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CA INTER – FINANCIAL MANAGEMENT

CHAPTER-1: SCOPE AND OBJECTIVES OF FINANCIAL MANAGEMENT

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Interested learners can watch the lectures for all the above topics in our You Tube Channel: [FINANCIAL MANAGEMENT - YouTube]

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Chapter-1.1: Meaning of Financial Management

1.1.1. Introduction

- Financial Management refers to **planning and controlling** of financial resources.
- In the course of acquiring, financing and managing assets for a business enterprise, the finance manager has to kept in mind his objective; **Maximization of Shareholders Wealth.**
- While the Accounting subject emphasize on computing book profits, the Financial Management subject focuses on computing **Cash Flow**.
- Financial Management can also be termed as art and not just **Science of Money Management**.

1.1.2. Basic Aspects of Financial Management

A. Procurement of Funds

- During olden days, the most probable sources of finance are own funds or loans from banks or money lenders.
- During modern times, there are **many sources** from which funds can be procured.
- Due to such varied sources available, the task of procurement of funds is becoming very **complex**.
- Almost every business becoming more and more competitive and to sustain profits in such a competitive environment, the finance manager has to ensure that funds are obtained at **low cost**.

  This requires using more innovative ways of fund raising. **E.g., Selling Carbon Credits (For explanation of what is carbon credit watch our lecture on You Tube: https://youtu.be/Istlp73iTqU).**
- The first and foremast task of the finance manager is to decide the extent of **equity and debt** financing to be used.

  Within debt financing there are 3 things that are primarily looked into viz., **Cost, Risk and Control**.

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B. Effective Utilization of Funds

- » The task of finance manager does not come to an end the moment he hands over the procured funds to the concerned division of the enterprise.
  - ✓ Rather his role extends beyond that. He is also for responsible effective utilization of funds.
  - ✓ For this purpose, he has to constantly monitor the utilization of funds and ensure that the funds are not kept idle and not wasted.
- » All funds are procured at a certain cost and after preparing to bear certain amount of risk. Therefore, if they are not property utilized, the business will be ruined.
- » Funds are to be invested in such a manner that they **generate returns higher than the cost of capital** to the firm.
- » Proper **balance** needs to be ensured **between:**
  a) Investment in **fixed assets** - To maintain the production at optimum level
  b) Investment in **working capital -** To ensure financial solvency.
- » Adequate working capital should be maintained. But at the same time, too much funds shall not be blocked in inventories, book debts etc.

1.1.3. Sources of Funds

(i) Equity

- » Though purchase of equity shares is riskier from the shareholders point of view, but the company's point of view raising funds from issuing equity shares **is less risky**.
  This is because there is no legal obligation to pay dividend to the equity shareholders.
- » From the cost point of view, issuing equity shares is **more costly** to the company. This is because of two reasons:
  a) As the purchase of equity shares involves more risk, the **equity shareholders** will **expect more** return from the company; and
  b) Dividends are **not tax deductible** in the company's financial statements.
- » Whenever the company issues new equity shares, the existing shareholders **control** over the company will get **diluted**.
  To avoid control dilution, the companies may choose either of the following:
  a) Issue of shares to the existing shareholders only, by way of **Rights offer**.
  b) Issue of shares without carrying voting rights also known as **Differential voting rights shares (DVR's)**.

(ii) Debentures

» From the cost point of view, issuing debentures is **less costly** to the company. This is because of two reasons:

a) As the repayment of money is guaranteed, there is less risk to the **debenture holders** and as such they **will expect less returns**.

b) Interest on debentures is **tax deductible** in the company's financial statements.

» From risk point of view, issuing debentures is **riskier** to the company because of **legal obligation** that company shall regularly pay interest and repay principal whether or not the company is earning sufficient profits.

(iii) Funding from Banks

Banks and Financial Institutions provide **long-term and short-term** needs of a business enterprise. Following are some of the services provided by banks and financial institutions:

a) Overdraft / Cash Credit.
b) Term Loans.
c) Bills Purchasing and Discounting.
d) Guarantee / Letters of Credit.

(iv) International Funding

Globalization enables raising funds from various countries. Following are some of the important ways of raising finance from international markets:

a) Foreign Direct Investment (FDI)
b) American Depository Receipts and Global Depository Receipts.
c) External Commercial Borrowings.

