Nature of financial management

Finance

ASSIGN BUSTER

Chapter 3 - NATURE OF FINANCIAL MANAGEMENT What isfinanceFinance can be defined as he art andscienceof managingmoney. Virtually all individuals and organizations earn or raise money and spend or invest money. Finance is concerned with the process, institutions, markets and instruments involved in the transfer of money among individuals, business and governments. Nature of Financial Management Financial Management as anacademicdiscipline has undergone fundamental changes as regard its scope and coverage.

In the earlier years, it was treated synonymously with the raising of funds. In the later years, its broader scope, included in addition to procurement of funds, efficient use of resources. Scope of Financial Management Financial is broadly concerned with the acquisition and use of funds by a business firm. The important tasks of financial management, as related to the above, may be categorized as follows: - A. Financial Analysis, Planning and Control • Analysis of financial condition and preference • Profit Planning • Financial forecasting • Financial Control B.

Investing • Management of current assets (cash, marketable securities, receivables and inventories) • Capital Budgeting (identification, selection and implementation of capital projects) • Managing of mergers, reorganizations and divestments C. Financing • Identification of sources of finance and determination of financing mix • Cultivating sources of funds and raising funds • Allocation of profits between dividends and retained earnings Important Topics in Financial Management Table 1. 1 Balance Sheet and Topics in Financial Management Share Capital

EquityCapital Structure and Cost of Capital Preference Reserves and Surplus Debentures Unsecured Loan Current Liabilities & ProvisionsWorking Capital Trade CreditorsFinancing Policy Provisions Fixed Assets (Net)Capital Budgeting Gross Block Less Depreciation InvestmentSecurity Analysis Current Assets, Loans and Advances Cash and bank balancesCash Management ReceivablesReceivables Management InventoriesInventory Policy Loans and Advances Miscellaneous Expenditure and Losses Table 1. 2 Income statement and Topics in Financial Management Net SalesRevenue risk Cost of goods Sold

Materials and stocks Wages and Salaries Other Manufacturing Expenses Gross ProfitGross profit margin Operating Expenses Selling and Administration Expenses DepreciationDepreciation Policy Operating Profit Non operating surplus / deficit Earnings before interest and taxBusiness risk InterestFinancial risk Profit before tax TaxTax planning Profit after taxReturn on equity DividendsDividend policy Retained EarningsGoals/ Objectives of Financial Management- Traditional Approach – It has been traditionally been argued that the objective of a company is to earn profit.

This means that the finance manager has to make decision in a manner that the profit is maximised. Each alternative, therefore, is to be seen as to whether or not it gives maximum profit. Profit maximization objective gives rise to a number of problems as below: - i) Profit maximization concept should be considered in relation to risks involved. There is a direct relationship between risk and profit. Many risky propositions yield high profit. Higher the risk, higher is the possibility of profits. If profit maximization is the only goal, then risk factor is altogether ignored. i) Profit maximization, as an

objective does not take into account time pattern of return. Proposal A may give a higher amount of profits compared to proposal B, yet if the returns begin to flow say 10 years later, proposal B may be preferred which may have lower overall profits but the returns flow is more early and quick. iii) Profit maximization, as an objective is too narrow. It fails to take into account the social considerations as also the obligations to various interests of workers, consumers, society as well as ethical trade practices.

Further, most business leaders believe that adoption of ethical standards strengthen their competitive positions. iv) Profits do not necessarily result in cash flows available to the stockholder. Owners receive cash flow in the form of either cash dividends paid to them or proceeds from selling their shares for a higher price than paid initially. Modern Approach - The alternative to profit maximization is wealth maximization. This is also known as Value maximization or Net Present Worth maximization. Value is represented by the market price of the company’s equity shares.

