Financial Management

MS109

MBA Second Semester

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- Finance

Meaning of Business Finance-can be defined as the activity concerned with planning , raising, controlling and administering of the funds used in the business.

- In the words of John J. Hampton, the term finance can be defined as the management of the flows of money through an organization, whether it will be a corporation, school, bank or government agency.

- According to Howard and Upton, “finance may be defined as that administrative area or set of administrative functions in an organization which relates with the arrangement of each and credit so that the organization may have the means to carry out the objectives as satisfactorily as possible.

- According to the Wheeler, “Business finance is that business activity which concerns with the acquisition and conversation of capital funds in meeting financial needs and overall objectives of a business enterprise”.

Financial Management

The process of procuring and judicious use of resources with a view to maximize the value of the firm.

"Financial Management is concerned with the efficient use of an important economic resource, namely, Capital Funds". *Solomon*

- **Interdependence with other areas of management**

- Financial management is concerned with the acquisition, financing, and management of assets with some overall goal in mind.

(JAMES C. VAN HORNE & JOHN M. WACHOWICZ, JR. Knoxville, Tennessee)

Financial Management concerns with

- Process of raising and optimum use of financial resources
- Maximizing value of the owners-equity shareholders

- What are a firm′s financial activities?
- Are they related to the firm′s other activities?
- What are the main functions of a finance manager?

Approaches to Financial Management

Traditional Approach

- Episodic Financing (Archer and Ambrosio)

Modern Approach

- Continuous Involvement

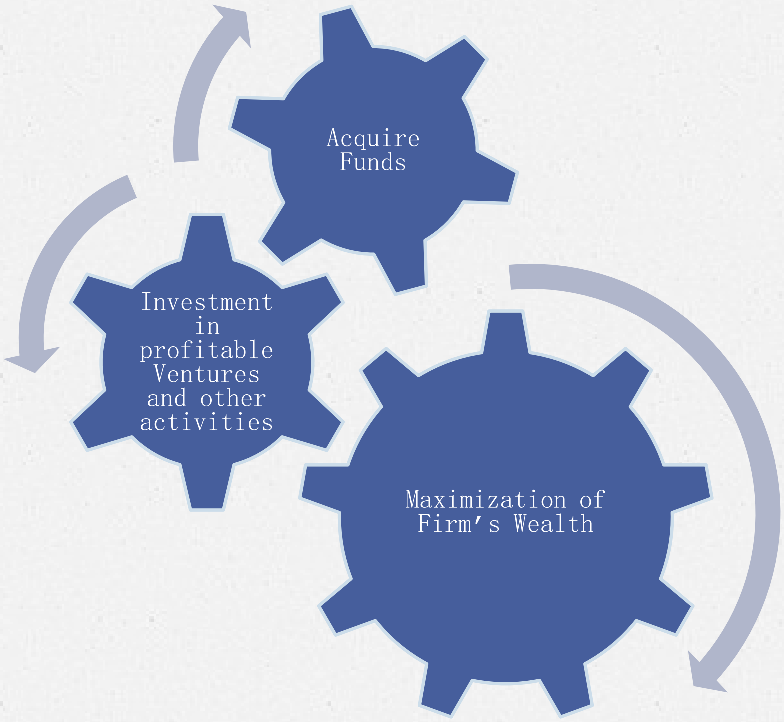
Traditional Approach

- Limited Role of Financial Management and Manager
- Focus on day to day activities.
- Episodic Financing
- Myopic view
- Insider Point of view
- Raising of Funds

