# INTRODUCTION TO FINANCIAL MANAGEMENT

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**COURSE TITLE: FINANCIAL MANAGEMENT**


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## Meaning

In simple terms, financial management is the business function that deals with investing the available financial resources in a way that greater business success and return-on-investment (ROI) is achieved. Financial management professionals plan, organize and control all transactions in a business. They focus on sourcing the capital whether it is from the initial investment by the entrepreneur, debt financing, venture funding, public issue, or any other sources. Financial management professionals are also responsible for fund allocation in an optimized way to ensure greater financial stability and growth for the organization.

### Definition

"Financial management is the activity concerned with planning, raising, controlling and administering of funds used in the business." – Guthman and Dougal

## Objectives of Financial Management

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

- To ensure regular and adequate supply of funds to the concern.
- To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders?
- To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
- To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.

- To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

**Scope of Financial Management**

**1. Investment decisions** includes investment in fixed assets (called as capital budgeting). Investment in current assets are also a part of investment decisions called as working capital decisions.

**2. Financial decisions-** They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.

**3. Dividend decision-** The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two:

**Dividend for shareholders-** Dividend and the rate of it has to be decided.

**Retained profits-** Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

**Finance Functions**

**(i) Financial Planning and Forecasting**

As a part of financial management function, financial managers have to do financial planning. It is the estimation of the value of the set of variables at some point in the future. It is a blueprint of what a firm should do in the future. To do so, financial managers need to take various factors into account.

These include a sales forecast, pro forma statements, asset requirements, economic assumptions and mode of financing investments. Financial planning can be done for a budget, expenditure and to save future income.

**(ii) Cash Management**

One of the functions of financial management is cash management. Decisions must be made in regards to what is to be done with the cash. Financial managers need to decide if they want to pay back to creditors, pay bills, meet current liabilities or invest in maintaining stock.

**(iii) Estimating Capital Expenses**

While estimating the capital expense, a company must keep the following points in mind:

**Promotional expenses:** It must be kept in mind that promotional expenses are incurred before any receipt. Promoters must be ready to bear these expenses since promoting a company is an expensive task. This stage requires investment and for that financial managers must be ready.

**Cost of current assets:** While estimating capital expenses, expenses on current assets must be included. These are the day to day expenses that are not fixed.

**Cost of fixed assets:** Machinery, land, and buildings are all part of fixed assets whose expenses can be calculated quite accurately. Their valuation helps in the accurate estimation of the capital requirements. Inflationary economic conditions and escalation features guide financial managers to do accurate valuation of fixed assets. This will be extremely important for estimating total capital requirements.

**4. Determining Capital Structure**

One of the functions of financial manager is determining the capital structure. Capital structure is the combination of debt and equity used to finance the overall operations and growth of a company. This is an important function of financial management. The following are the factors that help in determining capital structure**:**

**Loan covenant:** Loan covenants restrict companies from using strategies to cover debts. It can make it impossible for companies to raise money from the market after a certain limit. This can be detrimental for companies in the long run.

**Sustainability and Feasibility:** To determine a capital structure, the model should be feasible and sustainable if the company has to grow and make profits. To analyse growth and profitability, a sustainable growth model is used.

**Financial Slack:** Financial slack provides financial flexibility to a company. It consists of the serviceable and non-serviceable debt capacity of the firm. The higher the debt capacity, the higher will be the flexibility.

**Debt and Non-debt Tax Shields:** These have a very profound impact on the capital structure of the company. Debt allows interest tax shield from tax-deductible income, carried forward losses and reduced taxes that are levied on depreciation.

**5. Choosing Sources of Funds**

Another important financial management function is choosing the source of funds. This choice should be made after assessing the advantages and disadvantages of sources as well as the financing period. Funding options such as equity capital, banking institutions, debentures, preferred shareholders and third-party sources can be utilized as the source of funds.

