

FINANCIAL MANAGEMENT : AN OVERVIEW

Question 1

Outline the methods and tools of Financial Management.

(Final-Nov. 1996) (6 marks)

Answer

Finance Manager has to decide optimum capital structure to maximise the wealth of the shareholders. For this judicious use of financial leverage or trading on equity is important to increase the return to shareholders. In planning the capital structure, the aim is to have proper mix of debt, equity and retained earnings. EPS Analysis, PE Ratios and mathematical models are used to determine the proper debt-equity mix to derive advantages to the owners and enterprise.

In the area of investment decisions, pay back method, average rate of returns, internal rate of return, net present value, profitability index are some of the methods in evaluating capital expenditure proposals.

In the area of working capital management, certain techniques are adopted such as ABC Analysis, Economic order quantities, Cash management models, etc., to improve liquidity and to maintain adequate circulating capital.

For evaluation of firm's performance, Ratio analysis is pressed into service-with the help of ratios an investor can decide whether to invest in a firm or not. Funds flow statement, cash flow statement and projected financial statements help a lot to the finance manager in providing funds in right quantities and at right time.

Question 2

Explain as to how the wealth maximisation objective is superior to the profit maximisation objective.

(Final-Nov. 1999)(PE-II-May 2003 & Nov. 2003) (3 marks)

Answer

A firm's financial management may often have the following as their objectives:

- (i) The maximisation of firm's profit.
- (ii) The maximisation of firm's value / wealth.

The maximisation of profit is often considered as an implied objective of a firm. To achieve the aforesaid objective various type of financing decisions may be taken. Options resulting into maximisation of profit may be selected by the firm's decision makers. They even sometime

1.2 Financial Management

may adopt policies yielding exorbitant profits in short run which may prove to be unhealthy for the growth, survival and overall interests of the firm. The profit of the firm in this case is measured in terms of its total accounting profit available to its shareholders.

The value/wealth of a firm is defined as the market price of the firm's stock. The market price of a firm's stock represents the focal judgment of all market participants as to what the value of the particular firm is. It takes into account present and prospective future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock.

The value maximisation objective of a firm is superior to its profit maximisation objective due to following reasons.

1. The value maximisation objective of a firm considers all future cash flows, dividends, earning per share, risk of a decision etc. whereas profit maximisation objective does not consider the effect of EPS, dividend paid or any other returns to shareholders or the wealth of the shareholder.
2. A firm that wishes to maximise the shareholders wealth may pay regular dividends whereas a firm with the objective of profit maximisation may refrain from dividend payment to its shareholders.
3. Shareholders would prefer an increase in the firm's wealth against its generation of increasing flow of profits.
4. The market price of a share reflects the shareholders expected return, considering the long-term prospects of the firm, reflects the differences in timings of the returns, considers risk and recognizes the importance of distribution of returns.

The maximisation of a firm's value as reflected in the market price of a share is viewed as a proper goal of a firm. The profit maximisation can be considered as a part of the wealth maximisation strategy.

Question 3

Discuss the conflicts in Profit versus Wealth maximization principle of the firm.

(PE-II-Nov. 2007) (4 marks)

Answer

Conflict in Profit versus Wealth Maximization Principle of the Firm

The company may pursue profit maximisation goal but that may not result into creation of shareholder value. The profits will be maximized if company grows through diversification and expansion. But all growth may not be profitable. Only that growth is profitable where

$ROA > WACC$ or $ROE > K_E$ or Firms invest in positive NPV profits.

However, profit maximisation cannot be the sole objective of a company. It is at best a limited objective. If profit is given undue importance, a number of problems can arise like the term profit is vague, profit maximisation has to be attempted with a realisation of risks involved, it does not take into account the time pattern of returns and as an objective it is too narrow.

Whereas, on the other hand, wealth maximisation, as an objective, means that the company is using its resources in a good manner. If the share value is to stay high, the company has to reduce its costs and use the resources properly. If the company follows the goal of wealth maximisation, it means that the company will promote only those policies that will lead to an efficient allocation of resources.