Modern Approach

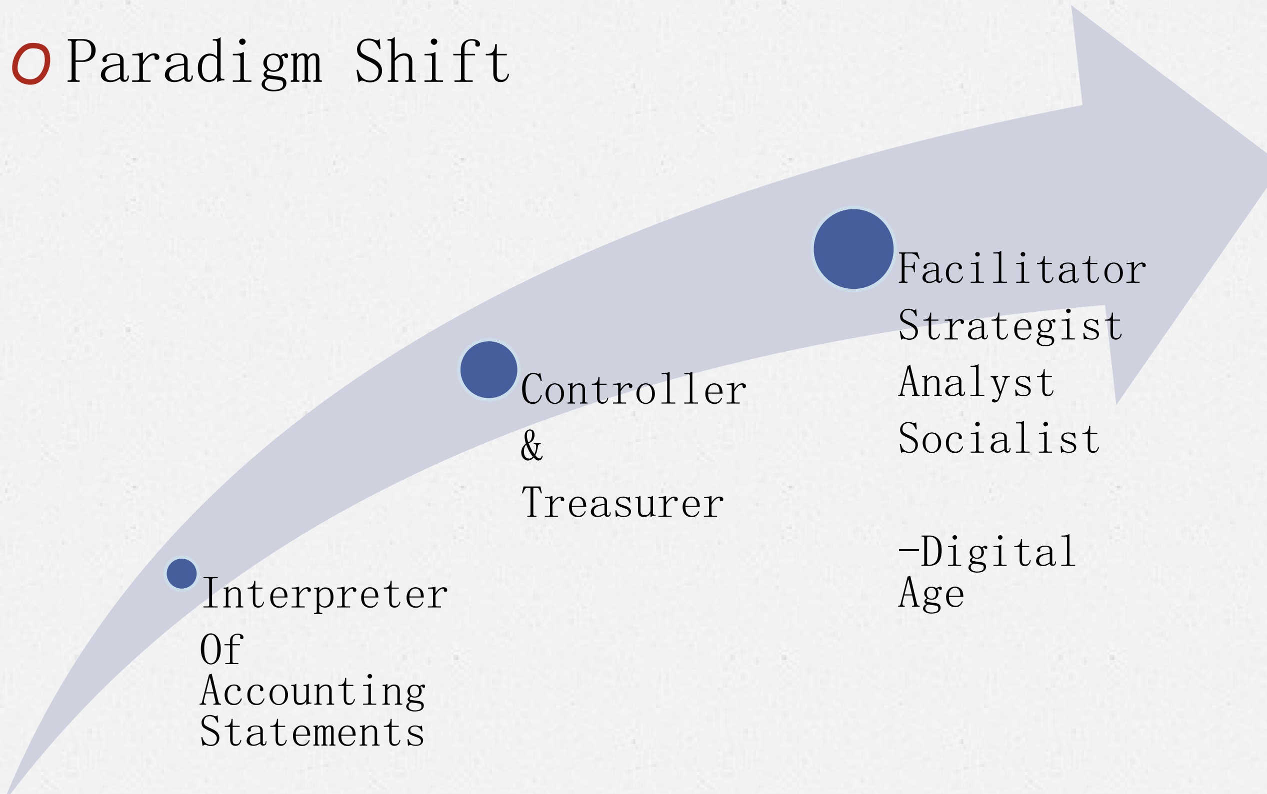
- Globalization, Liberalization and Privatization
- Shifted from Episodic Financing to Financial Management
- Raising and Allocation of funds
- Effective and efficient Utilization of financial resources.
- Maximization of Wealth

Continuous Cycle



New Perspective to Finance Manager

- Paradigm Shift



Finance Manager is expected to analyze

- Total Funds requirement of the firm
- The assets to be acquired
- Pattern of financing the assets

Dimensions of Decisions

- Investment Decisions
- Financing Decisions
- Dividend Decisions

Investment Decisions

- What is the optimal firm size?
- What specific assets should be acquired?
- What assets (if any) should be reduced or eliminated?
- Scarce monetary resources
- High Risk
- Enhance Internal growth
- Careful Selection of viable and profitable projects
- Profitable investment proposals
- Different alternatives of investments
- Determination of investment levels in different assets-Fixed and Current

- Ascertainment of total volume of funds
- Measurement of risk and uncertainty.
- Prioritizing investment decisions
- Buy or lease decisions
- Security Analysis and Portfolio Management
- Restructuring, reorganization, mergers and acquisition.