Prices in the share market at a given point of time, are the result of many factors like general economic outlook, particular outlook if the companies under consideration, technical factors and even masspsychology. However taken on a long-term basis, the share market prices of a company’s shares do reflect the value, which the various parties put on a company. Normally, the value is a function of two factors (i) The likely rate of earnings per share of a company (EPS) and (ii) The capitalization rate

EPS are calculated by dividing the periods total earnings available for the firm’s common shares by the number of shares of common shares outstanding. The likely rate of earnings per share (EPS) depends on the

assessment as to how profitably a company is going to operate in the future. The capitalisation rate reflects the liking of the investors for a company. If the company earns a higher rate of earning per share through risky operations or risky financing pattern, the investors will not look upon its shares with favour. To that extent, the market value of the shares of such a company will be low.

If a company invests its fund in risky ventures, the investors will put in their money if they get higher return as compared to that from a low risk share. The market value of a firm is a function of the earning per share and the capitalisation rate. Suppose the Earning per share are expected to be Rs. 7 for a share, and the capitalisation rate expected by the shareholder is 20 per cent, the market value of the share is likely to be 7 7 x 100 ------ = ---------- = Rs. 5 20% 20 This is so because at this price, the investors have an earning of 20%, something they expect from a company with this degree of risk. The important issues relating to maximizing share prices are Economic Value Added (EVA) and the focus on stakeholders. Economic Value Added (EVA) is a popular measure used by many firms to determine whether an investment – proposed or existing – contribute positively to the owner's wealth. EVA is calculated by subtracting, the cost of funds used to finance or investment from its after-tax-operations profits.

Investments with positive EVA increase shareholder value as those with negative EVA reduce shareholders value. For example, the EVA of an investment with after tax operations profits of Rs. 510, 000 and associated financing costs of Rs. 475, 000 would be Rs. 35, 000 (i. e. Rs. 410, 000 – 375, 000) Because this EVA is positive, the investment is expected to increase

owner wealth and is therefore acceptable. What about Stakeholders? Stakeholders are group such as employees, customers, suppliers, creditors, owners and others who have a direct economic link to the firm.

A firm with a stakeholder focus consciously avoids actions that would prove detrimental to stakeholders. The goal is not to maximize stakeholder well being but to preserve it. It is expected to provide long run benefit to shareholders by maintaining positive stakeholder relationships. Such relationship should minimize stakeholder turnover, conflicts and litigation. Clearly, the firm can better achieve its goal of shareholder wealth maximization by maintaining cooperation with other stakeholders rather than having conflict with them. The Role of ethics - Ethics is standards of conduct or moral judgment.

Today the business community in general and the financial community in particular are developing and enforcing ethical standards, purpose being to motivate business and market participants to adhere to both the letter and the spirit of laws and regulations concerned with business and professional practice. An effective ethics program is believed to enhance corporate value. An ethics program can reduce potential litigation and judgment costs, maintain a positive corporate image, and build shareholders confidence, and gain theloyalty, commitment andrespectof the firms stakeholders.

Such actions, by maintaining and enhancing cash flow and reducing perceived risk, can positively affect the firm’s share prices. Ethical behaviour is therefore viewed as necessary for achieving the firm’s goal of owner wealth maximization. Place of Finance function in the organization structure: - The finance function is almost the same in most enterprises. The details

may differ but the important features are universal in nature. The finance function occupies such a major place that it cannot be the soleresponsibilityof the executive.

The important aspects of the finance function have to be carried on by the top management i. e. the Managing Director and the Board of Directors. It is the Board of Directors, which makes all the material final decisions involving finance. Financial management in many ways is an integral part of the jobs of managers who are involved in planning, allocation of resources and control. The responsibilities for financial management are disposed throughout the organization. For example: • The engineer, who proposes a new plant, shapes the investment policy of the firm. The marketing analyst provides inputs in the process of forecasting and planning. • The purchase manager influences the level of investment in inventories. • The sales manager has a say in the determination of receivable policy. • Departmental managers, in general, are important links in the financial control system of the firm. The chief financial officer (CFO) is basically to assist the top management. He has an important role to contribute to good decision making on issues, which involve all the functional areas of the business. He must clearly bring out financial implications of all decisions and make them understood.

