a project must be made after careful assessment of various projects through capital budgeting.
- Long term funds are used in projects for various fixed assets, also for current assets and kept for financing the working capital requirements.

b. **Financing Decisions (F):**

- These decisions deal with ways and means of financing investment projects.
- So, these decisions relate to acquiring optimum finance to meet financial objectives and ensuring that fixed and working capital are managed effectively.

- Financial managers should have sound knowledge of various sources of funds and their respective cost.
- Long term sources of funds include equity capital and debt. Financial managers need to ensure that company has a sound Capital Structure that is a proper balance of equity and debt considering costs, risks, and control.
- Some important issues in capital structure decisions are:
  - What debt-equity ratio will be optimal for the firm?
  - Which instruments of equity and debt should the firm apply?
  - When should the firm raise finances?
  - What capital markets the firm should access?
  - At what price the firm should offer its securities?

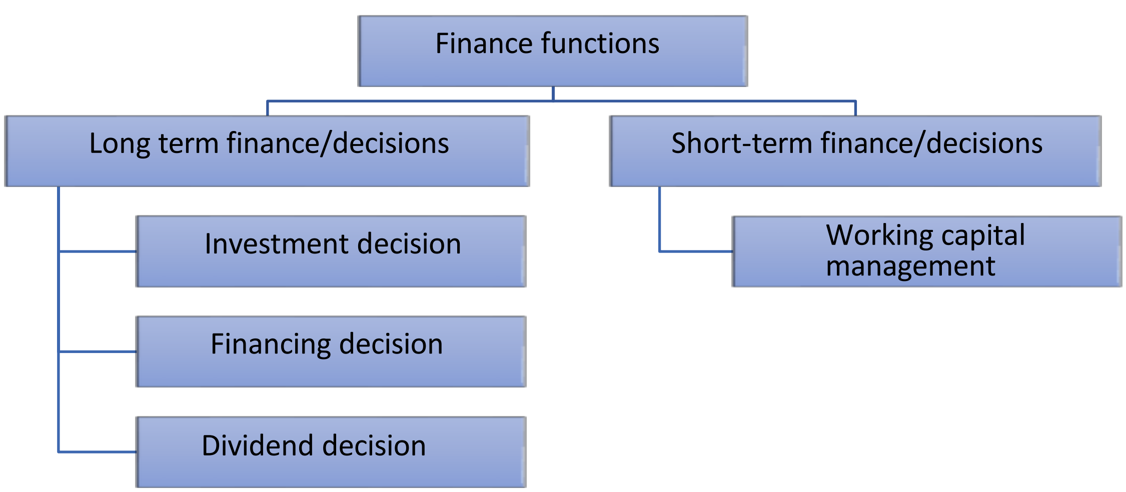
c. Dividend decisions:

- It is concerned with distribution policy of the firm.
- It involves determining how much and how frequently cash can be distributed to shareholder out of profits.
- The level and regular growth of dividends represent a significant factor in determining market value of company.

Short term Finance functions/decisions

Working Capital management (WCM):

- It is also called as sort-term financial management.
- It refers to day to day financial activities that deals with current assets and current liabilities.



SCOPE OF FINANCIAL MANAGEMENT:

According to management Guru Erza Solomon's concept of financial management, following aspects are covered in detail under financial management:

a. Determination of Size of company and Rate of growth.
b. Determination of Composition of assets.
c. Determination of Debt-Equity mix
d. Analysis, Planning, and control of financial affairs.

Overview of scope and function of financial management:

- In modern era financial management deals in three different kinds of decision namely Investment decisions, financing decisions and dividend decisions.
- Financial decisions often involve alternative course of actions. These alternative courses of action typically have different risk-return implications.

For example: A higher debt equity ratio, compared to a lower debt-equity ratio, may save taxes but expose the firms to greater risk. Or a 'hot stock' compared to a 'defensive stock' may offer higher expected return but at the same time there may be greater possibility of loss.

