

Financial Decisions

The finance manager is usually faced with the following different scenarios.

- What should be the size of firm and how fast should it grow.

[Size] is measured by the value of its assets and

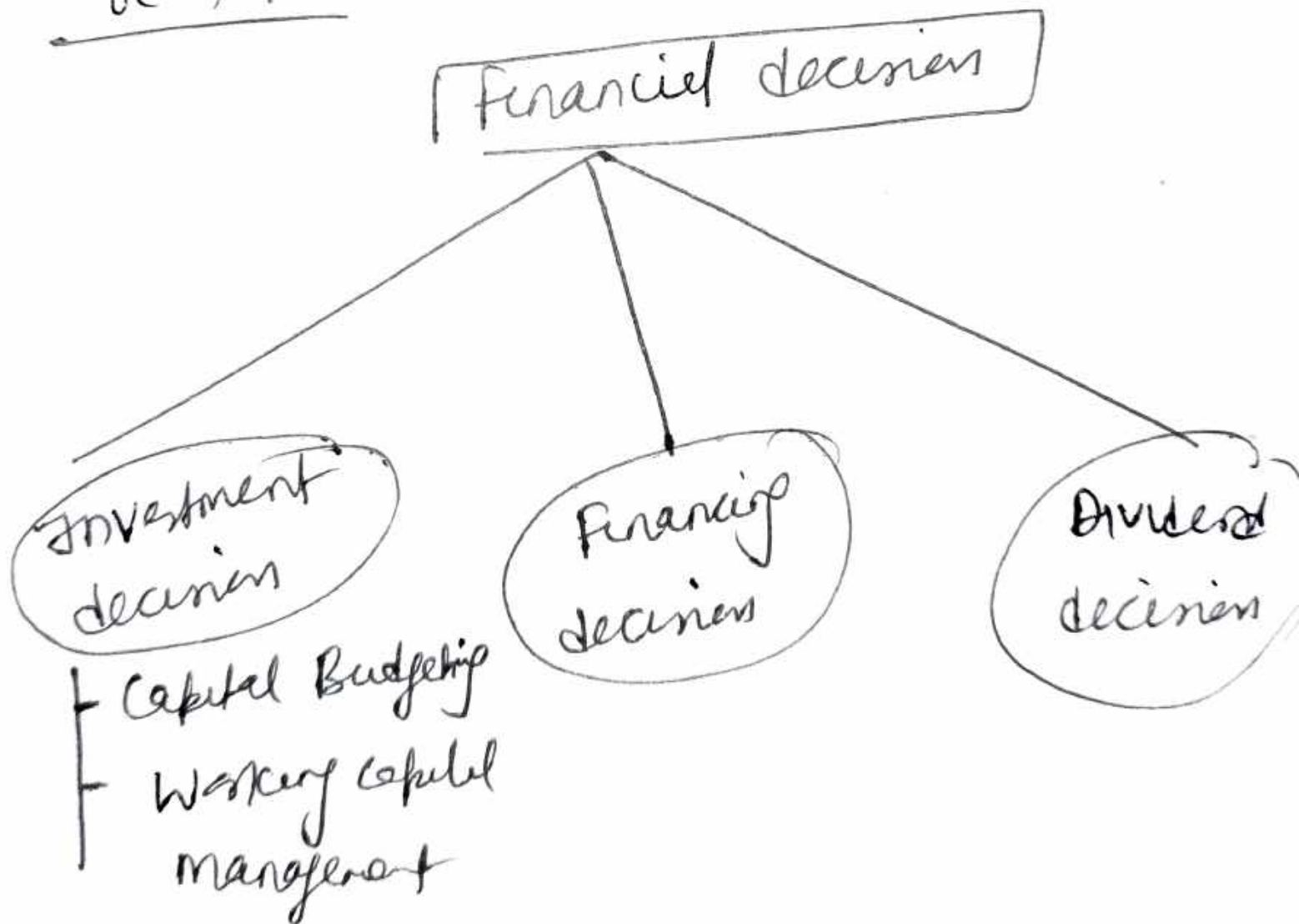
[Growth] is measured by % change in assets of the firm]

- what are the various types of assets to be acquired.
- what should be the pattern of raising funds from various sources.

(Decide the best mix of the liabilities and capital)

Depending upon the nature and size of firm, finance manager is required to perform these functions.

While performing his/her functions different decisions are required to be taken



Investment Decision:

- Decisions relating to assets composition of the firm.
- Selection of various assets in which a firm should commit its funds is a way to maximise returns on its investment with an overall goal of wealth maximization.
- The assets of the firm can be divided into two broad categories.
 - Long term assets = Assets involve commitment of funds for a longer period of time.
 - Short term assets = Assets involve commitment of funds for short duration of time, usually up to one year.