**6. Procurement of Funds**

One of the functions of financial management includes the procurement of funds to run the business. This is performed after deciding on the sources of funds. The sources of procuring funds differ according to the period of financing. These can include:

- Gaining capital in lieu of equity
- Releasing IPO to raise money from public
- Taking loans from financial institutions

**7. Investment of Funds**

While procuring funds is difficult, it is important to wisely invest these funds so that profit can be maximized. Proper calculation of the risk and ROI is crucial to prevent loss of funds. For this purpose, different tools such as net present value, internal rate of return and portfolio analysis are important. The investment decisions must be guided by 3 important principles viz. profitability, safety and liquidity.

**8. Surplus Disposal**

After investment and expenditure, the financial manager must decide on what is to be done with the surplus profit. They have to decide if the surplus profit should be reinvested in the business as retained profits or distributed as dividends. They can identify the rate of dividends and benefits like bonuses.

**Interface between Finance and Other Functions**

Finance is the study of money management, the acquiring of funds (cash) and the directing of these funds to meet particular objectives. Good financial management helps businesses to maximize returns while simultaneously minimizing risks.

Financial management is an integral part of overall management and not merely a staff function. It is not only confined to fund raising operations but extends beyond it to cover utilization of funds and monitoring its uses. These functions influence the operations of other crucial functional areas of the firm such as production, marketing and human resources. Hence, decisions in regard to financial matters must be taken after giving thoughtful consideration to interests of various business activities. Finance manager has to see things as a part of a whole and make financial decisions within the framework of overall corporate objectives and policies.

**Marketing-Finance Interface**

There are many decisions, which the Marketing Manager takes which have a significant location, etc. In all these matters assessment of financial implications is inescapable impact on the profitability of the firm. For example, he should have a clear understanding of the impact the credit extended to the customers is going to have on the profits of the company. Otherwise in his eagerness to meet the sales targets he is liable to extend liberal terms of credit, which is likely to put the profit plans out of gear. Similarly, he should weigh the benefits of keeping a large inventory of finished goods in anticipation of sales against the costs of maintaining that inventory. Other key decisions of the Marketing Manager, which have financial implications, are:

- ❖ Pricing
- ❖ Product promotion and advertisement
- ❖ Choice of product mix

- Distribution policy.

**Production-Finance Interface**

As we all know in any manufacturing firm, the Production Manager controls a major part of the investment in the form of equipment, materials and men. He should so organize his department that the equipment's under his control are used most productively, the inventory of work-in-process or unfinished goods and stores and spares is optimized and the idle time and work stoppages are minimized. If the production manager can achieve this, he would be holding the cost of the output under control and thereby help in maximizing profits. He has to appreciate the fact that whereas the price at which the output can be sold is largely determined by factors external to the firm like competition, government regulations, etc. the cost of production is more amenable to his control. Similarly, he would have to make decisions regarding make or buy, buy or lease etc. for which he has to evaluate the financial implications before arriving at a decision.

**Top Management-Finance Interface**

The top management, which is interested in ensuring that the firm's long-term goals are met, finds it convenient to use the financial statements as a means for keeping itself informed of the overall effectiveness of the organization. We have so far briefly reviewed the interface of finance with the non-finance functional disciplines like production, marketing etc. Besides these, the finance function also has a strong linkage with the functions of the top management. Strategic planning and management control are two important functions of the top management. Finance function provides the basic inputs needed for undertaking these activities.

**Economics – Finance Interface**

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 also be able to use economic theories as guidelines for efficient business operation. The primary economic principle used in managerial finance 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.

**Accounting – Finance Interface:** The firm's finance (treasurer) and accounting (controller) activities are typically within the control of the financial vice president (CFO). These functions are closely related and generally overlap; indeed, managerial finance and accounting are often not easily distinguishable. In small firms the controller often carries out the finance function, and in large firms many accountants are closely involved in various finance activities. However, there are two basic differences between finance and accounting; one relates to the emphasis on cash flows and the other to decision making.

**Risk and Trade- off**

As an investor, you must know more than the basics to become a savvy investor. To advance in your investment journey, you need to understand advanced concepts such as risk-return trade-offs.

The return of investment is of prime importance for every investor. But, while generating higher returns, investors fail to consider the risks involved. The returns of any investment in a financial market are directly related to its risk factor. This phenomenon is known as risk-return trade-off.