Financing Decisions

- When, where, from and how to acquire funds?
- What is the best type of financing?
- What is the best financing mix?

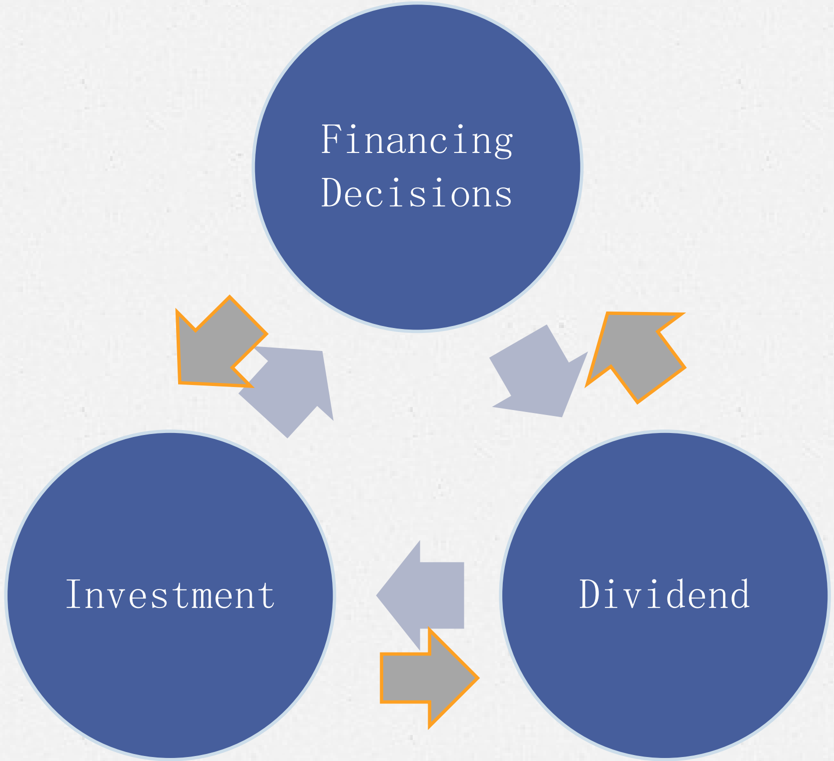
- Appropriate proportion of equity and debt.
- Mix of debt and equity is capital structure.
- Optimum Capital Structure- Maximizing market value of shares.
- Balance of risk and returns

- Financial leverage →↑Shareholder returns maximized (at a given level of risk)- ↑ Market value per share will be maximized.
- Impact of taxation and depreciation in maximization of EPS.
- Impact of over and under-capitalization on profitability.
- Determination of financing pattern of long term funds.
- Determination of financing pattern of medium or short term funds.
- Raising of funds through appropriate financial instruments.

Dividend Decision

- Decision of Retention Vs. Distribution
- Decision about all retention or partial retention.
- Optimum Dividend Policy
- Impacts growth of the company.
- Consideration of impact of levels of dividend and retention during different phases in economic cycle.
- Considerations of Legal and Cash Flow Constraints.

