

# **FINANCIAL MANAGEMENT**

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# INTRODUCTION TO FINANCIAL MANAGEMENT

## CHAPTER-1

- FINANCE

- Comes From the **Latin** word **Finis**
- **Art and science of handling money**
- Described as Life Blood of business
- May be **defined as provision of money at the time when it is needed.**

- FINANCIAL MANAGEMENT

- May be defined as **planning, organizing, directing and controlling** financial activities in a business enterprise.

# AREAS OF FINANCE FUNCTION

- **Investment decision**

- Effective **Utilisation of Funds**.
- Assess the **relative profitability** of each investment.
- Relate to **selection of assets** in which funds to be invested.

- **Finance decision**

- Related to **raise finance** for the concerned investment.
- Concerned with **composition of the sources of raising the funds**

- **Liquidity decision**

- Concerned with **management of current assets**.

- **Dividend decision**

- Concerned with **Disposal of Profit**
- Whether to **distribute Profit** or keep as **Retained Earnings**

- **Decisions regarding reporting, monitoring and controlling funds.**

- Enables **efficient and effective financial decision making**.

# IMPORTANCE OF FINANCIAL MANAGEMENT

- **Successful promotion**
  - In absence of a sound financial management, it is **Not** possible to prepare a sound financial plan.
- **Smooth running of the business**
  - Finance is required at each stage of business, i.e. promotion, incorporation, development, growth etc.
- **Co-ordination of functional activities**
  - Finance controls and co-ordinates all other activities in the enterprise like marketing, production etc.
- **Decision-making**
  - Various financial tools are available and by using this the best alternative (most profitable) will be selected.
- **Determinant of business success**
  - Financial managers play a very important role in success of business by advising the top management in solving various financial problems.
- **Solutions to financial problem**
  - Helps the top management by providing solutions to various financial problems faced by it.

# OBJECTIVES OF FINANCIAL MANAGEMENT

- **MAINTAIN LIQUIDITY OF THE FIRM**
- **PROFIT MAXIMISATION** (Explanation given in the 3<sup>rd</sup> slide)
- **WEALTH MAXIMISATION** (Explanation given in the 4<sup>th</sup> slide)
- **OTHER OBJECTIVES**
  - To Procure finance at reasonable cost at the time when it is needed
  - To ensure effective utilisation of funds raised.
  - To set aside sufficient profits from the profits earned for future requirements.
  - To harmonise the objectives of financial management with the overall objectives of the organisation.

# PROFIT MAXIMISATION

- Generally regarded as main objective of business enterprise.
- To safeguard the interest of the persons who are directly or indirectly connected with the company (**Shareholders, creditors, employees etc.**)
- According to this **view, the claim** of the financial management is **to earn the maximum rate of profits on capital employed.**

Advantages	Criticism
Profit is the standard for measuring the success or efficiency of a business enterprise	Profit cannot be ascertained well ahead as future is uncertain.
Profit is essential for survival	This approach is completely silent on the timing of profits to be maximise.
Social welfare is achieved through profit maximisation	It leads to exploiting workers and consumers
Maximisation of profit means maximum return to shareholders.	Profit maximisation attracts cut throat competition
Maximum profit enables to set aside sufficient funds for future expansion.	The term profit is vague. It doesn't explain whether it is gross profit or net profit, profit before tax or after tax etc.
Profit attracts investors to invest their savings in securities	

# WEALTH MAXIMISATION

- **Primary Goal** is maximisation of wealth of equity shareholders.
- Means maximisation of **market price per share** in the long run.
- It removes the limitations of profit maximisation.
- Based on the **concept of cash flows** rather than accounting profit.
- Also **considers time value of money**.

Advantages	Criticisms
Net effect of investment & benefits can be measured clearly	Is not descriptive of what firms actually do
Considers time value of money	Concept of wealth of shareholders differs from company to company
Is universally accepted because it take care of interests of financial institutions, owners etc.	Is not socially desirable
Guides the management in framing a suitable dividend policy	It is the indirect name of profit maximisation.
Considers the impact of risk factor	