Question 4

“The information age has given a fresh perspective on the role of finance management and finance managers. With the shift in paradigm it is imperative that the role of Chief Financial Officer (CFO) changes from a controller to a facilitator.” Can you describe the emergent role which is described by the speaker/author? (Final-Nov.2000) (6 marks)

Answer

The information age has given a fresh perspective on the role financial management and finance managers. With the shift in paradigm it is imperative that the role of Chief Finance Officer (CFO) changes from a controller to a facilitator. In the emergent role Chief Finance Officer acts as a catalyst to facilitate changes in an environment where the organisation succeeds through self managed teams. The Chief Finance Officer must transform himself to a front-end organiser and leader who spends more time in networking, analysing the external environment, making strategic decisions, managing and protecting cash flows. In due course, the role of Chief Finance Officer will shift from an operational to a strategic level. Of course on an operational level the Chief Finance Officer cannot be excused from his backend duties. The knowledge requirements for the evolution of a Chief Finance Officer will extend from being aware about capital productivity and cost of capital to human resources initiatives and competitive environment analysis. He has to develop general management skills for a wider focus encompassing all aspects of business that depend on or dictate finance.

Question 5

Discuss the functions of a Chief Financial Officer. (PE-II-May 2004) (3 marks)

Answer

Functions of a Chief Financial Officer

The twin aspects viz procurement and effective utilization of funds are the crucial tasks, which the CFO faces. The Chief Finance Officer is required to look into financial implications of any decision in the firm. Thus all decisions involving management of funds comes under the purview of finance manager. These are namely

- Estimating requirement of funds
- Decision regarding capital structure
- Investment decisions
- Dividend decision
- Cash management

1.4 Financial Management

- Evaluating financial performance
- Financial negotiation
- Keeping touch with stock exchange quotations & behaviour of share prices.

Question 6

Explain two basic functions of Financial Management.

(PE-II-Nov. 2002) (4 marks)

Answer

Two basic functions of Financial Management

Financial Management deals with the procurement of funds and their effective utilization in the business. The first basic function of financial management is procurement of funds and the other is their effective utilization.

- (i) *Procurement of funds:* Funds can be procured from different sources, their procurement is a complex problem for business concerns. Funds procured from different sources have different characteristics in terms of risk, cost and control.
 - (1) The funds raised by issuing equity share poses no risk to the company. The funds raised are quite expensive. The issue of new shares may dilute the control of existing shareholders.
 - (2) Debenture is relatively cheaper source of funds, but involves high risk as they are to be repaid in accordance with the terms of agreement. Also interest payment has to be made under any circumstances. Thus there are risk, cost and control considerations, which must be taken into account before raising funds.
 - (3) Funds can also be procured from banks and financial institutions subject to certain restrictions.
 - (4) Instruments like commercial paper, deep discount bonds, etc also enable to raise funds.
 - (5) Foreign direct investment (FDI) and Foreign Institutional Investors (FII) are two major routes for raising funds from international sources, besides ADR's and GDR's.
- (ii) *Effective utilisation of funds:* Since all the funds are procured at a certain cost, therefore it is necessary for the finance manager to take appropriate and timely actions so that the funds do not remain idle. If these funds are not utilised in the manner so that they generate an income higher than the cost of procuring them then there is no point in running the business.

Question 7

Write short notes on the following:

- (a) *Functions of Finance Manager.* *(Final-May 1998) (5 marks)*
- (b) *Inter relationship between investment, financing and dividend decisions.* *(Final-Nov. 1999) (5 marks)*
- (c) *Finance function* *(PE-II-May 2008) (2 marks)*

Answer**(a) Functions of Finance Manager**

The Finance Manager's main objective is to manage funds in such a way so as to ensure their optimum utilisation and their procurement in a manner that the risk, cost and control considerations are properly balanced in a given situation. To achieve these objectives the Finance Manager performs the following functions:

