INTRODUCTION TO FINANCE

In general, finance is defined as the provision of money at the time It is required.

Specifically it is defined as procurement of funds and their effective utilisation.

Financial management is defined as the management of flow of funds in a firm.

All business decisions have financial implications and therefore financial management is inevitably related with every aspect of business operations.

EVOLUTION OF FINANCE

It may be divided into three broad categories, i.e., traditional phase, transitional phase and modern phase.

1. The Traditional Phase (Up to 1940)

Initially finance was a part of economic activities and business owners were more concerned with the operational activities.

Characteristics of this phase were :

- finance function was **episodic** in nature.
- funds were arranged mainly from financial institutions or through shares/ debentures.
- the outsider's point of view was dominant

2. Transitional Phase (1940 – 1950)

Here though the nature of financial management was similar to traditional phase but greater emphasis was placed on day-to-day activities.

Funds analysis and control on a regular basis, rather than on a casual basis.

3. The Modern Phase (After 1950)

Started since mid 1950's.

Rapid growth of business and competition increases the importance of finance not only for episodic events but also for day-to-day activities.

The finance manager has emerged as a professional manager involved with funds to be raised by the firm, with the allocation of these funds to different projects and with the measurement of the result of each allocation.

Major characteristics of modern phase are :

- the firm (i.e., insider) is more important

- rational matching of funds to their uses so as to maximise the wealth of the current shareholders.

- the approach has become more analytical and quantitative

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FINANCIAL DECISIONS IN A FIRM

The decisions of raising funds investing them in assets and distributing returns earned from assets to shareholders are respectively known as financing decision, investment decisions and dividend decision.

A firm attempts to balance cash inflows and outflows while performing these decisions.

There are three broad areas of financial decision making – capital budgeting, capital structure and working capital management.

1. Capital Budgeting :

Means allocation of funds to different long term assets like investing in lands, machineries, infrastructures, distribution networks etc.

It also involves investment in any project.

2. Capital Structure :

It involves determining the best mix of debt, equity and hybrid securities to employ.

Once a firm has decided the investment project it wants to undertake, it has to figure out ways and means of financing them.

The key issues in capital structure decision are :

- what should be the optimal debt-equity ratio?
- which specific instruments should be employed?
- which capital market should the firm access?
- when should the firm raise finances?
- what price the firm should offer its securities?

Besides these – what should be the optimal dividend payout ratio?

In this case the objective is to minimise the cost of financing without impairing the ability of the firm to raise finances.

3. Working Capital Management :

It is also referred as **short-term financing decisions**.

Related to day-to-day financing activities and deals with –

- current assets (inventories, debtors, short term holdings of marketable securities and cash)

- current liabilities (short-term debt, trade creditors, accruals and provisions)

The key issues in this case are –

- what should be the optimum level of inventory?

- credit policy of the firm?

- where should the firm invest its short-term cash surpluses?

- what sources of short-term finance are appropriate for the firm?

FUNCTIONS OF FINANCE

The functions of finance involve three major decisions a company must make – the investment decisions, the financing decisions, and the dividend / share repurchase decisions.

1. The Investment Decisions :

Capital investment is the allocation of capital to investment proposals whose benefits are to be realized in the future.

The assets which can be acquired fall into two groups –

i) long term assets – which yield a return over a period of time in future.

ii) short term assets – those assets which in normal course of business are convertible into cash without any loss in value, usually within a year.

The decisions regarding long term assets are known as **capital budgeting** and regarding short term assets as **working capital management**.

2. Financing Decisions :

It relates to the choice of the proportion of sources to finance the selected investment proposals.

Thus, financing decisions covers mainly **capital structure** decisions.

3. Dividend Policy Decisions :

The dividend should be analysed in relation to the financing decision of a firm.

Two alternatives are available in dealing with the profits of the firm – they can be distributed to the shareholders in the form of dividends or they can be retained in the business itself.

The final decision will depend upon the preference of the shareholders and investment opportunities available before the firm.

GOALS/OBJECTIVES OF FINANCIAL MANAGEMENT

A goal of a firm may be defined as a target against which the firm's operating performance can be measured.

