Introduction to Financial Management

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Agenda

- Defining financial management
- Evolution of Finance as a Discipline
- Traditional & Modern Approach to Financial Management
- Objectives of Firm
- Important Decisions taken by FM
- Agency Problem

What we Do in Financial Management ???

Dividend Decision

Balance Sheet

Liab Leverage Analysis Assets .

Capital & Laibilities	**Fixed Assets**
Equity Share C	Land & Building
7% Pref.	Plant & Mchinery
8% Debenture	Furniture & Fi
Current Liabilities	**Current Assets**
Creditors	btors
Bills Payable	Receivables
Outstanding Expenses	Prepaid Expenses

Capital Structure Decision

Capital Budgeting

Working Capital Management

Mathematics of Finance : COC & TVM

Some Questions ???

- **What is Finance ?**
- **What are the Financial Activities of a Firm ?**
- **How are they related to other activities of the Firm ?**

Important Functions of a Business Firm

- **Production**
- **Marketing**
- **Finance**

A Firm acquires desired Capital; and employs it in activities which generates returns on invested capital

Management of Finance is Crucial ….

- **Success depends upon the Quality of Financial Decisions taken by it.**
- **They Determine the Future of the firm as well.**

Financial Management Combines

Two Aspects

Finance	Management
The Term Finance refers to Money & Credit	Broadly Means Decision Making

*In every function of Management the only common factor is 'Decision Making

Financial Management

According to Solomon (1978)

"Financial Management is concerned with the management decisions that results in the acquisition and efficient use of an important economic resource, viz; capital fund."

Financial Management

Definition by A.H. Wheeler :

"It is concerned with the Acquisition and Administration of capital funds in meeting the financial needs and overall objective of business enterprise"

