Chapter 1: Scope and objectives of financial Management

1) Introduction

* For the purpose of starting any new business/venture the entrepreneur goes through the following stages of decision making

Stage 1: Asset Allocation

Decide which asset to buy

Stage 2: Total Investment calculation

Compute the total investment amount required for the purchase of asset

Stage 3: Working capital Determination

Determine what is the total working capital required for running the business

Stage 4: financing sources

Identify the sources of funds available for the asset investment and working capital

* The financial management is concerned with efficient acquisition and allocation of fund with an objective to make profit to the owners
* The financial management mainly addresses the 3 major financial decisions. They are
  - (i) Investing
  - (ii) financing
  - (iii) Dividend

2) Meaning of financial Management

* financial management is a managerial activity of planning and controlling the firms financial resources
* financial management is concerned with acquiring, financing and managing the asset to accomplish the overall objective of the business
* financial management is also defined as planning for the future to ensure positive cash flow

3) Aspects of financial Management

(i) Procurement of fund
(ii) effective utilization of fund

(a) Procurement of fund

Sources of fund	Risk	Cost	Control
Equity share capital	↓	↑	Dilution in control
others	↑	↓	No Dilution in control

(b) effective utilization of fund

(i) utilization for fixed Asset

* The finance manager should ensure that the company enjoys optimum level of working capital without endangering financial insolvency
* The finance manager should possess sound knowledge of capital budgeting
* capital budgeting is a technique used by the finance manager to determine whether the investment in fixed asset would provide the desired return or not

(ii) utilization for current Asset

* The finance manager should ensure that the company enjoys optimum level of working capital
* The finance manager should ensure that the company do not block much funds in inventory, debtors ... etc

4) Evolution of financial Management

(a) Traditional Phase

In this phase, financial management is considered necessary only during the occational event such as take over, mergers, liquidation, expansion ... etc

(b) Transitional Phase

* In this phase, financial management is considered necessary for the day-to-day problems faced by the finance manager
* General problems related to fund analysis, planning and control were given more attention

(c) Modern Phase

* During this phase many theories were developed and also some important areas of financial management is developed
* Some of the important theories developed are
  - (i) efficient market
  - (ii) capital budgeting
  - (iii) valuation models and
  - (iv) option pricing .. etc

5) finance functions/ finance Decisions

The finance functions are divided in to long term and short term decisions

(a) Long Term Decisions

(i) Investment Decision

* This decision relates to investment of fund in various assets
* The funds procured from various sources are invested in various assets
* The funds are invested various fixed and current asset of the project
* The funds are invested in project after the examination of project through capital budgeting

(ii) financing Decision

* This decision relates to procurement of fund at optimum level
* The finance manager should have sound knowledge of various sources of funds available and their respective cost
* The company should have sound capital structure

(iii) Dividend Decision

* This decision relates to how much and how frequently dividend has to be paid as income to the owners/shareholders of the company and how much fund has to kept has retained earnings out of the profit of the company

(b) Short-term Decision

The short term decision is reduced to the management of current assets and current liability

6) Tasks of financial Management [BEST²]

Balancing cash inflow and outflow
Ensuring the sufficient level of working capital
Setting sales target
Taking care not to over invest in fixed asset
Tax planning

7) objectives of financial Management

(a) Profit Maximisation
(b) Wealth Maximisation

(a) Profit Maximisation

* It has been traditionally argued that the primary objective of business is profit maximisation
* The decisions of the finance manager should emphasis on the profit maximisation
* But if the profit is given undue importance many problems may arise some discussed below

(i) Profit is vague

* The Term Profit is vague because it does not Clarify what it exactly means
* It Means Different to Different People

(ii) Profit has to be attempted with a realisation of risk

* Risk and Return are Interconnected
* higher the risk, higher the return
* Risky Projects yield higher return
* finance manager should accept risky Projects only if they yield higher return
* Risk and return has to be balanced

(iii) Profit Maximisation does not consider time Pattern of return

(iv) Profit Maximisation as an objective is narrow

Profit Maximisation as an objective is narrow because it does not consider social considerations and various obligations such as Interest of workers, consumers, society and ethical Practices

(b) Wealth Maximisation

* wealth = Present value of Benefits - Present value of cost

* To Maximize and Measure wealth The finance Manager should follow
  (i) cash flow Approach
  (ii) cost benefit Analysis
  (iii) Application of time value of money

* value of the firm = No of Shares × Market value of shares

(or)

value of Equity + value of Debt

Particulars	objectives	Advantages	DisAdvantages
Profit Maximisation	To Increase the Profit of the Company	* Easy to calculate Profit * Easy to compare the Decisions with Profit	* Emphasis is on short term * Ignores Risk * Ignores time value of money
wealth Maximisation	To Increase the Market value of the share	* Emphasis is on Long Term * Recognizes time value of money * Recognizes Risk	* Difficult to Determine the Relationship between Decisions and Market Price * Can lead Management to frustration and anxiety

8) Role of finance Executive / CFO

(i) Budgeting Cost and Revenue
(ii) out sourcing Decisions
(iii) overseeing HR function
(iv) overseeing IT function
(v) Risk Management
(vi) Pricing Analysis
(vii) Managing Mergers and acquisition

9) Agency Problem

* Though in the case of sole Proprietor and Partnership firm the owners Participate in the Management but in the case of company the owners do not Participate in the Management of the Company. hence the owners and Management are different

* Though In Theory The Management has to take Decisions to the Interest of shareholders In reality the Management May place their Interest ahead of owners Interest
* There is a Principal and Agent relationship among the owners and the Management
* Agency Problem is a Problem arises when the Management Place their goals ahead of share holders / owners goals
* Agency cost is borne by the shareholders to monitor and control the behaviour of the Management and Maximise their wealth

Addressing the Agency Problem

* The Agency Problem related to debt is addressed by Imposing the negative covenants
* The Agency Problem between the Management and shareholders is addressed by linking the Managerial compensation with Profits to some extent and with Long Term objective of the Company with some extent

10) financial Distress and Liquidation

* financial Distress is a situation where the Current assets are not Adequate to pay the current liability
* Liquidation is a situation where the Inability to repay the debt and its a continuous situation of financial Distress

11) Inter relationship

* The finance functions are Divided in to 3 major Decisions. They are
  (i) Investment Decision
  (ii) financing Decision
  (iii) Dividend Decision
* These 3 decisions are Interrelated because the underlying objective of all the 3 decisions is wealth Maximisation
* since all the 3 decisions are Interrelated one has to consider its Joint Impact on the Market Price of the company's share and should be solved Jointly
* for example, In the Case of Investment Decision it is Influenced by financing Decision and financing Decision is Influenced by the Dividend Decision
* An efficient financial Decision can ensure optimum Joint Decision. This is Possible by evaluating each Decision and its Impact on the shareholder's wealth