A clear understanding of objective is very essential because it provides a frame work for optimum financial decision making.

A good objective should have following characteristics :

- it should be clear and unambiguous
- time frame should be there to evaluate success and failure of any decision
- it should be consistent with the long term objective of the firm

Followings are the two most discussed goals of financial management – profit maximisation, and wealth maximisation.

1. Maximisation of the profit of the Firm :

It is often considered as the implied objective.

Various types of financial decisions be taken with a view to maximise the profit of the firm.

It also leads to the welfare of the society. Hence it will result in efficient allocation of resources not only from the point of view of the firm but also for the society.

However there are some limitations of this objective –

- it ignores risk

- it ignores time value of money

- it is vague and ambiguous
- it may widen the gap between the perception of management and that of shareholders

Thus profit maximisation fails to be an operationally feasible objective of financial management.

2. Maximisation of Shareholder's Wealth :

This objective is generally expressed in terms of maximisation of a value of a share of the firm.

It is actually economic value of the firm which is defined as "the present value of the future cash flows generated by a decision, discounted at appropriate rate of discount which reflects the degree of associated risk.

The shareholders wealth is represented by the present value of all the future cash flows in the form of dividends or other benefits expected from the firm.

The market price of share reflects its present value.

Therefore economic value of shareholders wealth is the market price of the share.

Thus, all financial decisions are evaluated in terms of the firm’s future cash flows.

With this objective, the management will allocate the resources in the best possible ways within the given constraints of risk.

In operational terms, this objective seems to be practical.

The investors form expectations about the future cash flows and these expectations are reflected in the market price of the share.

However there are certain limitations of this objective –

- there should be an efficient capital market wherein the effect of a decision is truly reflected in the market price of the share.

- the market price of shares should not be influenced by speculative activities.

But wealth maximisation is considered as superior objective than that of profit maximisation.

CONFLICT OF GOAL BETWEEN MANAGEMENT AND OWNERS : AGENCY PROBLEMS

In companies, owners and management are separated from each other.

Management of a company is consisting of professionals who are more qualified and having technical expertise to run the business.

Because of difference in interest between owners (shareholders) and managers, chances of conflict is there.

To mitigate agency problem, effective monitoring has to be done and proper incentives have to be offered.

ORGANISATION OF THE FINANCE FUNCTION

A firm should give proper attention to the structure and organisation of its finance department.

It differs from company to company depending on their respective needs.