PAST EXAMINATION QUESTIONS

1. Explain the two basic functions of Financial Management. **(N-09:2M)**

Chapter-1.2: Evolution of Financial Management

Financial Management evolved as a **separate field of study** at the beginning of the century. The Evolution of Financial Management is divided into three phases, which are as follows:

1.2.1. Traditional Phase.

This Phase started early in the 20th Century and lasted for about four decades till 1940's. During this phase:

1. Financial Managements was considered necessary **only during occasional events** such as Mergers and Liquidation of entities.
2. Finance was managed from **outsider's point of view** (e.g., bankers).
3. The field of Financial Management focused **only** on managing the finances of **Corporates** placing very little importance on managing the finances of non-corporate entities.
4. Financial Management focused on **only long-term financing** with a lack of emphasis on working capital management.

1.2.2. Transitional Phase

1. This phase began in early 1940's and continued till 1950's.
2. The nature of financial management in this phase is almost similar to that of earlier phase but in addition to focus on **long-term financing**, due emphasis was **also** given to the **day-to-day** (working capital) problems faced by the finance managers.

1.2.3. Modern Phase

1. This phase began in mid 1950's and is still going on.
2. During this phase, the scope of financial management has greatly increased. It is during this phase, finance has emerged as a **separate field**.
3. Due to **integration** with ideas of economics and statistics, financial management resulted in more quantitative and analytical topic.
4. Now the emphasis of financial management was on **maximization of shareholder's wealth**.
5. During this phase, many theories have been developed regarding efficient markets, option pricing, valuation models etc.

Chapter-1.3: Finance Functions / Finance Decisions

1.3.1. Investment Decisions

- These decisions relate to the **selection of assets** in which the funds of the firm can be profitably invested.
- Such selection has to be made after careful assessment of the various alternatives through the use of **scientific technique** called capital budgeting.
- In addition to the investment in **fixed assets**, a portion of the long-term funds shall also be reserved to meet **working capital** requirements.
- **Asset management policies** are to be laid down regarding various items of current assets.
- The **inventory policy** would be determined by the production manager and the finance manager,
  keeping in view the requirement of production and the future price estimates of raw materials and the availability of funds

1.3.2. Financing Decisions

- These decisions relate to acquiring the **optimum finance** to meet financial objectives.
- To make such decisions effectively, the finance manager needs to possess a good **knowledge of the sources** of available funds and their costs.
- Finance manager should try to strike a **proper balance** between equity and debt.
- Before procuring finance, the finance manager has to verify whether the firm will be able to generate **sufficient cash flows** to pay the interest cost. Without sufficient cash flows, profits are of little use.
- Finance manager has to use various risk management techniques to manage the risk involved with each source of finance. E.g., ***Hedging techniques like forwards and options to be used to mitigate the foreign currency exchange risk arising from international borrowing.***

1.3.3. Dividend Decisions

- These decisions relate to the determination of the:
  a) Amount to be **paid out** - To meet the shareholders expectations or needs.
  b) Amount to be **retained** – To support the growth of the companies (*This decision is interlinked with Financing Decision)*.
- The importance of this decision lies in the fact that the level and growth of **dividends significantly impact the company's market value**.

Investment and Financing Decisions are relevant for both for profit and not for profit entities. Whereas, Dividend decisions are relevant to only for profit entities

PAST EXAMINATION QUESTIONS

1. Briefly explain the three finance function decisions (N-19(N), 3 Marks)

Chapter-1.4: Importance of Financial Management & Scope of Financial Management

1.4.1. Importance of Financial Management

With the proper administration of finance, a business enterprise can reach its full potential thereby achieving the growth targets.

"Money is to an enterprise; what oil is to an engine"

Importance of financial management can be best understood from the following tasks embodied in the domain of finance:

a. Not to over-invest in fixed assets (***For more learning about Asset Light Business Models of various corporates watch our lecture on You Tube: https://youtu.be/7uhhhnQklkk***)
b. Balancing cash outflows and inflows
c. Maintaining sufficient working capital.
d. Setting sales **revenue targets** that will deliver sustainable growth.
e. Increasing gross profit by setting the **correct pricing**. (***Without profits an organisation cannot sustain in the long run. For more discussion watch the above video)***
f. Increasing the net profits by controlling the administrative expenses and by finding most cost-efficient of doing the day-to-day business operations.
g. Proper **Tax Planning** to minimize the tax expense.