# SCOPE OF FINANCIAL MANAGEMENT or Approaches of Financial Management

Traditional Approach	Transitional Approach	Modern Approach
Evolved during 1920's and 30's	It was upto early 50's	Present Period
First manifestation in the book "Corporation Finance" by T L Greene	Coined in the book "Essays on Business Finance" by Wilford J Eiteman et al.	Henry Ford remarked "Money is an arm or leg either use it or loose it"
<p><b>Narrow Sense</b> because scope of finance function was confined <b>only to procurement of funds</b>. More over the <b>focus was on procurement of long term funds alone</b> and ignored the issue of working capital management.</p>	<p>Emphasis was <b>given on day to day problems</b> faced by financial managers.</p>	<p><b>Broad Sense</b> because it covers <b>both acquisition as well as their allocations</b>.</p>
<p>According to traditional approach, <b>application of fund is not done here but somewhere else</b>.</p>	<p>They focused in the <b>areas of fund analysis, planning and control</b>.</p>	<p>Major concern of financial management is <b>efficient allocation of funds</b> to various sources</p>
<p>Covered 3 interrelated aspects of raising and administering resources from outside. These are <b>Capital market, financial instruments and procedural and legal aspects of finance</b></p>		<p>Cover 3 broad areas namely <b>Investment decision, financial decision and dividend decision</b></p>



# FUNCTIONS OF FINANCIAL MANAGERS

## • EXECUTIVE OR MANAGERIAL FUNCTIONS

1. Financial forecasting and Planning
2. Procurement of Funds
3. Investment Decision
4. Management of Income
5. Management of Cash
6. Deciding upon borrowing policy
7. Negotiations for new financing
8. Analysis and Appraisal of financial performance
9. Advising the top management
10. Co-ordination and control
11. Helping in valuation decisions
12. Tax Administration
13. Miscellaneous Functions

## • ROUTINE FUNCTIONS

1. Record keeping and Reporting
2. Preparation of Financial Statements
3. Managing cash balance
4. Cash Planning and credit management
5. Safeguarding the valuable papers, securities, insurance policies etc.
6. Providing top management with information on current and prospective financial conditions of the business

# Basic Principles of Financial Management

Principle	Explanation
Risk and Return	Every decision has 2 aspects. Financial decisions are taken to <b>maximise returns through the calculation of risk &amp; return.</b>
Time value of Money	Evaluates cash flow expected to be generated at different times. Is the timing of cash flows because <b>money received today is worth more than the money received at a future date.</b>
Cash Flow Concept	Focuses <b>on inflows and outflows of cash.</b> Does <b>NOT deal with non cash items</b> like depreciation, amortization of preliminary expenses etc.
Incremental cash flow analysis	Are taken on the basis of incremental cash flow analysis. Concept helps in <b>judging whether the new project is good for the firm or not.</b> Also helps to <b>assess the additional working capital required.</b>
Wealth maximisation	Is the objective of modern financial management. <b>Means maximum wealth or value to the shareholders.</b>
Principle of 'No free Lunch	Financial manager should keep in mind that the <b>firm's resources or funds are scarce and not free of cost.</b> Hence <b>resources or funds should be used more profitably.</b>

# CONTROLLER AND TREASURER

- Both controller and treasurer are **2 subordinate officers of finance manager.**
- They are **appointed for organising finance function.**

Treasurer	Controller
concerned with <b>function of finance</b>	concerned with <b>function of control</b>
Is the <b>chief custodian of the funds</b> of the business.	Is the <b>watch-dog of business funds</b> and other resources in an organisation.
Is <b>responsible for handling the money</b> raised at events, making approved payments and making arrangements for counting money at events	Prime duty of the controller is <b>to see that every rupee is spent for the benefit of the business</b> and is <b>spent in accordance with the prescribed rule and regulations.</b>

# Role of Controller and Treasurer (Functions/Duties)

Sl. No	Role of Treasurer	Sl. No	Role of Controller
1	Provision of Finance	1	Planning and Controller
2	Investor Relations	2	Accounting
3	Cash Management	3	Reporting and Interpreting
4	Short Term Financing	4	Tax Administration
5	Credit and Collection	5	Government Reporting
6	Custody of Securities and other documents	6	Protection of Assets
7	Investments	7	Economic Appraisal
8	Insurance		

# VALUE MAXIMISATION

- Objective is to maximise the long term market value of the organization.
- Total value of an organization comprises of all the financial assets, such as equity, debt, preference shares and warrants.
- Here value maximization seeks to maximise not only the value of equity shares but also the value of all financial assets.
- Then only it can generate sufficient profits to pay dividend to the shareholders and finance all its activities, operations and projects.

