1. Introduction to Finance

Introduction

Financial management is that part of management which is concerned mainly with raising funds in the most economic and suitable manner and using these funds as profitably as possible.

Functional Aspects of Financial Management

- Anticipating financial needs
- Acquiring financial resources
- Allocating funds in business
- Administering allocation of funds
- Analyzing performance of funds
- Accounting and reporting

Scope Of Financial Management

Traditional Approach: This approach limited the role of financial management to procurement of funds by corporate to meet their financial needs. This includes:

- Institutional finance
- Financial Instruments/ securities
- Legal and accounting aspects of fund raising.

Limitations of traditional approach:

- Confined to procurement of funds and ignored issues relating to allocation of funds.
- Focus on long term funding and ignored issues involving working capital management.

B) Modern Approach:

As per this approach the role of financial management is not only procurement of finance but also the efficient and wise allocation of funds. The three broads decision areas of financial management are:

- Investment decision
- Financing decision
- Dividend decision

Objectives of Financial Management

Profit maximization and wealth maximization are the two basic financial objectives or goals. While, profit maximization has limited relevance in light of modern age principles of shareholder value creation, it can still be said that profit maximization remains the underlying motivation. However, shareholders` wealth does not increase in certain situations even if profits are maximized. Hence, shareholders` wealth maximization does hold high importance in modern financial system.

Profit Maximization

Profit maximization means maximizing rupee income of business. Profit is a function of revenue and cost. Profit maximization can occur when revenues are increased and cost is reduced or both. In this backdrop, pricing plays a very vital role.

In a market economic system or even under government-controlled system, competitive forces determine prices of goods manufactured by firms. These firms are therefore expected to produce the goods in most efficient manner and at least possible cost. Goods that have high demand will command higher prices. Higher profit opportunities attract other companies, which thereby increases competition. With increase in supply, equilibrium is reached at which demand and supply are equal. Consumers are therefore exposed to range of products, which also leads to switching of brands. Changes in demand towards products affects profits and general price level. Manufacturers, on the other hand, also shift in favour of profitable products.

Limitations

- **Definition of profit:** The clear or precise meaning of profit has not been explained in the theory of profit maximization. Does it mean short-term profit or long-term profit?

- **Time Value of Money:** The theory does not make distinction between returns earned in different periods. It considers benefits received today and benefits after a period on an equal footing.

- **Uncertainty of returns:** Two companies may have same earnings, but one of them could be highly vulnerable to changes in business environment that the other.

- **Does not consider wealth creation principle:** Profit maximization is not wealth maximization. Issuing additional shares can enhance profit and investing sale Proceeds in low-yielding instruments. In this case, profit after tax would increase but earnings per share would go down.

***Example**: Let us assume that a firm has 10,000 shares outstanding, profit after taxes of Rs.50, 000 and EPS of Rs 5. If the company sells additional 10,000 shares at Rs 50 per share and invests the proceeds (Rs 5,00,000) at 5% after taxes. Total profit after taxes will increase to Rs 75,000. But, EPS would decrease to Rs 3.75.*

Wealth Maximization

Wealth maximization seeks to maximization the ***net present value or wealth.*** In case of profit maximization profit is the basis or yardstick, while under this approach cash flows are measures of benefits. **Net Present Value (NPV) of a course of action is difference between the present value of its benefits and the present value of costs.**

Value of business is reflected in its share prices at a given point of time. However, what determines this value are host of factors like business environment, political conditions, and corporate strategies. **The value depends on two factors namely-earnings per share and capitalization rate.**

Earning per share depends on profitability of the company. If a company is able to earn Rs 5 on a share of Rs 10, its market value is higher than the company earning Rs 4 on same value of share.