1.4.2. Scope of Financial Management

As an integral part of the overall management, financial management is mainly concerned with **acquisition and use of funds** by an organization.

Following aspects are covered in the scope of financial management:

(a) Determination of **size of the enterprise** and determination of **rate of growth**.
(b) Determining the **composition of assets** of the enterprise.
(c) Determining the **financing mix** i.e. consideration of level of debt to equity, etc.
(d) Analysis, planning and control of financial affairs of the enterprise.

Interrelationship between Market Value, Financial Decisions and Risk-Return

The 3 variables viz., Market value, Financial Decisions and Risk-Return trade-off are interrelated in the sense that

While taking financial decisions, the finance manager has to do appropriate **trade-off (sacrificing one thing to get another)** between risk and return. Such trade-off involves:

a) ***Minimizing the risk*** to earn the required return.
b) ***Maximize the return*** for the given tolerable risk.
c) Risk should not be taken without ***adequate compensation*** in the form of return.
d) Risk should not be taken to an extent which makes earning ***risk premium is unsustainable***.
e) Risk should be taken only if it is related to ***ordinary course*** of business.
f) Risk relating to ***non-core activities*** should be either avoided or transferred by way of insurance.

PAST EXAMINATION QUESTIONS

1. State four tasks involved to demonstrate the importance of good Financial Management. **(Jan-2021: 4 Marks)**

Chapter-1.5: Objectives of Financial Management

To evaluate the efficiency and effectiveness of a finance manager, there should be some objective or goal with reference to which evaluation can be done.

Now the dilemma is what should be the ultimate goal of a finance manager. ***Without giving destination finance manager cannot walk.***

The two possible and most debatable goals are Profit Maximization and Wealth Maximization.

1.5.1. Profit Maximization

- It has traditionally been argued that the primary objective of a company is to earn Profit.
- Therefore, the objective of financial management is also profit maximisation.
- This implies that the finance manager has to make his decisions in a manner so that the profits of the firm are maximised.

Problems associated with Profit Maximization / Limitations of Profit Maximization

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. Some of these have been discussed below:

1. The term profit has **vague definition**. Therefore, it conveys a different meaning to different people. Accordingly, there might not be clarity as to what has to be achieved.
2. If profit maximisation is the only goal, then **risk factor is altogether ignored**. It results in the finance manager accepting highly risky proposals without due regard to the capacity of the firm to bear such high risk.
3. Profit maximisation **ignores the time pattern of returns**. It may result in selecting the projects with higher absolute profit ignoring the time value of money.
4. Profit maximisation **does not social considerations**. An entity cannot survive in the long-term, if it ignores social and moral obligations.

1.5.2. Wealth Maximization

- The shareholder value maximization model holds that the primary goal of the firm is to maximize its market value.
- Wealth Maximization decision implies that business decisions should seek to increase the **net present value or the economic profits** of the firm.
- For measuring and maximising shareholders wealth, finance manager should follow:
  a. Cash Flow approach not Accounting Profit.
  b. Costs benefit analysis.
  c. Application of time value of money.

Importance of Wealth Maximization

- Though, there are many goals, which a business enterprise may have, the primary goal remains to be wealth maximization, as it is critical for the very existence of the business enterprise.
- Wealth Maximization goal is critical because**, if this goal is not met, public and institutions would lose confidence** in the enterprise and will not invest further in the growth of the organization.
- If the growth of the organization is restricted then the other goals like community welfare will not get fulfilled.

Illustrative list of Goals of business enterprise other than wealth maximization

1. Achieving a higher growth rate
2. Attaining a larger market share
3. Gaining leadership in the market in terms of products and technology
4. Promoting employee welfare
5. Increasing customer satisfaction
6. Improving community life.