- Risks and return are two very important considerations what you must take while taking a financial decision.
- Every decision has some risks and expected return, consideration of both is essential to reach market value of the firm.

OBJECTIVES OF FINANCIAL MANAGEMENT:

Every decision making is guided by some objective to be achieved, and same is with financial management.

In financial management several objectives are possible like Maximisation of return on equity, Maximisation of profit, maximization of earnings per share, and maximization of wealth.

The two main objectives we will consider for discussion here;

i. **Profit Maximisation**
ii. **Wealth Maximisation**

i. Profit Maximisation:

- Profit maximization cannot be sole objective of a company.
- It is certainly not as inclusive as wealth maximization.

It has some prominent limitations like:

a) Vagueness	• The term profit is vague. It conveys different meaning to different people. If profits are uncertain and described by a probability distribution, the meaning of profit maximization is not clear. • For instance, profit may be in terms of total profit or rate of profit, it may be in long term or short-term period etc.,
b) Direct relation between risk and return	• If the financial manager is solely guided by profit maximization, then he/she ignores the risk factors. the concept higher the risk higher the profit motivates managers to accept high risky proposals also. However, risk must be aligned with profit maximization objective.
c) Time pattern of return is ignored	• Profit maximization objective leaves consideration of timing and duration undefined. There is guide for comparing profit streams of different durations.
d) Too narrow	• Profit maximization as an objective is too narrow. It does not consider the social consideration and interests of workers, consumers, society, and ethical trade practice.

ii. Wealth Maximisation

*****Cash matters The Most!**

- Whenever an investor finances a business proposal regardless of whether it is acquisition, new investment or restructuring, are always interested in cash returns.
- Any business proposal raises the value of the firm only when present value of benefits is greater than the present value of costs.
- Value maximization simply means to maximise the net present value (NPV) of the investment.

Wealth = Present value of benefits-Present value of costs

Here, to convert expected cash returns need to be converted in present value figure by applying appropriate discounting rate. The Discounting rate reflects the riskiness of the proposal and time.

- Shareholder value maximization model advocates that firm has to maximise its market value and implies that business decision should seek to increase NPV of the economic profit of the firm.

So, to measure and maximise wealth of shareholder the financial manager needs to follow:

- ***Cash flow and not accounting profit***
- ***Cost benefit analysis***
- ***Application of time value of money.***

Wealth of a firm?

According to Van Horne;

" Value of a firm is represented by the market price of the common stock. The market price of the firm's stock represents the focal judgement of all market participants as to what the value of the firm is. It considers present and prospective future earnings per share, the timings and risks of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock. The market price serves as the performance index or report card of the firm's progress. It indicates how well management is doing on behalf of stockholders."

V = N*MP
V = Value of firm **N = Number of shares** **P = Market price of shares**

OR

V = Ve + Vd
V = Value of firm **Ve = Value of equity** **Vd = Value of debt**

PROFIT V/S VALUE/WEALTH MAXIMISATION

Objectives of Company and those of the Shareholders should coincide, there should not be any conflict!

Imagine a large enterprise like reliance, tesla, L&T etc., and answer this simple question:

- Is it possible that tens of thousands of shareholders of respective companies can participate in management actively?

Your answer would be 'NO'.

- So, what happens the?

☺ Shareholders simply delegates their authority to Board of Directors, and BOD appoints the C.E.O/Top Management.

No, the problem is that shareholders differ in their investments horizon, risk bearing capacity, tastes, wealth etc.,. and hence it becomes vital to reach a common ground, a common objective which is satisfactory for both the management and the shareholders. And maximizing the wealth is that common objective for which every shareholder would agree.

As we have understood earlier;

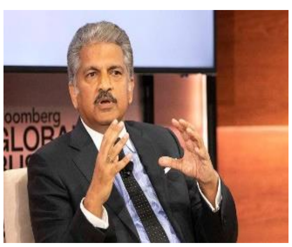
V = Ve + Vd

In this value of debt claims remain stable and hence value maximizing is basically maximizing the value of equity.