CFO (his designation vary from company to company) works directly under the President or the Managing Director of the company. Besides routine work he keeps the Board of Directors informed about all the phases of business activity, including economic, social and political developments affecting the business behaviour. He also furnishes information about the financial status

of the company by reviewing from time to time. The CFO may have different officers under him to carry out his functions. Broadly, the functions are divided into two parts. (i) Treasury function (ii) Control function

Treasury function (headed by financial manager) is commonly responsible for handling financial activities, such as financial planning and fund raising, making capital expenditures decisions, managing cash, managing credit activities, managing the pension fund and managing foreign exchange. The control function (headed by Chief Accountant / Financial Controller) typically handles the accounting activities such as corporate accounting, tax management, financial accounting and cost accounting. The treasurer's focus tends to be more external, the controllers focus more internal: - BOARD OF DIRECTORS

Managing Director/President V. P ProductionV. P FinanceV. P Sales Treasurer Controller Credit Cash Banking PortfolioCorporate Taxes Internal Budgeting Management Management Relation ManagementGeneral Audit Accounting & Cost Accounting Fig 1. 1 Organization chart of finance function Relationship of field of finance with economics – The field of finance is closely related to economics. Financial managers must understand the economic framework and be alert to the consequences of varying levels of economic activity and changes in economic policy.

They must be able to use economic theories as guidance for efficient business operation. Examples include supply-demand analysis, profit-maximizing strategies, and price theory. The primary economic principle used in managerial function is marginal analysis, the principle that financial decisions should be made and actions taken only when the added benefits

exceed the added costs. Nearly all-financial decisions ultimately come down to an assessment of their marginal benefits and marginal costs. Relationship to Accounting – The firm's finance (treasurer) and accounting (controller) activities are closely related and generally overlap.

Normally managerial finance and accounting are not often easily distinguishable. In small firms the Controller often carries out the finance function and in large firms many accountants are also involved in various finance activities. There are two basic differences between finance and accounting: - i) Emphasis on cash flows: - The accountant's primary function is to develop and report data for measuring the performance of the firm, assuming its financial position and paying taxes using certain standardized and generally accepted principles. The accountant prepares financial statements based on accrual basis.

The financial manager places primary emphasis on cash flows, the inflow and outflow of cash. ii) Relating to decision-making: - Accountants devote most of their operation to the collection and presentation of financial data. The primary activities of the financial manager in addition to ongoing involvement in financial analysis and planning are making investment decisions and making financing decisions. Investment decisions determine both the mix and the type of assets held by the firm. Financing decisions determine both the mix and the type of financing used by the firm.

However the decisions are actually made on the basis of cash flow effects on the overall value of the firm. Interface with other Functions - Finance is defined as the lifeblood of an organization. It is a common thread, which binds all the organizational functions as each function when carried out

creates financial implications. The interface between finance and other functions can be described as follows: - Manufacturing Finance - i) Manufacturing function necessitates a large investment. Productive use of resources ensures a cost advantage for the firm. i) Optimum investment in inventories improves profit margin. iii) Many parameters of the production cost having effect on production cost are possible to control through internal management thus improving profits. iv) Important production decisions like make or buy can be taken only after financial implications have been considered. Marketing Finance – i) Many aspects of marketing management have financial implications e. g. hold inventories to provide off the shelf service to customers and thus increase sales; extension of credit facility to customers to increase sales. i) Marketing strategies to increase sales have additional cost impact, which needs to be weighed carefully against incremental revenue. Personnel Finance – In the global competitive scenario business firms are moving to leaner and flat organizations. Investments in Human Resource Development are also bound to increase. Restructuring of remuneration structure, voluntary retirement schemes, sweat equity etc. have become major financial decisions in the area of human resource management. Strategic Planning – Finance –