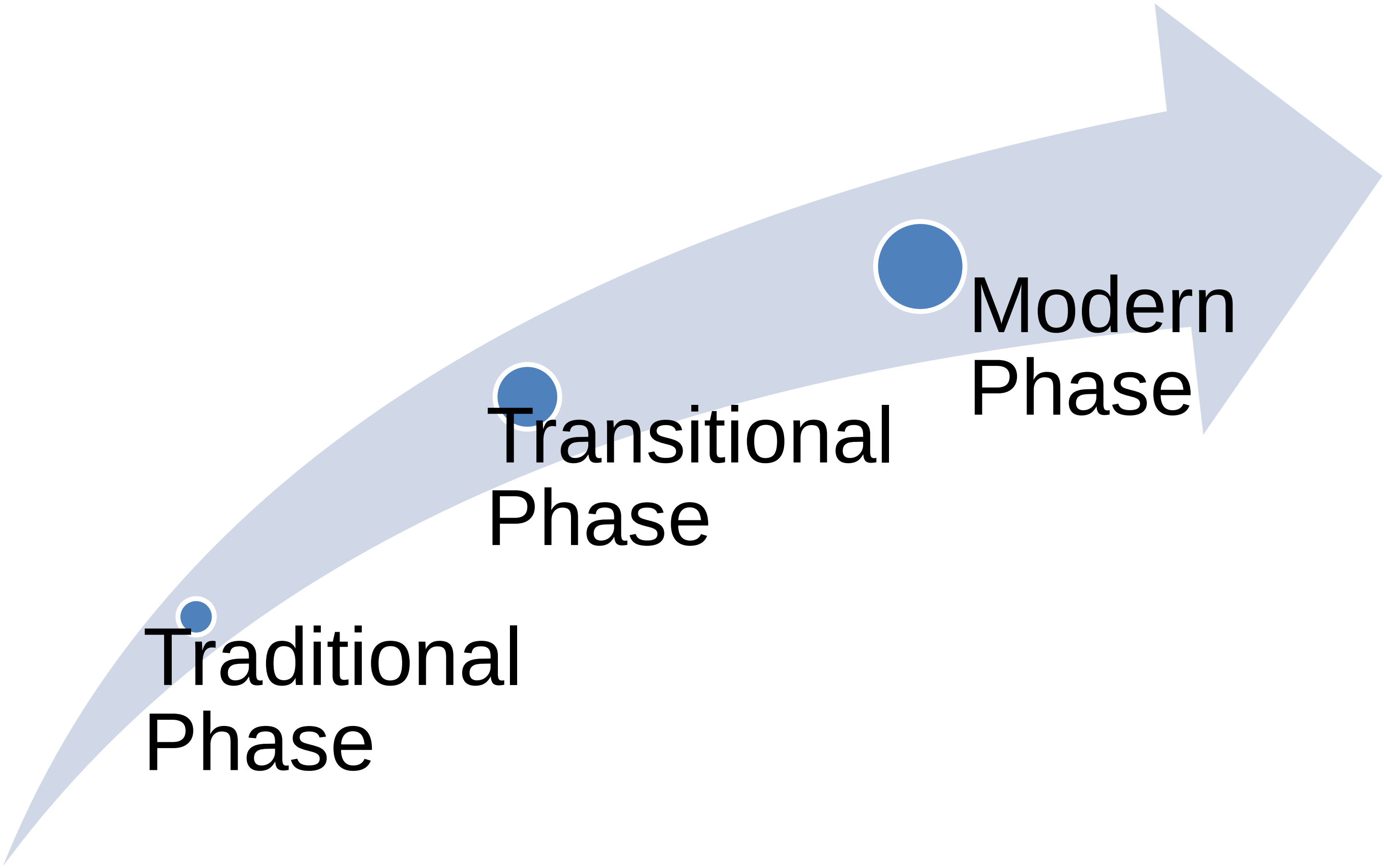
Financial Management is Concerned

Acquisition of Financial Resources

Efficient Use of Financial Resources

For the Achievement of Overall Objective of a Firm

Evolution of Finance as a Discipline



Traditional Vs Modern Approach

Traditional Approach	Modern Approach
Concerned with Procurement of Funds by Analyzing the Instruments, Institutions and Sources of Funds	Increased the Responsibility of FM and introduced the Integrated and analytical Scope of Finance
Traditional Approach was Based on Outsider looking in as it emphasized on Supplier of Funds Only	It regards it as an integrated finance function as it covers both acquisition and wise allocation of funds as well.

Contd..

Ignores the routine financial problems and focused on long term use of funds	**It considers the allocation of funds not only in long term but also in short term and routine matters**
FM was limited to preparation of Accounts, Reports and Procurement of Funds	It is regarded as a **Managerial Function and now includes** tools & Techniques for evaluation

Goals of Financial Management

- **Profit Maximization (profit after tax)**
- **Wealth Maximization**

Profit Maximization

- **To survive as an economic entity ,an organization must be Profitable.**

- **All those decisions which lead to increase in profit of firm should be undertaken & those which decreases Profit should be rejected.**

Profit is….

- An indicator of Economic Efficiency
- Ensures efficient allocation of resources
- Maximizes Social Welfare

Profit Maximization

- ***It Measures the Performance of a firm by looking at its Total Profit.***
- ***It does not considers the Risk which the firm may undertake in maximizing its Profits.***
- ***It ignores the effect of EPS, Dividend or any other Return to Shareholders on Wealth of the Shareholders.***

Shortcomings of *Profit Maximization*

Maximizing a firm's earnings after taxes.

- ***Its Vague : Not Clear Which Profit to Take … Amount or Rate ..ROI, ROE or ROTA***
- ***It Ignores timing and Quality of Benefits or Cash Flows***

Problems if we follow it…..

- Could increase current profits while harming firm (e.g., defer maintenance, issue common stock to buy Short term Securities, etc.).
- Ignores changes in the risk level of the firm.

Timing & Quantum of Cash Inflow is ignored

Year	Option I	Option II
1	15,000	Nil
2	20,000	35,000
3	30,000	30,000
Total	65,000	65,000

Wealth Maximisation

- **It is also known as Value Maximization or Net Worth Maximization**
- **Shareholders' Wealth is reflected in the Market Value of its Shares.**
- **The MPS of a share is a Present Value of all Future Cash Flows in terms of benefits and dividends expected from the Firm .**

Contd…

MPS can be optimized by the following Measures :

Investment Decision	Financing Decision	Dividend Decision
EPS = $\frac{Earnings\ After\ Tax}{No.of\ Equity\ Shares}$	Financing With Minimum Risk , Cost & Least Dilution of Control (RCC)	Paying Dividend to meet expectations of Shareholders

Wealth Maximisation

- **SWM (Shareholders' Wealth Maximization) is the difference between the PV of Benefits and PV of its Costs.**
- **Any Financial Action which creates positive NPV , creates wealth for its Shareholders and vice versa.**

Wealth Maximisation

Wealth Maximization can be understood as :

$$W = \frac{CF1}{(1+i)1} + \frac{CF2}{(1+i)2} + \frac{CF3}{(1+i)3} + \cdots \frac{CFn}{(1+i)n} - CO$$

Where

W = Net Worth of the Project

CF1, CF2 ….CFn = Cash Inflows or the benefits expected from the Project

i = discount factor

Co = Cost of the Project

Wealth Maximization

- Concept of Wealth Maximization considers all future cash flows, Dividends, Earnings Per Share (EPS), Risk of a Decision etc.
- The Objective of maximization of Shareholders' Wealth is Operational & Objective in its Approach.

Wealth Maximisation is Considered to be Better

- It Measures benefits in terms of Cash Flows and not the Profit
- It Incorporates the Concept of TVM
- Also Considers Risk and Uncertainty attached to future benefits
- can be applied to all decision areas of finance
- It is Exact, Precise and Clear

Profit Maximization Vs Wealth Maximization

Which One is better ?

