Fundamentals of Financial Management

Chapter 1

BOOK TO BE REFERRED : Fundamentals of Financial Management by

R.P. Rustagi

Vanitha Chadha
Department of Commerce

FINANCE AS A AREA OF STUDY

TYPES OF FINANCIAL ACTIONS

- Financial Management of trading or manufacturing firms
- Financial Management of Financial Institutions
- Financial activities relating to investment management
- International Finance
- Public Finance

SCOPE OF FINANCIAL FUNCTION

- Procuring the required quantum of funds as and when necessary, at the lowest cost
- Investing these funds in various assets in the most profitable way
- Distributing returns to the shareholders in the order to satisfy their expectations from the firm

DECISIONS TAKEN BY FINANCE MANAGER

1. INVESTMENT DECISIONS
   a) CAPITAL BUDGETING DECISIONS
   b) WORKING CAPITAL DECISIONS
2. FINANCING DECISIONS
3. DIVIDEND DECISIONS

GOAL OR OBJECTIVE OF FINANICIAL MANAGEMENT

A good objective of financial management should have the following characteristics

- It should be clear and unambiguous
- It comes with a clear and timely measure that can be used to evaluate the success or failure of a decision
- It should be consistent with the long term existence of the firm

GOALS OF FINANCIAL MANAGEMENT

- MAXIMIZATION OF THE PROFITS OF THE FIRM
- MAXIMIZATION OF THE SHAREHOLDERS WEALTH

MAXIMIZATION OF THE PROFITS OF THE FIRM

BENEFITS

- The profit can be measured in terms of the accounting total profit available to the shareholders.
- The profit is regarded as the yardstick for the economic efficiency of any firm
- The profit maximization as objective will result in efficient allocation of the resources not only from the point of view of firm but also for the society as such

MAXIMIZATION OF PROFITS

LIMITATIONS

- It ignores risk
- It concentrates on profitability only and ignores the financing aspect of the decision and risk associated with that financing
- It ignores timing of costs and returns and thereby ignores the time value of money
- The profit maximization as an objective is vague and ambiguous
- It can widen the gap between the perception of the management and the shareholders
- It concentrates on immediate effect

MAXIMIZATION OF SHAREHOLDERS WEALTH

- The measure of wealth which is used in Financial management is the concept of "Economic Value".
- The economic value is defined as the present value of the future cash flows generated by a decision, discounted at appropriate rate of discount which reflects the degree of associated risk.
- The economic value concepts takes into account the timing of cash flows
- It takes into account the risk through discounting process.
- The shareholders wealth is represented by the present value of all the future cash flows in the form of dividends or other benefits received from the firm
- The market price of the share reflects this value.

MAXIMIZATION OF SHAREHOLDERS VALUE contd..

- The maximization of shareholders wealth as an objective implies that financial decisions will be taken in such a way that the shareholders receive highest combination of dividends and increase in market price of the share.
- The underlying assumption in this approach is that the shares are traded in efficient capital markets.
- This goal implies long term perspective of the firm. The market price reflects all the future benefits from the firm t its shareholders, therefore the management cannot focus on short term profits at the cost of long term perspective.
- The goal is linked to the three basic decisions of the firms namely, investment decision, financing decision and the dividend decision.