1.5.3. Conflict between Profit Maximization vs Wealth Maximization

Profit Maximization	Wealth Maximization
1. There is no uniform definition for the term "**Profit**"	a. There is a standard definition for wealth i.e., **Market value** of share
2. It ignores **risk** element	b. It considers risk element
3. It ignores **time value** of money	c. It considers time value of money
4. It has a **narrow focus**. It emphasizes only the interest of shareholders	d. It has **broad focus**. It emphasizes on the entire spectrum of stakeholders
5. It uses **accrual** principle.	e. It uses **cash** principle for quantification
6. It focuses on **accounting value**	f. It focuses on **market value**

7. It is a **short-term** measure	g. It is a **long-term** measure
8. It is suitable for **single period** evaluation	h. It is suitable for **multi-period** evaluation
9. It is appropriate when the **uncertainty** is business ecosystem is less	i. It serves beset even when the uncertainty in the business ecosystem is more
10. It gives scope for management **mis-use of powers** for their personal benefit	j. It prevents management abuse of power.

Where the time period is short and degree of uncertainty is not great, wealth maximization and profit maximization amount to essentially the same.

PAST EXAM QUESTIONS

1. Write two main objectives of Financial Management **(N-18(N), 2M)**
2. Write any two limitations of profit Maximization **(N-18(N), 2M)**
3. Explain the limitations of profit maximization objective of Financial Management. **(3 Marks, November, 2007)**
4. Distinguish between Profit Maximization and Wealth Maximization **(M-15:4M, and M-17:4M)**
5. Discuss conflict in profit versus wealth maximization objective. **(2 Marks; 4 Marks, June 2009; November, 2010 & November, 2012)**
6. "The profit maximization is not an operationally feasible criterion." Comment on it. **(4 Marks, May, 2012)**

Chapter-1.6: Role of Finance Executive

"Today's CFO team is expected to add value well beyond the traditional roles of cost management, controls and acting as the conscience of the organization. These roles are challenging enough, but today's CFO is expected to work in collaboration, by serving as the integration hub for key business processes, as a catalyst for change including business transformation, and as a consultant or trusted business advisor in helping to create sustainable growth."

Jeff Thomson, IMA President and CEO

The stereotypical image of an introverted bookkeeper has been replaced by well-rounded professionals who are expected to have a deep understanding of a company and provide operational insights & support. a Chartered Accountant has to make a commitment to lifelong learning. Stay ahead of the curve on technology, data analytics and forensics. **Keki Mistry – CEO of HDFC**

- Finance executive has an important role to play in the company's financial success.
- **Responsibilities of finance executive** include:

(a) **Financial analysis and planning**: Determining the proper amount of funds to be deployed.

(b) **Investment decisions:** The efficient allocation of funds to specific assets.

(c) **Financing and capital structure decisions:** Raising funds on favourable terms.

(d) **Management of financial resources** (such as working capital).

(e) **Risk management:** Protecting assets.

Tracking the change in the role of finance executive
(Traditional vs Modern role of finance executive)

Traditional Role (What a CFO used to do?)	Modern Role (What a CFO is expected to do now?)
1. Budgeting. 2. Accounting. 3. Tracking accounts payable and accounts receivable. 4. Preparing internal financial reports for management. 5. Preparing annual and periodical financials for the use of investors. 6. Regulatory Compliance such as tax filing.	a. Strategic Planning. b. Pricing Analysis. c. Overseeing the HR Function. d. Making Decisions about outsourcing. e. Risk Management. f. Profitability Analysis. g. Participating in the decisions of M&A and managing M&A's

PAST EXAMINATION QUESTIONS

1. Explain the Functions of Chief Financial Officer (CFO) **(M-19(O), 5 Marks)**
2. What are the roles of Finance Executive in Modern World **(M-18(N), 2 Marks)**
3. Discuss emerging issues effecting the future role of CFO **(M-14:4M, N-16:4M)**

E.g., *Artificial Intelligence, Block Chain Technology, Forensic etc. Answer to this question is not clear in the ICAI Sources. Please watch our You Tube Channel for further understanding of those issues.*

4. Discuss the functions of a Chief Financial Officer. **(3 Marks, May, 2004)**
5. What are the main responsibilities of a Chief Financial Officer of an organisation? **(3 Marks; 4 Marks, May, 2007; May, 2010 & November, 2011)**
6. List out the role of Chief Financial Officer in today's world **(N-20(N), 4 Marks)**