**What is Risk-Return Tradeoff?**

Every type of investment is associated with some risk, which can significantly vary between two options. For instance, equity stocks have one of the highest levels of risks in the financial markets i.e. they also have the highest returns potential. If you have selected quality stocks, they can generate more than 10%-12% returns annually.

**Risk Return Trade off Definition**

On the other hand, investment options such as bank FDs come with minimum risk with annual returns around the range of 6%-7%. Every type of investment, equity, mutual funds, bullion market, or even real estate, this relationship between risk and returns is prevalent everywhere.

So, every investor must consider the risk-return trade-off at the time of selecting an investment to meet their goals.

**Risk-return trade-off in mutual funds**

Mutual funds returns vary considerably between small-cap funds, mid-cap funds, large-cap funds, hybrid funds, debt funds etc. and so does the risk. Small-cap equity funds have the highest level of risk, while debt funds are known to be relatively safer. Higher level of risk in small-cap funds can deliver higher returns as compared to low-risk debt funds.

However, a higher level of risk doesn't guarantee higher returns. While high-risk investment options do have higher returns potential, there's always uncertainty and can deliver significant losses too.

**How is the Risk-Return Trade-Off Calculated?**

Generally, the risk and return trade-off are calculated with the help of a few metrics. In the case of mutual funds, investors determine the trade-off with the help of these metrics:

**Alpha**

Alpha measures the risk-adjusted returns of a mutual fund scheme against its underlying benchmark. If a mutual fund follows Nifty 50, the risk-adjusted returns of the fund above or below the performance of the benchmark are considered alpha. For instance, a negative alpha of 1 means that the mutual fund underperformed in comparison to its benchmark by 1%. A positive alpha indicates better performance than the benchmark. The higher the alpha is, the higher is the returns potential.

**Beta**

Beta measures the volatility of the fund according to the benchmark. A higher or positive beta means that the fund is more volatile as compared to its benchmark. Funds have lower or negative beta if their volatility is lower than the benchmark.

**Sharpe Ratio**

Sharpe Ratio is used for analyzing the risk-adjusted returns potential of a mutual fund scheme. In other words, it measures the potential returns of a scheme against each unit of risk the scheme

The standard deviation of a fund is compared against the standard deviation of funds from the same category to evaluate volatility and risk.

**Standard Deviation**

Standard deviation measures the individual returns of an investment over time against its average return for the same period. So, a higher standard deviation means that the fund is volatile and carries a higher level of risk as compared to a fund with a lower standard deviation.

The standard deviation of a fund is compared against the standard deviation of funds from the same category to evaluate volatility and risk.

**Risk-Return Trade-Off and Portfolio Creation**

While the trade-off applies to every type of investment, investors emphasize more on it at the time of portfolio making. One should vary risk levels, investments and returns potential to build a well-balanced portfolio and protect against market volatilities. Focus on your investment objective, risk appetite, and investment horizon so that the risk-return trade-off of your portfolio perfectly matches your investment profile.

**Time Value of Money**

Time Value of Money (TVM) is a fundamental financial concept, stating that the current value of money is higher than its future value, given its potential to earn in the years to come. Thus, it suggests that a sum of money in hand is greater in value than the same sum of money received in the next couple of years.

The time value of money (TVM) is the idea that money available at the present time is worth more than the same amount in the future due to its potential earning capacity. This core principle of finance holds that, provided money can earn interest, any amount of money is worth more the sooner it is received.

The time value of money is the greater benefit of receiving money now rather than receiving later. It is founded on time preference. The principle of the time value of money explains why interest is paid or earned? Interest, whether it is on a bank deposit or debt, compensates the depositor or lender for the time value of money.

**Concepts of Time Value of Money**

**(a) Cash Flow**

Cash flow is either a single sum or the series of receipts or payments occurring over a specified period of time. Cash flows are of two types namely, cash inflow and cash outflow and cash flow may be of much variety namely; single cash flow, mixed cash flow streams, even cash flows or uneven cash flows.

**(b) Cash Inflow**

Cash inflows refer to the receipts of cash, for the investment made on the asset/project, which comes into the hands of an individual or into the business organisation account at a point of time/s. Cash inflow may be a single sum or series of sums (even or uneven/mixed) over a period of time.