Decisions relating to Long term assets or fixed assets are known as Capital Budgeting

Decisions relating to Short term assets or current assets are known as Working Capital management.

Capital Budgeting Decision

- ① Decisions relating to long term commitment of present funds with the expectations of earning a satisfactory return on these funds over a period of time in future.
- ② These decisions give a directions to the firm and also determine its future earning potential.
- ③ These are irreversible decisions
- ④ Cost and benefits of these decisions are measured in term of cash outflows and inflows.
- ⑤ Since benefits of these investment proposal accrue in a future period, therefore there is an element of risk and uncertainty attached with such benefits.

Working Capital Management

- ① Management of investment is short term assets i.e. current assets of the firm.
- ② short term financial decisions.
- ③ There are dangers of both excessive W.C. as well as shortage of W.C.
- ④ A finance manager has to ensure sufficient and adequate working capital to the firm.

Financing Decision

- It deals with financing pattern of the firm.
- Concerned with the procurement of the required funds at the required time with minimum possible cost of capital.
- It relates to making a choice between various source of finance, and deciding optimum financing mix.

Dividend Decision

- It deals with appropriation of after tax profits.
- Dividend is the return that shareholders expect from the company for the contributions made by them towards the capital of the company.
- Therefore, Dividend decision is related to shareholder's share in the profits of the company.

OBJECTIVES OF FINANCIAL MANAGEMENT

Traditionally - Profit Maximization - but it has several limitations.

Currently objective of FM is maximization of economic well being or wealth of owners popularly known as wealth maximisation.

Objections to Profit Maximisation

- It is a vague concept. There are many definitions of profits.
- It ignores the timing of returns.
- It ignores risk.
- In new business environment profit maximization is regarded as
 - unrealistic
 - difficult
 - inappropriate

Shareholders' Wealth Maximization

- Maximizes the net present value of a course of action to shareholders.
- Accounts for the timing & risk of the expected benefits.
- Benefits are measured in terms of cash flows.

Measure of owner's economic well being

Price of a share of its market value.

Market value of shareholder's equity =
market capitalization = market price $\times$ No. of shares

Asymmetric Information (Mgt. has more information)

Fundamental objective of MGT is actually to maximize the market value of the firm's shares.

Share price is an indicator but not a sole indicator.

Wealth Maximization $\leftrightarrow$ Maximization of EPS
[It suffers from abuse.
Limitations as profit max.]

Whether maximization of EPS is same as shareholder's wealth maximization?

Should the mgt. strive to maximize EPS?
Yes, provided it should not be at the cost of wealth $\leftrightarrow$ not at the cost of long term returns.

ECONOMIC VALUE ADDED (EVA)

It is the diff. between a firm's operating profit $\leftrightarrow$ cost of capital.

$$\begin{aligned} K &= \text{cost of capital} \\ &= K_d + K_e \\ &= \text{Int'l.} \end{aligned}$$

EVA is an actual value addition.

$$\text{EVA} = \text{PAT} - K_0$$

Perfor. 2012

Determine how well a Co. has produced value for its investors.

Profit
10,000

Cost of Equity
12000

EVA
-2000

Share price should decline as there is no value added.

OR 10,000

8000

2000

MARKET VALUE ADDED (MVA)

Diff. b/w the market value of capital and amount of capital invested.

measuring the level of value a co. has accumulated ^{over time}
In theory, it is the present value of all expected future economic profits.

AGENCY RELATIONSHIPS

An agency relationship arises whenever one or more individuals called a Principal, hires another individual or organisation, called an agent, to perform some service & then delegates decision making authority to that agent.

Shareholders vs. Mgt.

Creditors vs. Shareholders

Agency Conflicts / Problems

Within the financial mgt. context, the primary agency relationships are those

- 1) b/w shareholders & managers.
- 2) b/w shareholders & creditors.

Agency Conflict on Problem 1:

(Shareholders vs. Managers)

1. Arises due to separation of ownership & mgt.
2. Managers may pursue their own personal goals at the cost of shareholders, or may play safe & create satisfactory wealth for shareholders than the maximum.

Managers may avoid taking high investment & financing risks that may otherwise be needed to maximize shareholder's wealth. Such "satisfying" behaviour of managers will frustrate the objective of SWM as a normative guide.

Agency Costs

Are incurred to reduce agency conflicts. It primarily covers:-

- 1) Managerial compensation plans - incentives - bonus, performance shares, stock options (ESOPs), various fringe benefits etc.