Advantages & Disadvantages of Profit maximization and Wealth Maximisation goals:

Goal	Objective	Advantage	Disadvantage
Profit maximisation	**High Profit**	a. Easy to calculate b. Easy to determine link between financial decisions and profits.	i. Emphasize short-term gain. ii. Ignore risks. iii. Ignore timing of returns. iv. Require immediate resource.
Shareholder's wealth maximisation	**Highest Market value of shares.**	a. Emphasize long term gains. b. Recognize risks c. Recognize timing of returns. d. Considers shareholder's return	i. Offers no clear relationship between financial decisions and share price. ii. Can lead to management anxiety and frustration.

AS SAID BY ANAND MAHINDRA:



"All of us beginning to look at companies as owned by shareholders. The key is to raise shareholder's return. Those companies where promoters continue to believe that they own the company and everything they do is in their own interest, are in trouble."

IMPORTANCE OF FINANCIAL MANAGEMENT

Money is to enterprise, what blood is to a human body!

The importance of financial management can be best depicted through mentioning various tasks that it involves;

- **Increase in organizational efficiency.**
- **Helps in avoiding over investment in fixed assets.**
- **Creating a balance of cash outflow with cash inflow so to avoid cash deficit or excess cash.**
- **Maintaining sufficient level of short-term working capital**
- **It helps to reduce financial costs.**
- **Helps in reducing costs in day-to-day operations.**
- **It increases the shareholder's wealth.**
- **Tax planning to minimize taxes business must pay. Etc.,**

ORGANISATION OF FINANCE FUNCTION AND ROLE OF FINANCE EXECUTIVE

- ✓ CFO- Chief finance officer may also be designated as director finance or VP Finance.
- ✓ The responsibilities for financial management spread throughout the organization however many tasks of financial management and allied areas. These tasks are distributed between two financial officers of the firm namely 'treasurer' and 'Controller'.
- ✓ Treasurer is responsible for financing and investment activities like capital budgeting, procuring finance, cash management, credit administration and banking relationship.
- ✓ Controller is primarily concerned with accounting and control activities like financial accounting, taxation, management accounting and control and internal auditing.

Responsibilities of Finance Officer

Responsibilities include:

Responsibilities	Description
a. Financial analysis and Planning	Determining amount of fund to be employed.
b. Investment decisions	Allocation of funds.
c. Financing decisions	Capital structure decisions.
d. Financial resource management	Working capital management.
e. Risk management	Protecting various assets.

EMERGING ROLE OF FINANCE EXECUTIVE

CFO in Past	CFO at Present
• Budgeting • Forecasting • Accounting • Treasury management • Preparing internal financial reports for management • Preparing quarterly, annual filings for investors • Tax filing • Tracking accounts payable and accounts receivables. • Travel and entertainment expense management	• Budgeting • Forecasting • Managing M&As • Profitability analysis • Pricing analysis • Decisions about outsourcing • Overseeing the IT function. • Overseeing HR function. • Strategic planning • Regulatory compliance • Risk management

FINANCIAL DISTRESS AND INSOLVENCY

- ✓ Imagine a situation when firm is not able to pay debt liability on consistent basis whether the short term and long term and is also not able to meet other current obligations- in this situation you may easily say that there going to be huge stress on the firm.

- ✓ This situation when firm's cashflow is not sufficient to meet current obligation is called as financial distress.
- ✓ Further assume what if this distress continues for long period of time? So, now the firm will have to sell asset to meet expenses.
- ✓ Think further, what if firm's revenue is inadequate to revive from this consistent negative cash flow and to meet obligations? So, now the firm become insolvent.

Note: Think of various causes, effects, and remedies in context of financial distress and being insolvent.