Chapter-1.7: Financial Distress and Insolvency
&
Agency Problem and Agency Cost

1.7.1. Financial Distress and Insolvency

- Financial distress is a position where **Cash inflows of a firm are inadequate** to meet all its current obligations.
- Financial distress may be due to **lack of proper management** of product pricing, input pricing and proportion of debt etc.
- If the revenues of the firm are not sufficient to meet its obligations, the firm may be **forced to sell its assets**.
- Such forced sales is usually at far less than fair price.
- Such **lower realizations** from sale of assets will further deteriorates the financial position and solvency of the firm.

Insolvency is the result of continuous financial distress.

To know how a company can detect in advance as to whether it is in financial distress or not, please watch our lecture on You Tube: https://youtu.be/JSBCifBlPt0

1.7.2. Agency problem and Agency Cost

- There is a principal agent relationship between managers and other important stakeholders of the company viz., debt lenders and equity investors.
- Agency Problem refers to the reality that many managers place their **personal goals ahead of the stakeholder's interest**.
- The agency problem arises if manager's interests are not aligned to the interests of the debt lender and equity investors.
- **Agency Problem leads to Agency Cost**, which is the additional cost borne to monitor and control the manager's behaviour.
- **Agency Problem are of 3 types:**
  - Conflict between shareholders and management.
  - Conflict between majority shareholders & minority shareholders.
  - Conflict between shareholders and other stake holders.

- Generally, Agency Costs are of four types (i) monitoring (ii) bonding (iii) opportunity (iv) structuring.

  For more discussion on types of agency problems and types of agency Costs, please watch our lecture on You Tube: https://youtu.be/JZ4P5KvAGLA

Addressing Agency Problem

1. The agency problem of debt lender would be addressed by imposing **negative covenants** i.e. the managers cannot borrow beyond the specified limits.
2. Agency problem between the managers and shareholders can be addressed if the **interests of the managers are aligned to the interests of the share- holders**.
   Such alignment may be done by linking the managerial compensation to the profits and some measure of long-term performance of the organisation.

Chapter-1.8: Relationship between Financial Management and Other Disciplines

1. Financial Management is not an independent domain, rather it is an interdependent domain within the overall management.
2. Financial management depends heavily on other important areas, which include:
    a) Accounting.
    b) Quantitative Methods.
    c) Economics.
3. **Accounting is the primary** discipline on which the financial manager depends considerably.
4. Economics is also heavily influences the finance manager in his decision making.
5. The **marketing, production and quantitative methods are only indirectly related** to day-to-day decision making by financial managers **and are supportive in nature**.

1.8.1. Relationship between Accounting and Financial Management

» Accounting is an important input in financial decision making.

» Accounting generates information relating to operations of the organisation.

» The outcome of accounting is the financial statements such as balance sheet, income statement, and the statement of changes in financial position.

» The information contained in these statements and reports helps the financial managers to measure the past performance and make decisions for the future.

Though the accountant also makes decisions and finance manager also collects data, but the primary focus of the accountant is to collect data and the primary focus of the finance manager is to take decisions.

Financial management begins where accounting ends

1.8.2. Distinction between Accounting and Financial Management

Accounting	Financial Management
It uses Accrual Principle for decision making	It uses cash principle for decision making
It is back-ward looking function	It is a forward-looking function
It collects, classifies and presents the data	It analyses the data and applies the insights
It mostly uses internal data	It uses both internal and external data.

1.8.3. Relationship between FM and Other disciplines

» For its day-to-day decision-making process, financial management depends on other subjects such as marketing, production and quantitative methods apart from accounting.

» Financial managers should consider the impact of new product development and promotion plans made in **marketing** since their plans will require capital outlays and have an impact on the projected cash flows.

» Changes in the **production** process may require capital expenditures which the financial managers must evaluate and finance.

» The tools and techniques of analysis developed in the **quantitative methods** are helpful in analysing complex financial management problems.

PAST EXAMINATION QUESTIONS

1. Differentiate between Financial Management and Financial Accounting.

(2 Marks, November, 2009)

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