Chapter 1 : Introduction, Nature and scope of Financial Management

Financial Management?

Financial Management is broadly concerned with the acquisition and use of funds by a business firm. Its scope may be defined in terms of the following questions.

- How large should the firm be & how fast should it grow?
- Composition of firm's assets?
- Mix of the firm's financing ?
- Analyzing, planning & controlling its financial affairs?

Meaning and definition

It refers to planning, acquiring, utilisation and controlling of financial resources/activities. It deals with investment decisions, financing decisions, dividend decisions, liquidity decisions, budgetary control etc.

According to R.C. Osborn : “The finance function is the process of acquiring and utilising funds by a business.”

Goals of Financial Management

- Profit Maximization (profit after tax)
- Maximizing Earnings per share(EPS)
- Shareholder’s Wealth Maximization

1. Profit Maximisation

- Profit maximization is the main aim of any business and therefore it is also an objective of financial management. Profit maximization, in financial management, represents the process or the approach by which profits Earning Per Share (EPS) is increased. In simple words, all the decisions whether investment or financing etc. are focused on maximizing the profits to optimum levels.
- Profit maximization is the traditional approach and the primary objective of financial management. It implies that every decision relating to business is evaluated in the light of profits. All the decisions with respect to new projects, acquisition of assets, raising capital etc are studied for their impact on profits and profitability. If the result of a decision is perceived to have a positive effect on the profits, the decision is taken further for implementation

PROFIT MAXIMIZATION

PROFIT MAXIMIZATION is the traditional approach and the primary objective of financial management. It represents the process or the approach by which profits EPS is increased.

ADVANTAGES

- Economical Survival
- Measurement Standard
- Social Welfare
- Economical Welfare

DIS ADVANTAGES

- Haziness of the concept "Profit"
- Ignores time value of money
- Ignore Risk
- Ignores Quality

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Wealth Maximization

Wealth maximization means maximizing the wealth of the shareholders in terms of market value of the share and value of the firm. This involves increasing the **Earning per share** of the shareholders.

Wealth maximization is regarded as operationally and managerially the better objective because:

- Time value of money
- The risk or uncertainty of future earning
- Effect of dividend policy on the market price of the share

Steps for achieving the objective of wealth maximization

The objectives of financial management are such that they should be beneficial to owners, management, employees & customers.

These objectives can be accomplished only by maximizing the **Value of the firm** through the following ways:

- Increase in profits
- Reduction in cost
- Sources of funds
- Minimize risk
- Long run value
- Good track record of dividend payment

"Wealth Maximization is superior criteria than profit maximization"

WEALTH MAXIMIZATION

Wealth Maximization = Maximization of Shareholder's Wealth

A shareholder holds share in the company/business and his wealth will improve if the share price in the market increases which in turn is a function of net worth.

Wealth = NPV of Financial Decision = PV of Future Cash Flow - Cost

Wealth Maximization Model v/s Profit Maximization Model

- Based on Cash Flow and not on Profits. Profits can be manipulated (by changing assumption, depreciation etc.)
- Profit maximization presents a short term view as compared to Wealth Maximization.
- Timing of return is ignored in Profit maximization
- Considers the risk and uncertainty factor while considering the discounting rate.

EVA = NOPAT – (Capital Employed X WACC)

Sources of Wealth Creation

Industry Attractiveness

- ✓ Barrier to competitor's entry
- ✓ Substitutes
- ✓ Bargaining powers of buyers
- ✓ Bargaining power of suppliers
- ✓ Competition among competitors