**(c) Cash Outflow**

Cash outflow is just opposite to cash inflow, which is the original investment made on the project or the asset, which results in the payment/s made towards the acquisition of asset or getting the project over a period of time/s.

**(4) Discounted Cash Flow- The Mechanics of Time Value:**

The present value of a future cash flow (inflows or outflows) is the amount of current cash that is of equivalent value to the decision maker today. The process of determining present value of a future payment (or receipts) or a series of future payments (or receipts) is called discounting. The compound interest rate used for discounting cash flows is called discount rate.

**(5) Even Cash Flows /Annuity Cash Flows:**

Even cash flows, also known as annuities, are the existence of equal/even/fixed streams of cash flows may be a cash inflow or outflow over a specified period of time, which exists from the beginning of the year.

**(6)Uneven/Mixed Streams of Cash Flows:**

Uneven cash flows, as the concept itself states, is the existence of un-equal or mixed streams of cash inflows emanating from the investment made on the assets or the project.

**(7) Single Cash Inflows:**

A single cash inflow is a single sum of receipt of cash generated from the project during the given period, for which the present value is ascertained by multiplying the cash inflow by the discount factor.

**(8) Multiple Cash Inflows:**

Multiple cash inflows (even or mixed cash inflows) are the series of cash flows, may be annuities/mixed streams of cash inflows which are generated from the project over the entire life of the asset.

**(9) Future Value/Compound Value [FV/CV]:**

The future value concept states as to how much is the value of current cash flow or streams of cash flows at the end of specified time periods at a given discount rate or interest rate. Future value refers to the worth of the current sum or series of cash flows invested or lent at a specified rate of return or rate of interest at the end of specified period.

**(10) Compounding:**

The process of determining the future value of present money is called compounding. In other words, compounding is a process of investing money, reinvesting the interest earned & finding value at the end of specified period is called compounding.

**(11) Present Value:**

The present value is just opposite to the future value. Present value refers to the present worth of a future sum of money or streams of cash flows at a specified interest rate or rate of return. It is also called a discounted value.

In simple terms it refers to the current value of a future cash flow or series of cash flows.

**(12) Discounting:**

The inverse of the compounding process is discounting technique. The process of determining the present value of future cash flows is called discounting.

**(13) Effective Interest Rate / Time Preference Rate:**

Time preference rate is used to translate the different amounts received at different time periods; to amounts equivalent in value to the firm/individual in the present at common point reference. This time preference rate is normally expressed in 'percent' to find out the value of money at present or in future.

**(14) Risk:** In business, the finance manager is supposed to take number of decisions under different situations. In all such decisions, there is an existence of risk and uncertainty.

**Sources of Finance**

A company can raise capital from a variety of sources. Each source has distinct features that must be properly analyzed in order to choose the greatest accessible method of obtaining finances. For all organizations, there is no one optimum source of funding. A choice of the source to be used may be made depending on the situation, purpose, cost, and associated risk.

Finance is required at the point when an entrepreneur decides to launch a business. For example, funds are needed to buy furniture, equipment, and other fixed assets. Similar to this, funds are needed for regular operations, such as buying supplies or paying employees' salaries. Additionally, a business needs funds to expand. For Example, if a company wants to raise funds to fulfil its fixed capital requirements, long-term finances may be necessary, which can be raised through either owned or borrowed funds. Similarly, if the goal is to meet the day-to-day needs of the business, short-term sources may be utilized.

**1. Retained Earnings:**

In most cases, a company does not release all of its earnings or share its profits with its shareholders as dividends. A part of the net earnings may be retained in the company for future use. This is known as retained earnings. It is a source of internal finance, self-financing, or profit ploughing. The profit available for reinvestment in an organization is dependent on a variety of factors, including net profits, dividend policy, and the age of the organization.

**2. Trade Credit**

Trade credit is credit given by one trader to another for the purchase of products and services. Trade credit facilitates the purchase of goods without the need for immediate payment. Such credit shows in the buyer of goods' records as 'sundry creditors' or 'accounts payable.' Business organizations frequently utilize trade credit as a form of short-term finance.