# Legal, Operating and Tax Environment for Financial Decisions

- Legal Environment
  - Legal environment comprises of various Acts passed by Government, various policies announced by the Government, institutional framework, Government rules and regulations etc.
    - Government policies
    - Various Acts
    - SEBI Guidelines

# Legal, Operating and Tax Environment for Financial Decisions-contd.

- Operating Environment
  - The environment within which a business operates, largely influences its decisions. It consists of
    - General Economic Conditions
    - Degree of Competition
    - Globalisation
    - Level of risk and stability of earnings
    - Nature and size of the business
    - Liquidity Position
- Tax Environment

# Agency Problem in Financial Management

- **Agency Problem** refers to a conflict of interest between a company's management and the company's stockholders.
- In short agency theory is a risk sharing between Principal (Owners or Shareholders) and Agent (Managers).
- In large companies there is a separation between managers and owners and here managers are the decision making authority in an organization and shareholders are the owners of the organization.
- This is called **Agency Theory**.
- Managers are the agents who are entrusted with the responsibility of looking after the interests of the principals (shareholders) misuse their power or authority for their personal benefits.
- Thus agency problem is a situation in which agents of an organization (management) use their authority for their own benefit rather than that of the principals (shareholders).
- **Agency costs** arise due to the conflicts between shareholders and their company's managers.



# 3 Types of Agency problem

- Stockholders Vs Management
- Stockholders Vs Creditors
- Stockholders Vs Other Stakeholders

# Causes of Agency Problems and their Solutions

## Conflict between Managers and Shareholders

### Causes

- Remuneration
- Risk Profile Differences
- Difference in Valuation horizon
- Unnecessary Perks
- Creative Accounting System
- Pursuing and Self Esteem Goals.

### Solution to the Problems

- Threat of Firing
- Threat of hostile takeovers
- Performance Based Remuneration
- Having a voluntary code of ethics
- Rewarding Managers with Shares

# Causes of Agency Problems and their Solutions

- Conflict between Owners who possess the majority or controlling interest in the firm and the minority or non controlling owners
- Conflict between the firm itself and the other parties with whom the firm contracts, such as creditors, employees, Government and customers.
- Causes for the Problems or Conflict Between Customers and the firm

# Type of Agency Costs

- Direct Agency Cost
  - Corporate expenditure
  - Monitoring costs
  - Bonding costs
  - Residual costs
- Indirect Agency Cost

# Future Value of a Single Present Cash Flow

- $A = P(1+r)^n$
- Where
  - A= Amount at the end of the period (Future Value)
  - P= Principal at the beginning of the period (i.e. Present Amount)
  - r= Rate of interest
  - n= Number of years for which compounding is done.

# Illustration 1

- Calculate Compound Value When ₹ 10,000 is invested for 3 years at 8% interest
- A) p.a Solution = ₹ 12,597
- B) p.a compounded on quarterly basis [Clue A =  $P(1+r/m)^{m*n}$ ]
- Solution to B = ₹ 12,682

# Doubling Period

- The doubling period is the length of period in which an amount becomes double at a given rate of interest.
- This can be find from compound value Table III that it takes about 9 years to double at 8% and about 6 years at 12%.
- Double period can also be determined using the Rule of 72 or the Rule of 69.
- According to the Rule of 72, the doubling period Is calculated as follows:
- Doubling Period =  $72/\text{Rate of interest}$
- According to Rule of 69, Doubling period =  $0.35 + (69/\text{Rate of Interest})$

# Illustration 2

- If A DEPOSITS AN AMOUNT OF ₹ 10,000 at 6% interest, in how many years will this amount double? Work out the problem by using the Rule of 72 and Rule of 69.