(2) Direct Intervention by shareholders i.e. monitoring costs - restrictive clauses, limited decision making power etc.

(3) Threat of firing

(4) Threat of takeover (Hostile takeover) - if company's stock is undervalued threat of takeover increases.

Cash rich co.'s are soft targets for acquisition.

Agency Conflict II (Shareholders vs Creditors)

Shareholders are concerned with wealth maximization while creditors want safe & regular returns.

If shareholders acting through mgt., causes a firm to sell some relatively safe assets & invest the proceeds in large new project that is far riskier than the firm's old assets then interests of creditors are avoided.

Agency Costs

1. Restrictive clauses in loan or debt agreements.

2. Representation of creditors in board of mgt.
3. Corporate Governance.

→ SWM & Accounting Regularities

Xerox - inflated, pre-tax earnings (in 2000's)

Enron - inflated earnings & concealed debt.

World com - didn't account for \$ 3.80bn expenses

Satyam

→ SWM & Social Responsibility

Not contradictory - theoretically
but practically it seems contradictory.
In long term it is beneficiary.

Now there is more towards "Maximization of stakeholder's wealth".

→ Finance Managers Role

- very imp. & dynamic in globalized era.
- Has become more strategic, CFO is now at par with CEO.
- changes in external environment such as FEMA, free pricing of shares, changes in cash-credit system, new fin. instruments etc. have added to his role.

→ The changing role of CFO & the finance function.

Then

Support function
reporting to CEO

External focus on bankers,
capital raising

Now

Strategic role,
Partnering with CEO.

Internal Focus
Focus on shareholders
value, regulatory
compliance.

RISK - RETURN TRADE-OFF

→ Risk and expected return move in tandem; the greater the risk, the greater the expected return.

→ financial decisions of the firm are guided by risk-return trade-off.

Example : for investment decision

— small, medium & large plant.

Financing decision

More financial risk - debt
less fin. risk - equity

[acc. to
co.'s point
of view]

(High risk)

→ Venture Capital funding is
from equity capital.
(less risky)

Dividend distribution - less risk, less return.
Retained earnings - high risks, high returns.

Working Capital Requirement high
- Low risk, low return.

The return & risk relationship

Return = Risk-free rate + Risk premium

Risk-free rate is compensation for time
& risk premium for risk.

CAPM

$$E(R) = R_F + (R_M - R_F) \beta$$

Time Value of Money (Time Preference for Money)
Means that a sum of money has more value now, rather than the same amount at some future time.

money received today has more value than money received in future

Reasons:-

1. Risk & uncertainty $\rightarrow$ future money has uncertainty
2. Re-investment opportunities
3. Preference for current consumption.

Investment Decision: It is related to the decision up relating to Assets Composition of the firm.

Fixed Assets $\rightarrow$ Capital Budgeting decision

Current Assets $\rightarrow$ Working Capital Management

$\rightarrow$ If interest rate is zero, will there be time value of money?

Yes, because of risk & preference for consumption.

$\rightarrow$ If there is no inflation, will there be time value of money?

1.10 Combined $\rightarrow$ yardstick for economic efficiency of any firm.

Profit Maximization vs wealth Maximization

The objective of profit maximization measures the performance of a firm by looking at its total profit. It does not consider the risk which the firm may undertake in maximization of the profit. The profit maximization, as an objective does not consider the effect of coming per share, dividend paid or any other return to shareholders on the wealth of the shareholders.

Firm is concerned with financial decision

- Investment Decision - all the decision relating to Assets Composition of the firm.
- Financial decision
- Dividend decision

Financial Decision: It deals with financial pattern of the firm. Whether we should go for

Shareholder funds or borrowed funds

$$\text{Sinking fund (Annuity)} = \frac{FV}{CVFA}$$

$$FV = \text{Annuity} \times CVFA$$

25/7/12

Annual Compounding

$$FV = PV (1+r)^n$$

$$FV = P(1+r)^n$$

$$P \times CVF$$

Semi-annual Compounding

$$FV = PV \left(1 + \frac{r}{2}\right)^{2n}$$

Continuous Compounding

$$FV = PV e^{rt}$$

NPV is a financial decision is the diff. b/w PV of Cash inflows & PV of Cash Outflows

$$NPV = \sum_{t=1}^n \frac{C_t}{(1+k)^t} - C_0$$

FV of ...

$$FV =$$

$$= [P \times CVFA]$$

$$PV = \frac{FV}{(1+r)^n}$$

$$PV = \frac{FV}{(1+r)^n}$$