**3. Factoring:**

Factoring is a financial service in which the 'factor' provides a variety of services such as :

Bill discounting (with or without recourse) and debt collection for the client: Under this, receivables from the sale of goods or services are sold to the factor at a certain discount. The factor takes over all credit control and debt collection from the buyer and protects the company against any bad debt losses.

**4. Lease Financing:**

A lease is a contractually enforceable arrangement whereby a one party, the owner of an asset, grants the other party the right to use the asset in exchange for a monthly payment. In other terms, it is the rental of an asset for a certain amount of time. The party who owns the assets is known as the 'lessor,' while the party who utilises the assets is known as the 'lessee.' The lessee pays the lessor a predetermined periodic sum known as lease rental in exchange for the usage of the asset.

**5. Public Deposits:**

Public deposits are deposits gathered from the public by organizations. Interest rates on public deposits are often higher than those on bank deposits. Anyone who wants to make a monetary contribution to an organization can do so by filling a specified form.

In return, the organization gives a deposit receipt as proof of payment. A business's medium and short-term financial needs can be met through public deposits. Deposits are beneficial to both the depositor and the organization. While depositors receive higher interest rates than banks, the cost of deposits to the corporation is lower than the cost of borrowing from banks. Companies often seek public deposits for up to three years. The Reserve Bank of India regulates the acceptance of public deposits.

**6. Commercial Papers:**

Commercial Paper (CP) is an unsecured promissory note. It was first created in India in 1990 to allow highly rated corporate borrowers to diversify their sources of short-term borrowings and to give investors an additional instrument.

**7. Issue of Shares:**

A share is the smallest unit of a company's capital. The firm's capital is split into small units and issued to the public as shares. The capital gained via the issuance of shares is referred to as 'Share Capital.' It's a kind of Owner's Fund.

**There are two kinds of shares that can be issued:**

**Equity Shares:** These are shares that do not pay a fixed dividend, but do have ownership and voting rights. Owner of the firm refers to the company's equity shareholders. They do not get a set dividend, but are paid dependent on the company's profitability.

**Preference Shares:** Preference shares are shares that have a slight preference over equity shares. Preference Shareholders get a set dividend rate and have the right to receive their capital before equity shareholders in case of liquidation. They do not, however, have any voting rights in the company's management.

**8. Debentures:**

Debentures are an effective instrument for raising long-term debt capital. A firm can raise capital by issuing debentures with a fixed rate of interest. A firm's debenture is recognition that the company has borrowed a specified amount of money, which it commits to repay at a later period. Debenture holders are part of the company as the company's creditors. Debenture holders get a definite stated amount of interest at predetermined periods, such as six months or a year.

**9. Commercial Banks:**

Commercial banks play an important role in providing finances for a variety of purposes and time periods. Banks provide loans to businesses in a variety of ways, including cash credits, overdrafts, term loans, bill discounting and the issuance of letters of credit. The interest rate imposed on such credits varies depending on the bank as well as the nature, amount, and duration of the loan.

**10. Financial Institutions:**

The government has established many financial institutions in the country to give financing to businesses. They provide both owned and loan capital for long- and medium-term needs. These organisations are often known as 'Development Banks' since they aim to promote a country's industrial development.

**Factors affecting Financial Decisions**

There are various factors that affect the financing decision. These are as follows:

**Cost:** The cost of raising funds from different sources is different. A financing manager generally prefers the cheapest source of finance.

**Risk:** The risk associated with different sources of finance is a different borrowed fund has a high degree of risk, as compared to the owners. The financial manager considers the risk involved with each source before taking a financing decision. In the case of equity, the risk is low, and in the case of debt, the risk is high.

**Floatation Cost:** Floatation cost refers to the cost, which is involved in the issue of securities. In the case of equity, floatation cost is low, and in the case of debt, floatation cost is high. Some of the examples are underwriting commission, broken range stamp duty, etc. The firm prefers securities with the least floatation cost.

**Cash flow Position:** A company with a strong cash flow position can take the advantage of debt because interest payment and re-payment of principal amount can be preferred by companies when there will be a shortage of cash.

**Level of Fixed Operating Costs:** Owner's fund is preferred by firms with a higher level of operating costs, like rent, salaries, insurance premiums, etc., because interests payment on debt will further add to the cost burden. And in case of moderate or low fixed operating costs, firms can go for borrowed funds.