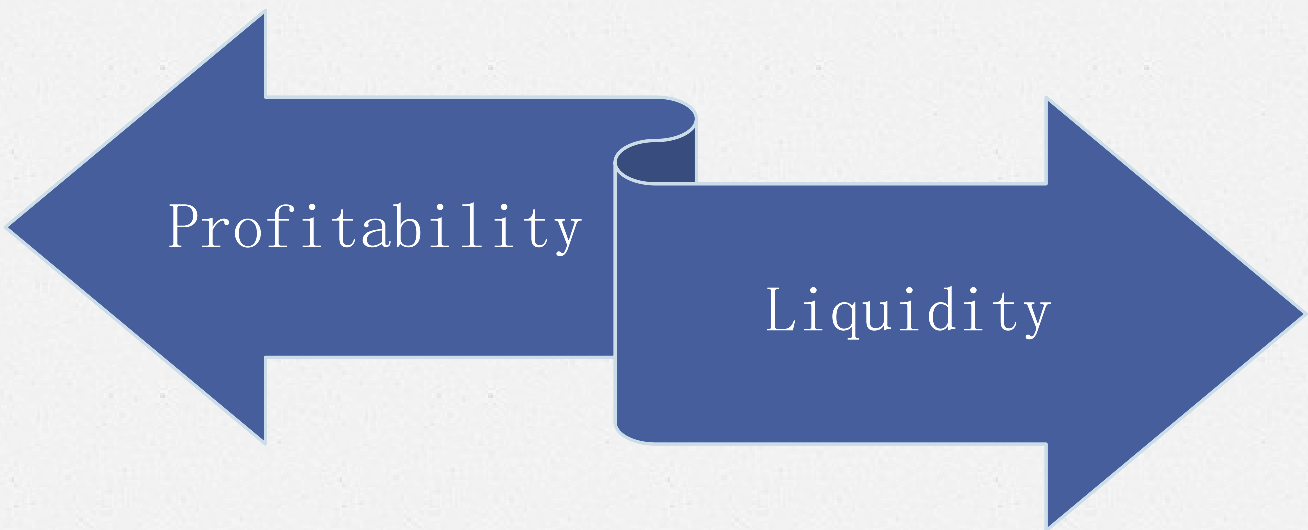
Interrelationship between the decisions



Short term decisions

- Decisions involving less than a year.
- Liquidity decisions affects firm’s profitability.
- Management of Current assets.
- Illiquidity leads to insolvency

Key Question-
Trade off between Profitability and Liquidity



Objectives of Financial Management

1) Profit Maximization?

this goal ignores:

a) TIMING of Returns
b) UNCERTAINTY of Returns
2) Shareholder Wealth Maximization?

this is the same as:

a) Maximizing Firm Value
b) Maximizing Stock Price

Profit Maximization

- Is profit maximization an operationally feasible criterion?
- Do it considers Owner's Economic Welfare?

Fails to maximize the economic welfare

Problems with this objective-

- It is vague and narrow
- Ignores Times Value of Money
- Ignore risk factors
- Emphasizes on Short run Profitability and Short term projects.
- Fails to considers Social Responsibility of the business-maximization of firm’s profit

Maximizing PAT

Increase in PAT will not ensure maximization of Owner's Welfare

Maximizing EPS

Market Value of Company / Growth Opportunities

Maximizing PBIT

Does not reveal true picture

Shareholders' Wealth Maximization

- SWM- Maximizing NPV of a course of action to shareholders
- NPV or wealth of a course of an action=

  PV of Benefits-PV of Costs

Wealth will be maximized if NPV criterion is followed for making financial decisions

Principle of Additivity =NPV (A)+NPV(B)

- Benefits are measured in cash flows rather than Accounting Profits.
- Appropriate and Operationally feasible criterion.
- Wealth created by a company through its actions is reflected in the market value of the company shares.

- Value of Company’s Shares-Represents Market price-Reflect shareholders’ perception about the quality of financial decisions

Why SWM?

- Considers long term survival and growth.
- Consistent to the objective of owners economic welfare.
- Suggests regular and consistent dividends payments to shareholders.
- Considers risk and time value of money.
- Considers all future cash flows, dividends payment to shareholders.
- Wealth of equity shareholders is represented by market value of equity shares.