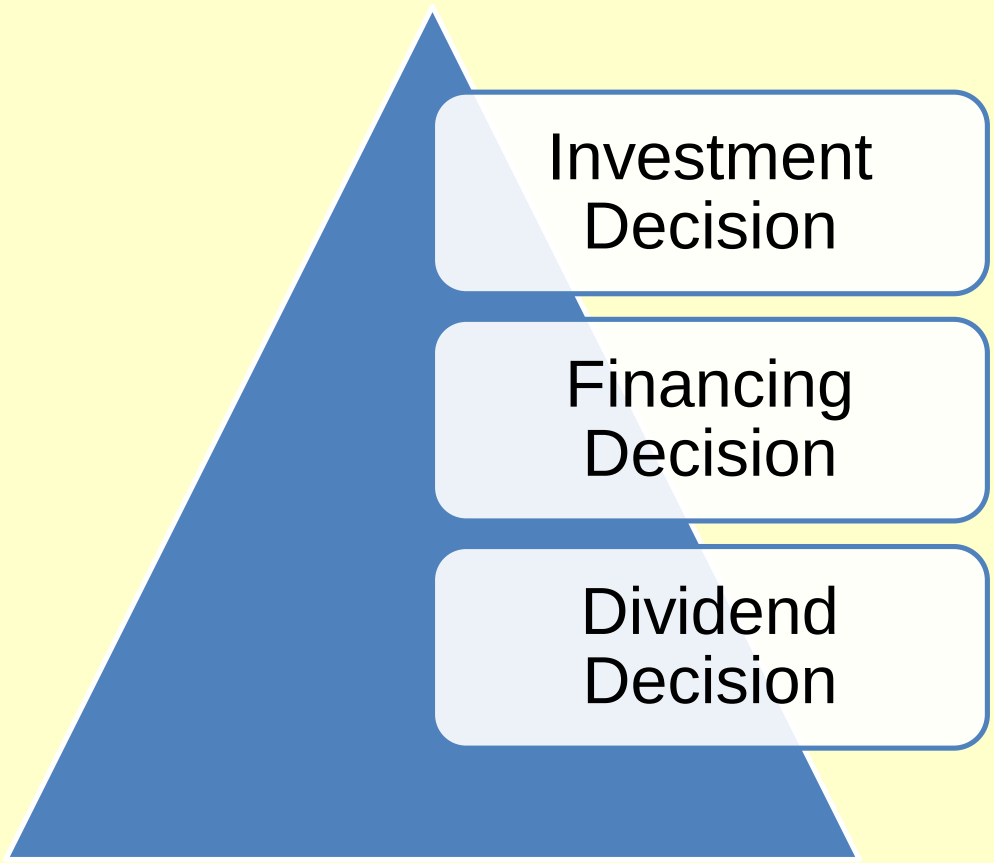
Profit Maximization

- **Attempts to judge the performance of a firm by the Profit earning only.**
- **It looks at earnings but not at EPS**

Wealth Maximization

- **Considers Present Value & Future Dividends**
- **Talks of EPS**
- **Favours Owner, Institutions, Employees & Equity Holders**

Decisions Taken by a Finance Manager



Investment Decisions

Most important of the three decisions.

- What is the optimal firm size?
- What specific assets should be acquired?
- What assets (if any) should be reduced or eliminated?

Financing Decision

- What is the best type of financing?
- What is the best financing mix ?
- How will the funds be physically acquired?

Dividend Decision

- What is the best dividend policy ?
- Should Dividend be Paid or Profit be Retained in the Business ?
- Risk –Return Complexion of a Firm is also affected by this decision

Decisions
By
a
Finance
Manager

Investment Decisions

Financing Dividend Decisions

Dividend Decisions

Others

Achievement of Goals

Risk Return Trade - Off

- **A Finance Manager can not avoid the Risk nor can he make a decision by considering the return aspect only.**
- **FM tries to optimize the Risk & Return.**
- **A Particular combination of Risk & Return, where both are optimized are known as Risk – Return Trade off.**

Guiding Principle for a Finance Manager

Risk	Risk has to be Minimum
Cost	Cost of Capital to be Minimum
Control	Least Dilution of Control

Role of Management

Management acts as an *agent* for the owners (shareholders) of the firm.

An *agent* is an individual authorized by another person, called the principal, to act in the latter's behalf.

Agency Problem

- **In a Corporate Set up, there exists separation of Ownership (Shareholders) and control (Management).**
- **Agency Problem arises due to the conflicting interests between Shareholders and Management of the Company.**
- **Shareholders Expect Maximization of Wealth… Directors May start achieving their goals like Remuneration, Incentive, Power etc.**

Agency Theory

- Jensen and Meckling developed a theory of the firm based on *Agency Theory*.
- *Agency Theory* is a branch of economics relating to the behavior of principals and their agents.

Agency Theory ..Contd..

- Principals must provide *incentives* so that management acts in the principals' best interests and then *monitor* results.
- Incentives include, stock options, perquisites, and bonuses.

Resolving Agency Problem

1. By Incurring Agency Costs :

   Monitoring Costs like Periodic Audit, Credit Rating Fees,

   Compensation Costs

Resolving Agency Problem

2. Pressure from Outside Groups /Market Forces :

- **Institutional Pressure**
- **Threat of Hostile Takeover**
- **Pressure from Media /Financial Analyst**

CSR Vs Wealth Maximisation

- Wealth maximization does *not* preclude the firm from being socially responsible at the corporate level.
- We view the firm as producing *both* private and social goods.
- Then *shareholder wealth maximization* remains the appropriate goal in governing the firm.

Thanks