Competitive Advantage

- ✓ Cost advantage
- ✓ Differentiation Advantage

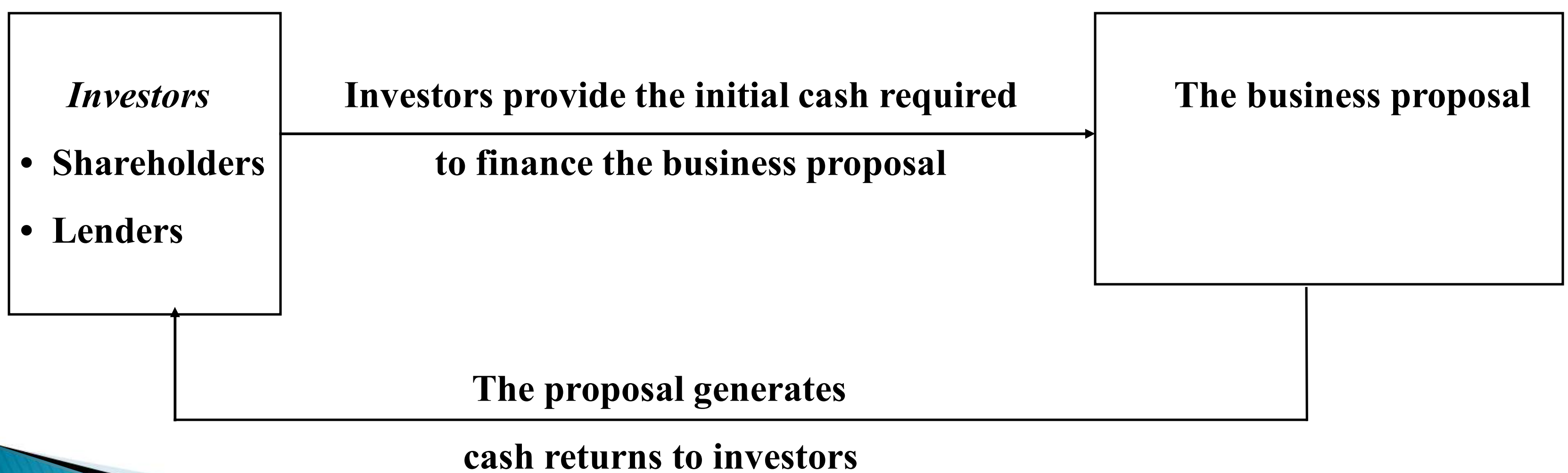
Profit Maximization Vs Wealth Maximization

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.