- (i) *Estimating the requirement of Funds:* Both for long-term purposes i.e. investment in fixed assets and for short-term i.e. for working capital. Forecasting the requirements of funds involves the use of techniques of budgetary control and long-range planning.
- (ii) *Decision regarding Capital Structure:* Once the requirement of funds has been estimated, a decision regarding various sources from which these funds would be raised has to be taken. A proper balance has to be made between the loan funds and own funds. He has to ensure that he raises sufficient long term funds to finance fixed assets and other long term investments and to provide for the needs of working capital.
- (iii) *Investment Decision:* The investment of funds, in a project has to be made after careful assessment of various projects through capital budgeting. Assets management policies are to be laid down regarding various items of current assets. For e.g. receivable in coordination with sales manager, inventory in coordination with production manager.
- (iv) *Dividend decision:* The finance manager is concerned with the decision as to how much to retain and what portion to pay as dividend depending on the company's policy. Trend of earnings, trend of share market prices, requirement of funds for future growth, cash flow situation etc., are to be considered.
- (v) *Evaluating financial performance:* A finance manager has to constantly review the financial performance of the various units of organisation generally in terms of ROI. Such a review helps the management in seeing how the funds have been utilised in various divisions and what can be done to improve it.
- (vi) *Financial negotiation:* The finance manager plays a very important role in carrying out negotiations with the financial institutions, banks and public depositors for raising of funds on favourable terms.
- (vii) *Cash management:* The finance manager lays down the cash management and cash disbursement policies with a view to supply adequate funds to all units of organisation and to ensure that there is no excessive cash.
- (viii) *Keeping touch with stock exchange:* Finance manager is required to analyse major trends in stock market and their impact on the price of the company share.

1.6 Financial Management

(b) Inter-relationship between Investment, Financing and Dividend Decisions

The finance functions are divided into three major decisions, viz., investment, financing and dividend decisions. It is correct to say that these decisions are inter-related because the underlying objective of these three decisions is the same, i.e. maximisation of shareholders' wealth. Since investment, financing and dividend decisions are all interrelated, one has to consider the joint impact of these decisions on the market price of the company's shares and these decisions should also be solved jointly. The decision to invest in a new project needs the finance for the investment. The financing decision, in turn, is influenced by and influences dividend decision because retained earnings used in internal financing deprive shareholders of their dividends. An efficient financial management can ensure optimal joint decisions. This is possible by evaluating each decision in relation to its effect on the shareholders' wealth.

The above three decisions are briefly examined below in the light of their inter-relationship and to see how they can help in maximising the shareholders' wealth i.e. market price of the company's shares.

Investment decision: The investment of long term funds is made after a careful assessment of the various projects through capital budgeting and uncertainty analysis. However, only that investment proposal is to be accepted which is expected to yield at least so much return as is adequate to meet its cost of financing. This has an influence on the profitability of the company and ultimately on its wealth.

Financing decision: Funds can be raised from various sources. Each source of funds involves different issues. The finance manager has to maintain a proper balance between long-term and short-term funds. With the total volume of long-term funds, he has to ensure a proper mix of loan funds and owner's funds. The optimum financing mix will increase return to equity shareholders and thus maximise their wealth.

Dividend decision: The finance manager is also concerned with the decision to pay or declare dividend. He assists the top management in deciding as to what portion of the profit should be paid to the shareholders by way of dividends and what portion should be retained in the business. An optimal dividend pay-out ratio maximises shareholders' wealth.

The above discussion makes it clear that investment, financing and dividend decisions are interrelated and are to be taken jointly keeping in view their joint effect on the shareholders' wealth.

(c) Finance Function

The finance function is most important for all business enterprises. It remains a focus of all activities. It starts with the setting up of an enterprise. It is concerned with raising of funds, deciding the cheapest source of finance, utilization of funds raised, making provision for refund when money is not required in the business, deciding the most profitable investment, managing the funds raised and paying returns to the providers of funds in proportion to the risks undertaken by them. Therefore, it aims at acquiring sufficient funds, utilizing them properly, increasing the profitability of the organization and maximizing the value of the organization and ultimately the shareholder's wealth.