Capitalization rate essentially reflects the risk perception of investors towards the company. Market value is in turn driven by capitalization rate. Capitalization rate essentially is the expected return. Investment in shares would fetch more returns than 1-year fixed deposit with a bank. However, the premise is that of the risk element. The degree of risk depends on type of business, management background, financial strength and corporate strategies. A company may have high EPS but still may have risky financing pattern or weak operations, thereby affecting share prices on long-term basis. Suppose that expected EPS is Rs 6. If the capitalization rate expected by shareholders is 20%, then market price of share is likely to be Rs 30. (*Market price of share: (100 x 6) / 20 = 30*)

Finance Functions

Investment Decision
Investment decision or capital budgeting involves the decision of allocation of capital or commitment of funds to long-term assets that would yield benefits in the future. The basic considerations while making investment decisions are (a) evaluating prospective returns on new investments and (b) measurement of cut-off rate against that the prospective returns.

Future benefits of investments are difficult to measure due to uncertainty, and so investment decisions involve risk. In other words, such decisions must be evaluated in light of risk and returns. Cut-off rate is the minimum rate of return, the computation of which is difficult in practice. Additionally, investment decisions also involve decision of re-investing of funds to replace assets that are non-profitable or less productive.

Financing Decision
Financing decision involves planning with regard to source and timing of raising funds to meet corporate needs. Deciding the right capital mix or capital structure is the central theme of financing decisions. Capital structure is the proportion of equity and debt.

A capital structure is considered to be optimum when market value of shares is maximized. The use of debt affects return and risk of shareholders. It may enhance the return on equity, but also increases risk. Higher the debt component, the company is said to a high gearing or high leverage.

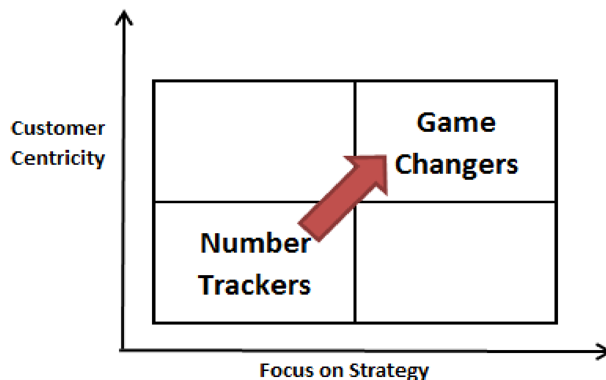
Dividend Decision
This involves deciding whether the company should distribute all profits or retain them or distribute a portion it. The amount of retained or distributed depends on whether the company can make profitable use of funds. Dividend decisions primarily depend on trend of earnings, cash flow position, prevailing tax policies and future requirement of funds for expansions and corporate growth.

Liquidity Decision
Liquidity is the most important ingredient of business. Decisions on liquidity management primarily involve management of current assets. Sufficient investments must be made in current to avoid dangers of insolvency. However, the company would lose out on profitability, as idle current assets do not yield any return.

Role of CFO in new age business environment

Most critical task of the CFO is measuring and monitoring their company's performance. The problem is that typical metrics used to manage organizations are *lagging metrics.* Leading metrics that enable proactive decisions, transforming the CFO office to be *game changers* rather than *number trackers*. Financial measures easier to obtain and monitor, many companies focus on financial measures only, however, they are inherently lagging measures. Lagging measures are a reflection of an outcome. They reflect performance results at the end of a given period and therefore reflect success or failure that has already happened.

Focus on strategy customer centric approach-
Must have a clear understanding of the company's vision and the role of each internal customer in realizing that vision. Finance function plays an imperative role in helping to set strategy and enable the organization to achieve long-term aspirations. Also encompasses building right capabilities (i.e. the people, processes, and systems) that will drive and enable strategic success in the organization.



Finance as a function has different roles and deliverable mentioned as under --

A) External Activities
1. Capital raising
2. Managing relationship with shareholders
3. Business Planning
4. Measuring and reporting financial and operating results and managing finance & accounting processes
5. Regulatory and Legal Compliance

Enterprise Activities

1.Provide analytical support and advice to business heads in dealing with vendors, customers
2. Managing risks
3. Overseeing company wide HR strategy and IT strategy
4. Managing M&A and corporate restructuring
5. Optimization of business operations.

Source : The Superstar CFO: Optimizing An Increasingly Complex Role by Sam Knox, CFO Research Services.