Finance function is an important tool in the hands of management for strategic planning and control on two counts – i) The decision variables when converted into monetary terms are easier to grasp. ii) Finance function has strong inter-linkages with other functions. Controlling other functions through finance route is possible. Methods and Tools of Financial Management – i) In the area of Financing – Funds are procured from long-

term sources as well as short-term sources. Long-term funds may be made available by owners, i. e. hareholders, lenders through issue of debentures / bonds, from financial institutions, banks and public at large. Short-term funds may be procured from commercial banks, suppliers of goods, public deposits etc. The finance manager has to decide on optimum capital structure with a view to maximize shareholder’s wealth. Financial leverage or trading on equity is an important method by which return to shareholders can be increased. ii) For evaluating capital expenditure (investment) decisions, a finance manager uses various methods such as average rate of return, payback, internal rate of return, net present value and profitability index. ii) In the area of working capital management there are various methods for efficient utilization of current resources at the disposal of the firm, thus increasing profitability. The centralized method of cash management is considered a better method of managing liquid resources of the firm. iv) In the area of dividend decision, a firm is faced with the problem of declaring dividend or postponing dividend declaration, a problem of internal financing. There are tools to tackle such situation. v) For the evaluation of a firm’s performance there are different methods.

For example, ratio analysis is a popular technique to evaluate different aspects of a firm. vi) The main concern of the finance manager is to provide adequate funds from the best possible source, at the right time and the minimum cost and to ensure that the funds so acquired are put to best possible use through various methods / techniques are used to determine that funds have been procured from the best possible available services and

the funds have been used in the best possible way: Funds flow and cash flow statements and projected financial statements help a lot in this regard.

The changing role of Financial Management in India – Modern Financial Management has come a long way from the traditional corporate finance. The finance Manager is working in a challengingenvironment, which changes continuously. As the economy is opening up and global resources are being tapped, the opportunities available to finance manager have no limits. At the same time one must understand the risk in the decisions. Financial management is passing through an area of experimentation and excitement, as a large part of the finance activities carried out today were not heard a few years ago.

A few instances are enumerated below: - i) Interest rates have been deregulated, further interest rates are fluctuating, and minimum cost of capital necessitates anticipating interest rate movements. ii) Rupee has become freely convertible in current account. iii) Optimum debt equity mix is possible. The firms have to take advantage of the financial leverage to increase the shareholders wealth. However financial leverage entails financial risk. Hence a correct trade off between risk and improved rate of return to shareholders is a challenging task. v) With free pricing of issues, the optimum price of new issue is a challenging task, as overpricing results in under subscription and loss of investor confidence whereas under pricing leads to unwarranted increase in number of shares and also reduction of earnings per share. v) Maintaining share prices is crucial. In the liberalized scenario the capital markets is the important avenue of funds for business. The dividend and bonus policies framed, has a direct bearing on the share

prices. i) Ensuring management control is vital especially in the light of foreign participation in equity (which is backed by huge resources) making the firm an easy takeover target. Existing managements may loose control in the eventuality of being unable to take up the share entitlements. Financial strategies to prevent this are vital to the present management. Forms of Business Organization – The three most common forms of business organization are the sole proprietorship, the partnership and the company.

Other specialized forms of business organizations also exist. Sole proprietorship are the most In terms of total receipts and net profits corporate form of business dominate. Sole Proprietorship – A sole proprietorship is a business owned by one person who runs for his own profit. Majority of the business firms are sole proprietorships. The typical sole proprietorship is a small business e. g. bakeshop, personal trainer or plumber. The majority of sole proprietorship is found in the wholesale, retail, service and construction industries.

Typically, the proprietor along with few employees runs the business. He raises capital from personal resources or by borrowing and is responsible for all business decisions. The sole proprietor has unlimited liability, towards creditors not restricted to the amount originally invested. The key strengths and weaknesses of sole proprietorship are given in table 1. 3. Partnership – A partnership firm is a business run by two or more persons for profit.