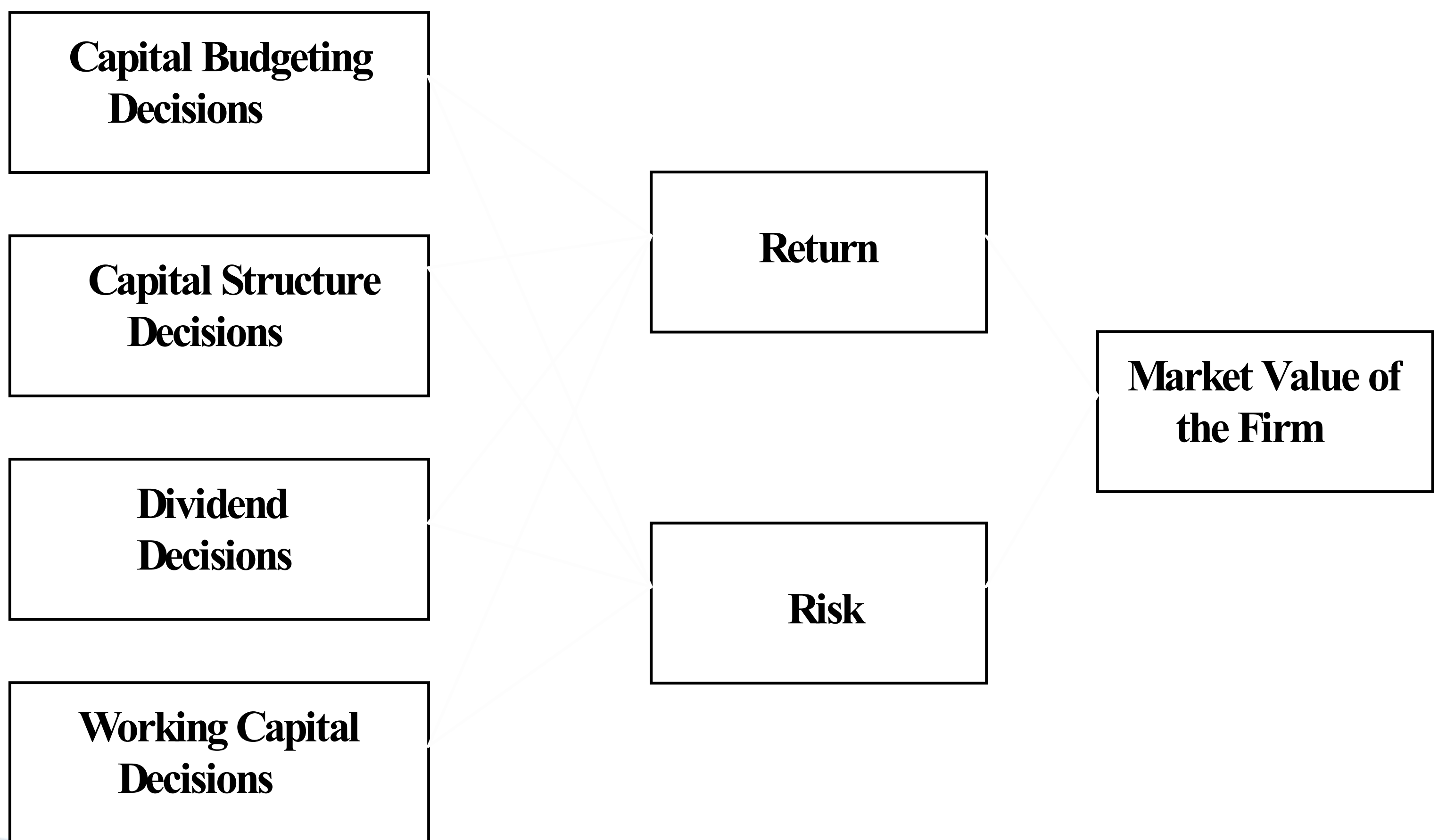
THE FUNDAMENTAL PRINCIPLE OF FINANCE

A business proposal-regardless of whether it is a new investment or acquisition of another company or a restructuring initiative –raises the value of the firm only if the present value of the future stream of net cash benefits expected from the proposal is greater than the initial cash outlay required to implement the proposal.

CASH ALONE MATTERS



DECISIONS, RETURN, RISK, AND MARKET VALUE and SCOPE OF FINANCIAL MANAGEMENT



Decisions or scope of Financial Management

- Investing Decision
- Financing Decision
- Dividend Decision
- Liquidity Decision

Investing Decision

- Investment in Short Term & Long Term Projects

- Short Term Projects

– Decisions relating to Working Capital Mgt.

–Inventory Management,

– Receivables Management, etc.

Long Term Decision

- Relates to Capital Budgeting Decisions
- Techniques:

(i) Traditional- Payback Period, Accounting Rate of Return

(ii) Modern- Net Present value Method, Internal Rate of Return, Profitability Index, etc.

Financing Decision

- Decision relation to Funding of the Projects
- *Sources*

  –Short Term (trade credit, bank overdraft,etc.)

  –Long Term

  (i) *Owners Funds* (Equity/Preference Share Capital, Retained Earnings)

  (ii) External Funds(Debentures, Long Term Loans, etc.)

Dividend Decision

This decision relates to How much of the Earnings to be

DISTRIBUTED AS DIVIDENDS?

AND

HOW MUCH TO BE KEPT

AS RETAINED EARNINGS?

Liquidity / working capital Decisions

- Decisions related to **working capital** is another crucial scope of financial management. Decisions involving around working capital and short term financing are known as working capital decision. It also manages the relationship between short term assets and its **liabilities**.
- Short term assets include cash in hand, receivables, inventory, short-term securities, etc. Creditors, bills payable, outstanding **expenses**, **bank** overdraft, etc are a firm's short term liabilities. Short term assets can be exchanged with cash within one calendar year. Similarly, the liabilities are to be settled within an **accounting** year.

RELATIONSHIP OF FINANCE TO ACCOUNTING

- Accounting is concerned with score keeping, whereas finance is aimed at value maximising.
- The accountant prepares the accounting reports based on the accrual method. The focus of the financial manager is on cash flows.
- Accounting deals primarily with the past. Finance is concerned mainly with the future.

EMERGING ROLE OF THE FINANCIAL MANAGER IN INDIA

The job of the financial manager in India has become more important, complex and demanding due to the following factors:

- **Liberalisation**
- **Globalisation**
- **Technological developments**
- **Volatile financial prices**
- **Economic uncertainty**
- **Tax law changes**
- **Ethical concerns over financial dealings**
- **Shareholder activism**

EMERGING ROLE OF THE FINANCIAL MANAGER IN INDIA

The key challenges for the financial manager appear to be in the following areas:

- **Investment planning and resource allocation**
- **Financial structure**
- **Mergers, acquisitions, and restructuring**
- **Working capital management**
- **Performance management**
- **Risk management**
- **Corporate governance**
- **Investor relations**

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