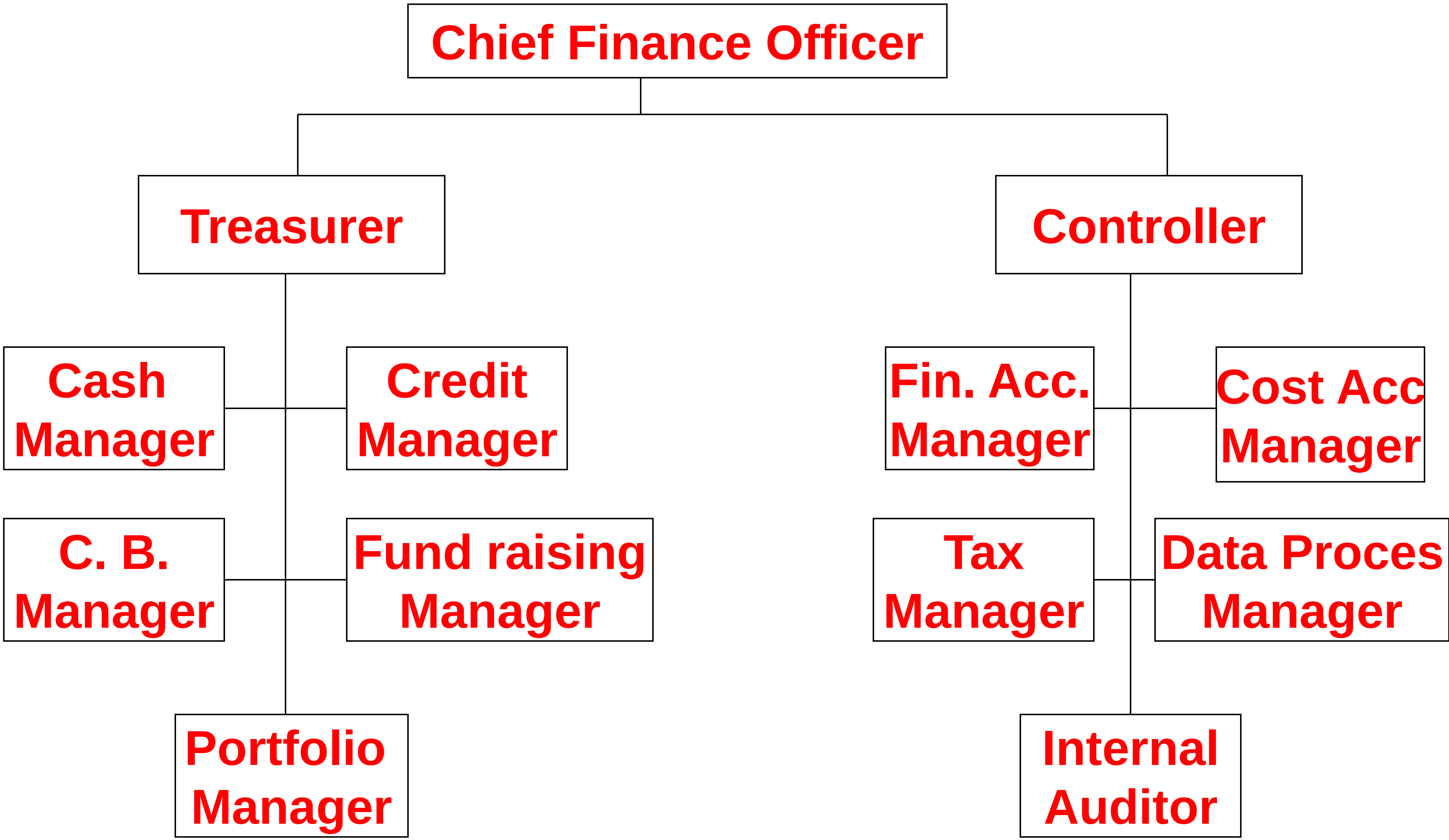
The titles used to designate the key finance officer are also differs from company to company like – **Vice President (Finance), Chief Executive (Finance), General Manager (Finance), Director (Finance), Chief Finance Officer (CFO)**.

CFO supervises the work of treasurer and controller.

Treasurer – obtaining finance, banking relationship, cash management, credit admin, C.B.

Controller – financial accounting, internal auditing, taxation, management accounting and control

ORGANISATION OF THE FINANCE FUNCTION



RELATIONSHIP OF FINANCE TO OTHER AREAS OF MANAGEMENT

1. Relationship to Economics :

There are two important linkages between economics & finance -

- macro economic environment defines the setting within which a firm operates, and

- micro economic theory provides the conceptual understanding of the tools of financial decision making.

2. Relationship to Accounting :

They are closely related but differ with each other primarily in three aspects -

1. Record-Keeping Vs Value Maximising

Accounting is mainly concerned with record keeping, whereas finance is aimed at value maximising.

The primary objective of accounting is to measure the performance of the firm, assess its financial condition, and determine the base for tax payment.

The primary goal of finance is to create shareholder value by investing in positive NPV projects and minimising the cost of financing.

2. Accrual Method Vs Cash Flow Method

Accounting is mainly concerned with the cash-flow while finance is concerned about magnitude, timing and risk of cash-flows.

3. Certainty Vs Uncertainty

Accounting deals with the past data hence it is relatively certain while finance is concerned mainly with the future hence it is having a high degree of uncertainty.

3. Relationship to Marketing :

Marketing is one of the most important area on which the success or failure of a firm depends.

Price of a product can only be set after consultation with finance manager.

4. Relationship to Production Department :

Any decision of production department will affect the financial position of the firm.

Thus all the decisions should be evaluated in the light of the objective of maximisation of shareholder's wealth. Thus finance manager has an important role to play.

5. Relationship to Personnel Management :

The recruitment, training and placement of staff is the responsibility of personnel department and all of these requires finance. Thus the decision regarding these aspects can not be taken in isolation of finance department.