Partnership accounts for the next majority of business and they are typically larger than sole proprietorship. Finance, legal and real estate firms often have large number of partners. Most partnerships are established by a written contract known as ‘ Deed of Partnership’. In partnership, all partners

have unlimited liability for all the debts of the partnership. In India, partnership is governed by the Partnership Act, 1932. Strengths and weaknesses or partnerships are summarized in Table 1. 3. Company Form –

A company form of business is a legal entity, separated from the owners, with perpetual succession. Just like an individual, the company can sue and be sued, make and be party to contracts and acquire property in its own name. The company form of organization is the dominant form of business organization in terms of receipts and profits. Although, corporations are involved in all types of business, manufacturing corporation account for the largest portion of corporate business receipts and net profits.

The key strengths and weaknesses of corporate form are summarized in Table 1. 3. The owners of the company are its shareholders, whose ownership is evidenced by either common shares or preference shares. Shareholders get a return by receiving dividends i. e. periodic distribution of earnings or gains through increase in share price. Owner's liability is limited to the amount paid on their shares. Shareholder elects the Board of Directors through vote.

The Board of Directors has the ultimate authority in running the organization including making the general policy. The President or Chief Executive Office (CEO) is responsible for managing day to day operations and carrying out the policies established by the Board. The CEO is required to report periodically to the firm's board of directors. The corporate form of business are subject to strict control by Regulatory Agencies including Companies Ac, 1956, SEBI, etc. Table I - Strengths and weaknesses of the common forms of business organizations Sole Proprietorship | Partnership | Company | | | | | | Strengths |

| | | | | | | Owners receive all profits and incurs all losses | Can raise more funds than the sole proprietorship | Owners liability is limited to the extent paid on | | | their shares | | Low organizational costs | Borrowing powers enhanced by more owners | | | | | Can achieve large size via sale of shares | | | More available manpower and managerial skill | | | Income is included and taxed on owners personal tax | | Ownership (share) is readily transferable | | return | Income included and mixed on individual partner’s tax | | | | return | Long life of the firm | | Independence | | | | | | Can have professional managers | | Secrecy | | | | | | Has better access to financing | | Ease of dissolution | | | | | | Receives some tax advantage | | | | | | | | | | Weaknesses – | Owners have unlimited liability and may have to cover | | | | debts of other partners | Taxes generally higher, because corporate income is | | Owner has unlimited liability towards debt of the firm| | taxed and dividends paid to owners are also taxed. | | Partnership is dissolved when partner dies |(the latter has been exempted at the hands of the | | Limited fund raising power limits growth | | shareholders in India) | | | Difficult to liquidate or transfer partnership | | | Proprietor must be jack-of-all trades | | More expensive to organize than other forms of | | | | business | | Difficult to give employees long-runcareer| | | | opportunities | | Subject to greater control by regulating authorities | | | | | | Lacks continuity when proprietor dies or unable to | | Lacks secrecy since the shareholders must receive | | operate | | financial reports at periodic intervals | | | | | Limited Liability Partnership A limited liability partnership (LLP) is a partnership in which some or all partners (depending on the jurisdiction) have limited liability.

It therefore exhibits elements of partnerships and corporations. In an LLP, one partner is not responsible or liable for another partner's misconduct or negligence. This is an important difference from that of an unlimited partnership. In an LLP, some partners have a form of limited liability similar to that of the shareholders of a corporation. In some countries, an LLP must also have at least one " general partner" with unlimited liability. Unlike corporate shareholders, the partners have the right to manage the business directly. In contrast, corporate shareholders have to elect a board of directors under the laws of various state charters.

The board organizes itself (also under the laws of the various state charters) and hires corporate officers who then have as " corporate" individuals the legal responsibility to manage the corporation in the corporation's best interest. An LLP also contains a different level of tax liability from that of a corporation. Limited liability partnerships are distinct from limited partnerships in some countries, which may allow all LLP partners to have limited liability, while a limited partnership may require at least one unlimited partner and allow others to assume the role of a passive and limited liability investor. As a result, in these countries, the LLP is more suited for businesses where all investors wish to take an active role in management. There is considerable confusion between LLPs as constituted in the U. S. nd that introduced in the UK in 2001 and adopted elsewhere — see below — since the UK LLP is, despite the name, specifically legislated as a Corporate body rather than a Partnership. India The Limited Liability Partnership Act 2008 was published in the official Gazette of India on January 9, 2009 and has been notified with effect from 31 March 2009. However, the

Act, has been notified with limited sections only. The rules have been notified in the official gazette on April 1, 2009. The first LLP was incorporated in the first week of April 2009. 1. In India, for all purposes of taxation, an LLP is treated like any other partnership firm. 2. be limited to their agreed contribution in the LLP. 3.