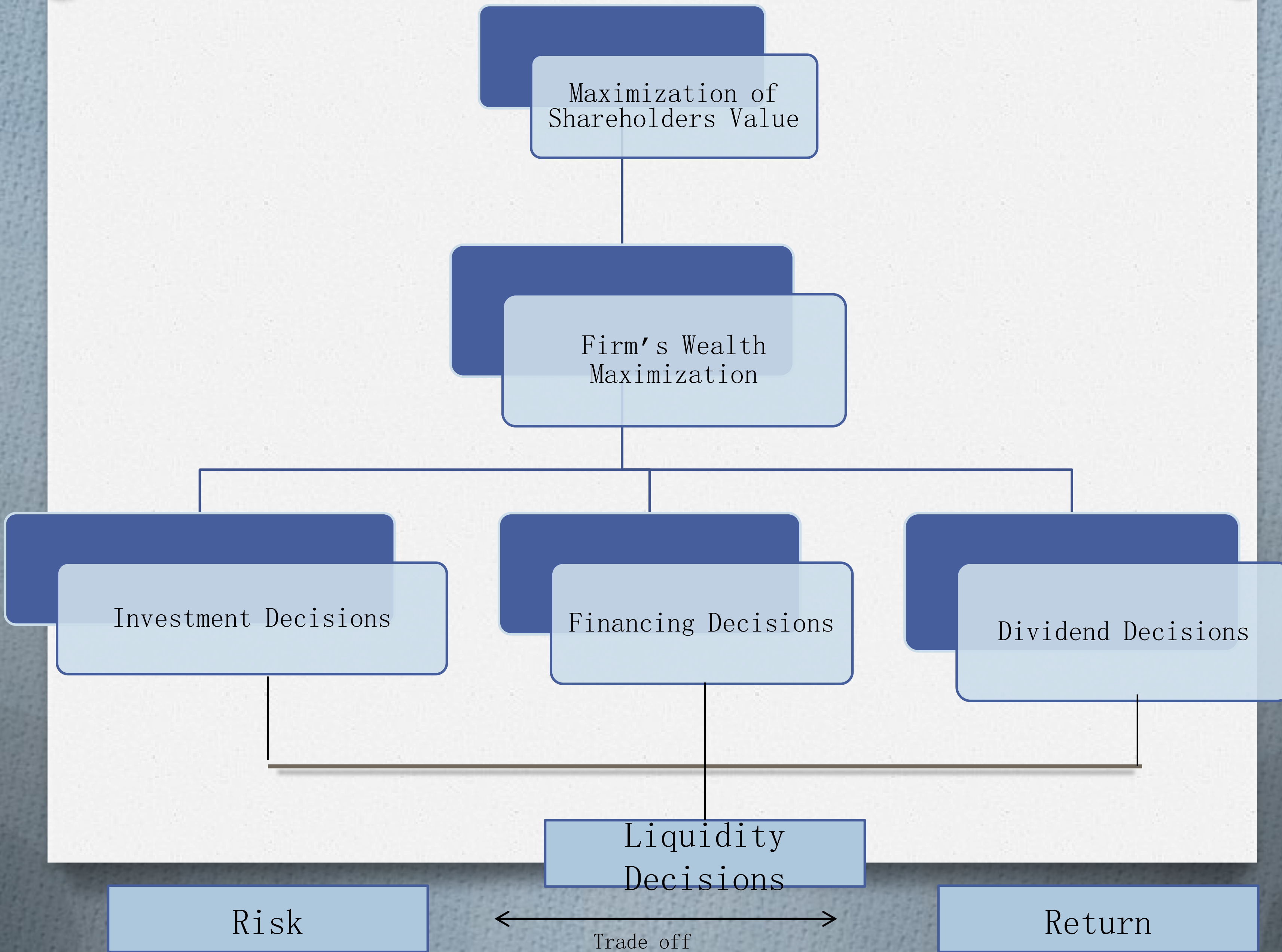
Importance of considering shareholders

- Separation of ownership from management.
- Increase in competition.
- CSR –Need of the Hour
- Maximization of Wealth not only for shareholders but also for stakeholders

Redefinition from Wealth Maximization to Value Maximization

- Maximization of utility value of shareholders.

- Wealth maximization of society
- Society's resources are optimally allocation- Contributes in capital formation and growth-Economic Welfare of society.


Maximization of Shareholders Value
Firm's Wealth Maximization
Investment Decisions
Financing Decisions
Dividend Decisions
Liquidity Decisions
Risk
Trade off
Return

Thank You !

References

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- Heartfelt acknowledgement is conveyed to all the sources