# Finding Period

## Illustration-3

- Mrs. Asha took a loan of ₹ 2,00,000 at the rate of 8% per annum. In how many years can she repay the loan if she plan to pay ₹ 40,000 at the end of each year.
- Solution
  - $A = P(1+r)^n$
  - $2,00,000 = 40,000 (1+0.08)^n$
  - $(1.08)^n = 2,00,000/40,000 = 5000$
  - $(1.08)^n = PVIFA\ i,n =$  Present Value interest factor of an annuity for period n at rate i = 5000
  - For this refer **table-II**
  - Since the rate is 8%, look for a value close to 5000 under the head rate of 8%.
  - The closest value that can be observed under that rate is 5.206 which falls in 7 years.
  - Hence rate is around **7 years.**

# Effective and nominal rates of interest

- Effective rate of interest and the nominal rate of interest are equal whenever they generate the same compounded sum or FV.
- The effective rate of interest will be helpful to compare two or more investment opportunities where one offers interest rate half yearly and another in quarterly or yearly or monthly then the effective rate of interest rate will be useful
- $EIR = (1+r/m)^m - 1$
- Where
  - EIR= Effective Interest Rate
  - r= Nominal rate of Interest
  - m= Number of times compounding is done in a year.
  - If  $m=1$  i.e. compounding is once in a year, then  $EIR = r$

# Illustration 4

- Mr Arun deposited ₹ 10,000 in a bank for a period of 1 year. The bank offers two options (1) to receive interest at 12.5% p.a. compounded quarterly or to receive interest at 12.6% p.a compounded half yearly.
- Which option should be accepted?

# Home Work

- Learn Future Value of a series of equal cash flows or annuity of cash flows and solve Example 6,7 and 8 in Calicut University Publications Financial Management Text Book. (Page No 32,33 and 34).

# Compound Value of Annuity Due

- This theory is based on the assumption that series of payments are made at the beginning of the year
- $FV_a = A \left[ \frac{(1+r)^n - 1}{r} \right] * (1+r)$
- Where
- $FV_a$  = Future value of annuity
- $A$  = Annuity
- $r$  = rate of interest
- $n$  = Number of years
  
- Example-9 (Page No 35)
  
- Mr. Kumar deposits ₹ 5,000 at the beginning of each year for 5 years in a bank and the deposit earns a compound interest at 8% p.a. Calculate the amount at the end of 5 year period.

# Discounting Value Technique or Present Value Technique

- In case of compounding technique, we calculate the value of money at the end of the period.
- This means we calculate the future value of present money.
- Discounting technique is the reverse of compounding.
- Here we calculate the present value of a future firm.
- In order to calculate present value of any amount, the same formula which was used for compounding purpose is used but in a reverse manner and that is why discounting technique is called as reverse of compounding.
- Here also we learn to calculate present value (PV) of a single future amount and (ii) PV of a series of future cash flows.

# PV of Single Future Sum

- $PV = P/(1+r)^n$
- Where
- PV= Present Value or Discounted Sum
- P = Principal amount or cash flow
- r= Rate of interest or discount rate
- n= Number of years
- The same can be calculated by using the PV table as follows
- **PV = P \* PV factor**
- For calculating PV factor, refer table 1 check the rate of interest and number of years. Matching number will be present value factor or PV Factor.
- Multiply P with PV factor to get Present Value
- **Illustration 5**
- Find out the PV of ₹ 12,597 receivable after 3 years at 8% rate of interest by following formula method and PV factor table ?

# Present Values of a series of future cash flows

- In a business scenario, investment is normally made today and returns are spread over a future period.
- Obviously before investing investor would like to know whether the investment is desirable or not.
- When comes about this analysis, cash flows may be uniform or changing at periodical intervals.
- In both situations, the following formula may be used to calculate PV.
- $PV = \frac{P_1}{(1+r)} + \frac{P_2}{(1+r)^2} + \frac{P_3}{(1+r)^3} + \dots + \frac{P_n}{(1+r)^n}$
- Where  $P_1, P_2, P_3, p_n$  = Principal amount or cash flows after period 1,2,3 etc.
- $r$  = Discount rate;  $n$  = number of years



# Illustration-6

- Annuity received is ₹ 5000 p.a Calculate the present value of annuity received for four years, if the discount factor is 6%?

- **Solution**

- $$PV = \frac{P_1}{(1+r)} + \frac{P_2}{(1+r)^2} + \frac{P_3}{(1+r)^3} + \dots + \frac{P_n}{(1+r)^n}$$

- Here  $P_1, P_2, P_3, P_4 = 5000$ ;
- $r=6\%$ ;  $n=4$  years

## Shortcut Method

Year	P	Discount Factor 6% (Refer Table-1)	PV (₹)
1	5000	0.943	4715
2	5000	0.890	4450
3	5000	0.840	4200
4	5000	0.792	3960
Total		3.465	17325

# Assignment

- Solve rest of the following questions from page no 38 to 40

**THANK YOU**