**Control Consideration:** The issue of more equity shares may lead to a dilution of management control over the business. Debt financing has no such implication. Companies that are afraid of taking over will prefer debt. It means if existing shareholders want to retain complete control of the company, then the debt should be preferred. However, if they don't mind the loss of control, then the company may go for equity. So we can say that equity dilutes control, whereas debt doesn't affect control.

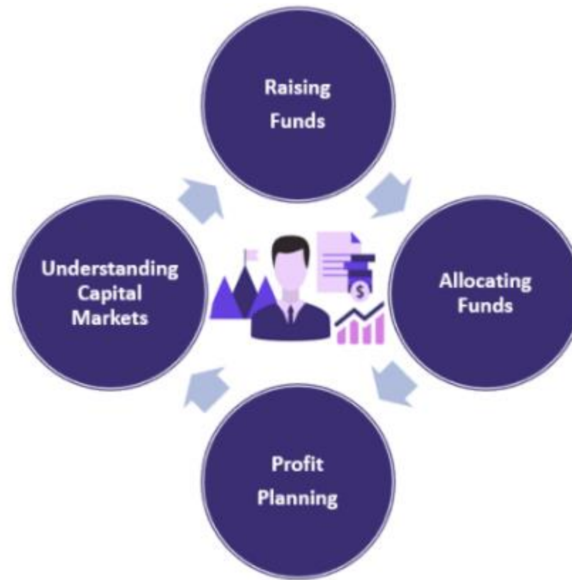
**State of Capital Market:** The condition of the stock market also helps in making the source of finance. In the case when the stock market is rising, during this period it is also easy to raise funds for the issue of shares because people are interested to invest in equity shares. But in case of a depressed market, company may face difficulties for issue equity shares.

**Role of Finance Manager in Financial Management**

Financial activities of a firm is one of the most important and complex activities of a firm. Therefore in order to take care of these activities a financial manager performs all the requisite financial activities.

A financial manager is a person who takes care of all the important financial functions of an organization. The person in charge should maintain a far sightedness in order to ensure that the funds are utilized in the most efficient manner.

His/hers actions directly affect the Profitability, growth and goodwill of the firm.




**1. Raising of Funds**

In order to meet the obligation of the business it is important to have enough cash and liquidity. A firm can raise funds by the way of equity and debt. It is the responsibility of a financial manager to decide the ratio between debt and equity. It is important to maintain a good balance between equity and debt.

**2. Allocation of Funds**

Once the funds are raised through different channels the next important function is to allocate the funds. The funds should be allocated in such a manner that they are optimally used. In order to allocate funds in the best possible manner the following point must be considered.

- The size of the firm and its growth capability
- Status of assets whether they are long-term or short-term
- Mode by which the funds are raised

These financial decisions directly and indirectly influence other managerial activities. Hence formation of a good asset mix and proper allocation of funds is one of the most important activity.

**3. Profit Planning**

Profit earning is one of the prime functions of any business organization. Profit earning is important for survival and sustenance of any organization. Profit planning refers to proper usage of the profit generated by the firm.

Profit arises due to many factors such as pricing, industry competition, state of the economy, mechanism of demand and supply, cost and output. A healthy mix of variable and fixed factors of production can lead to an increase in the profitability of the firm. Fixed costs are incurred by the use of fixed factors of production such as land and machinery. In order to maintain a tandem it is important to continuously value the depreciation cost of fixed cost of production. An opportunity cost must be calculated in order to replace those factors of production which has gone thrown wear and tear. If this is not noted then these fixed cost can cause huge fluctuations in profit.

**4. Understanding Capital Markets**

Shares of a company are traded on stock exchange and there is a continuous sale and purchase of securities. Hence a clear understanding of capital market is an important function of a financial manager. When securities are traded on stock market there involves a huge amount of risk involved. Therefore a financial manger understands and calculates the risk involved in this trading of shares and debentures.

It's on the discretion of a financial manager as to how to distribute the profits. Many investors do not like the firm to distribute the profits amongst shareholders as dividend instead invests in the business itself to enhance growth. The practices of a financial manager directly impact the operation in capital market.