AGENCY PROBLEM AND AGENCY COST

OWNERS ARE NOT MANAGERS

- Alignment of owner's interest and managers interest is vital if not so agency problem arises.
- In case of companies, especially large public companies there is separation of ownership and management which may leads to possible conflict of interest between 'Principals' (Owners/Shareholders) & 'Agents"(Managers).
- So, agency problem arises when the agents place personal goals ahead of goals of principals.
- Agency problem gives rise to 'Agency cost' in form of Monitoring, Bonding, Opportunity, and structuring costs.
- Agency cost may be defined as the difference between value of an actual firm and value of hypothetical firm in which management and shareholder's interest are perfectly aligned.

HOW TO ADDRESS AGENCY PROBLEM:

- Agency problem between principals and agents can be addressed by making a perfect alignment of interests of two.
- To reduce agency problem, effective monitoring and appropriate incentives need to be exercised.
- Monitoring can be done by bonding managers, periodical review of manager's actions, auditing of financial statements, in case of debt lenders
  negative covenants can be imposed etc.,
- ***Following efforts are worth noting in this direction:***
  - ➢ Incentives are linked to profit and long-term objectives of company.
  - ➢ Give managers stake in ownership by means of giving rights to buy shares at certain price or performance shares, this will further help in addressing the issue with the underlying assumption that maximization of the stock price is the objective of investors.

- Effective monitoring by bonding managers, auditing financial statements etc.,

FINANCIAL MANAGEMENT AND RELATED DISCIPLINES

A. Relationship to Accounting:

- Financial and accounting functions are closely related and falls within the domain of CFO. Accounting is necessary input in financial management functions.

Let us understand how these two differ and how they relate?

Point of differentiation & Relationship	Description
A. Treatment of Funds: Accrual Method Vs Cash flows method	**In accounting:** • Management of fund is based on accrual basis • Do not reflect fully the financial condition of organization. • There may be uncollectible receivables leading to shortage of liquidity. **In financial management- Cash flow:** • Revenue is recognized only when cash is received. • Helps managers to avoid insolvency and achieve desired goals.
B. Decision making: Certainty Vs Uncertainty	**Purpose of accounting:** • Collect and present financial data of past, current, and future operations of the company. **Financial management:** • Use these data for decision making. • Financial management begins where accounting ends.
C. Objective: Score Keeping Vs Value Maximising	**Accounting:** ✓ It is about record keeping **Financial management:** ✓ It is about Value maximization.

Practice Problems

1. Profit maximization doesn't consider risk or uncertainty, whereas wealth maximization considers both risk and uncertainty. Suppose there are two product, X & Y and their projected earnings over the next 5 years are as shown below:

Year	Product X	Product y
1	10,000	
2	10,000	
3	10,000	
4	10,000	
5	10,000	

Which product will be preferred by profit maximization approach and why?

Theoretical questions:

2. Point out the difference between Financial Management and Financial accounting.
3. "Financial Management is concerned with acquisition and financing and long-term credit". Elaborate.
4. Discuss the two main aspects of the finance function.
5. Discuss three main considerations in procuring funds.
6. Explain "Wealth Maximization" and "Profit Maximization" objectives of Financial Management.
7. Discuss the role of a CFO.
8. In recent years, there have been a number of environmental, pollution, and other regulations imposed on business. In view of these changes, it's maximization of shareholder wealth still a realistic objective? Explain.

Past Year Theoretical Questions:

9. Describe the changing scenario of Financial Management in India.
10. Explain finance function.
11. Explain phases of the evolution of financial management.
12. Explain three finance function decision.
13. What are two main aspects of the finance function?
14. State out four tasks involved to demonstrate the importance of good Financial Management.
15. Write two main objectives of Financial Management.
16. List out the steps to be followed by the manager to measure and maximize the shareholder's wealth.
17. State advantages of "Wealth Maximization" goals in Financial Management.
18. Discuss the conflict in profit versus Wealth maximization principle of the firm.
19. Distinguish between "Profit maximization" and "Wealth maximization" objective of firm.
20. Discuss emerging issues affecting the future role of CFO.
21. What are the roles of Finance Executive in modern World?
22. List out the role of CFO in today's world.
23. Differentiate between financial management and financial accounting.