Further, no partner would be liable on account of the independent or unauthorized actions of other partners, thus allowing individual partners to be shielded from joint liability created by another partner's wrongful business decisions or misconduct. 4. LLP shall be a body corporate and a legal entity separate from its partners. It will have perpetual succession. Indian Partnership Act, 1932 shall not be applicable to LLPs and there shall not be any upper limit on number of partners in an LLP unlike an ordinary partnership firm where the maximum number of partners can not exceed 20, LLP Act makes a mandatory statement where one of the partner to the LLP should be an Indian. 5. Provisions have been made for corporate actions like mergers, amalgamations etc. 6.

While enabling provisions in respect of winding up and dissolutions of LLPs have been made, detailed provisions in this regard would be provided by way of rules under the Act. 7. The Act also provides for conversion of existing partnership firm, private limited company and unlisted public company into a LLP by registering the same with the Registrar of Companies (ROC) 8. Nothing Contained in the Partnership Act 1932 shall effect an LLP. 9. The Registrar of Companies (Roc) shall register and control LLPs also. 10. The governance of LLPs shall be in electronic mode based on the successful model of the present Ministry of Corporate Affairs Portal. Chapter

Assignments – 1. What are the tasks of Financial Management? 2. Discuss the salient features of the traditional approach to Corporation Finance. 3.

Discuss the distinctive features of modern approach to Corporation Finance. 4. What is the normative goal of financial management? 5. " Financial Management is an integral part of the jobs of all managers. Hence it cannot be entrusted to a staff Department". Discuss. 6. Discuss some of the problems the financial managers in a developing country like India have to grapple with. 7. Draw a typical organization chart highlighting the finance function of a company. 8. Which of the following functions should be the responsibility of a Finance Manager? i) Maintaining the books of account. ii) Negotiating loans with banks iii) Preparation of cost statements iv) Conducting of internal audit v) Analysis of new projects i) Ensuring that enough cash is available at all the branches and factories of the company. vii) Assisting the management in taking a decision regarding the quantum of dividend. viii) Negotiating under-writing agreements in case of new issues ix) Preparing the financial statements. x) Deciding about change in the policies regarding recruitment. xi) Decision on administrative practices. xii) Change in marketing and advertising techniques routine. 9. Which of the following statements are true? i) It is the job of the finance manager to approve all payments. ii) The finance manager has to keep a proper balance in the procurement and use of funds. iii) Acquisition of fixed assets is of no concern to the finance manager. v) It is always advisable to distribute the total amount of profit as dividend. v) Since it is crucial that all sections of the business have adequate cash, it is a good policy to give each sections of the business double the amount of cash that they normally require so that they

can meet even emergencies. vi) Debentures and loans from financial institutions are very important sources of long-term funds. vii) It is better if no credits are given to the customers since this would mean that no amounts are tied up in sundry creditors. viii) In a period of rising prices, it is better to stock as much as raw material as possible, irrespective of the cost of procuring funds. x) A proper capitalization ensures that there is a balance between long-term funds and short-term funds and also proper ratios are maintained between the various sources of funds. 10. Which of the following statements do you agree? i) Financial management is essential only in private sector enterprise. ii) Only capitalists have to bother about money. The bureaucrat is to administer and not manage funds. iii) The public administrators in our country must be given a basic understanding of essentials of finance. iv) A state owned Transport Company must immediately deposit in the bank all its takings. v) “ Financial Management is counting pennies. We do not believe in such miserly attitude”. vi) “ Finance function is important as any other function in an organization”.