MAXIMIZATION OF SHAREHOLDERS WEALTH

LIMITATIONS

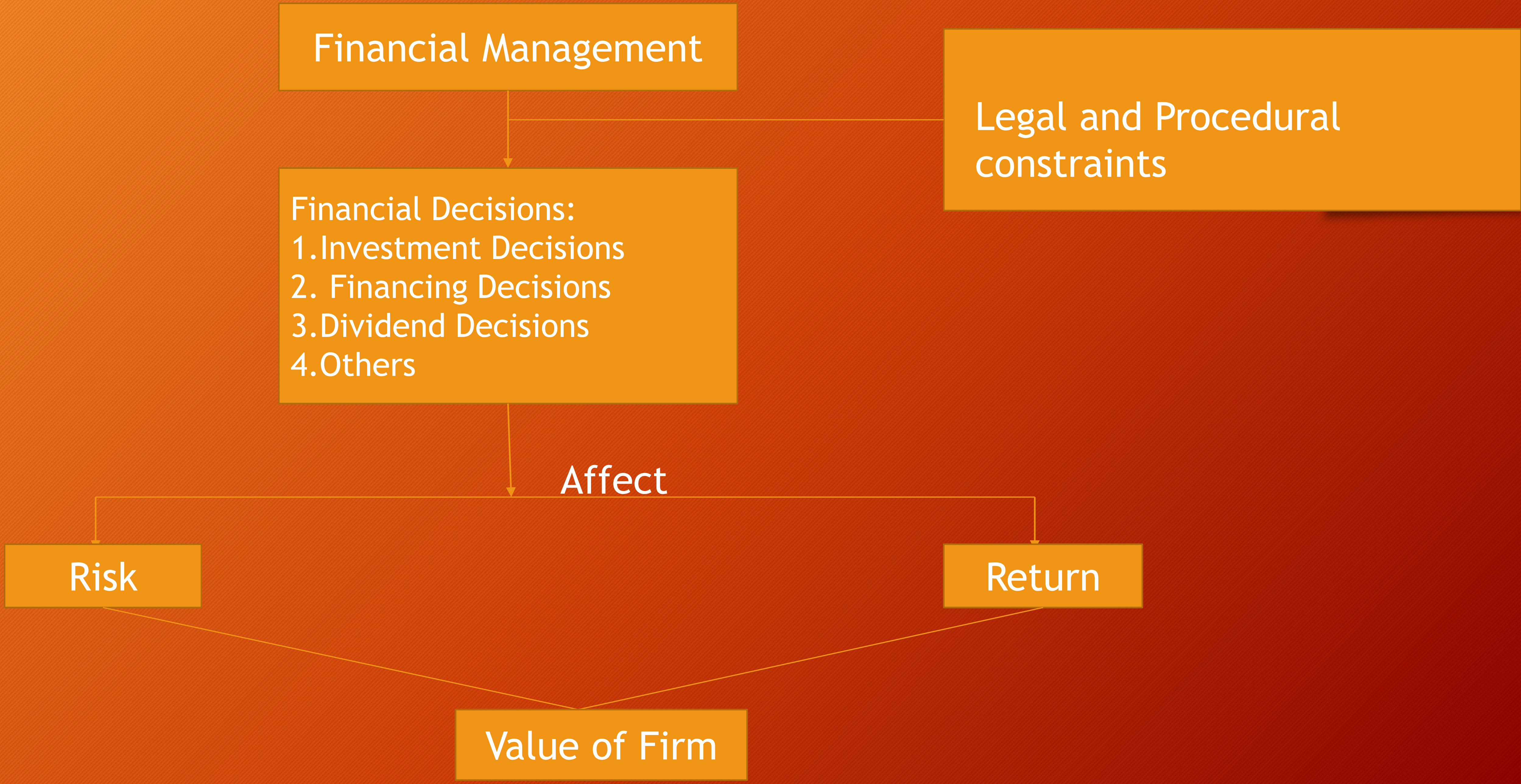
- The first limitation is the assumption of efficient capital markets that reflect true values of shares. But in practice, the share values are subject to many extraneous factors. The prices are influenced by the social, economic and political scenario in the country.
- Another limitation is that there are other stakeholders in the company apart from shareholders like creditors, professional managers and employees.

Profit Maximization vs Wealth Maximization

- The objective of profit maximization measures performance only on the basis of total profit. It ignores risk and does not take into account the effect of earnings per share, dividends paid or any other return to shareholders
- The objective of maximization of shareholders wealth considers all cash flows, dividends, earning per share, risk of the decision etc.
- The objective of shareholders wealth maximization is operational and objective in its approach. The shareholders would prefer an increase in wealth against the generation of increasing flow of profits to the firm.

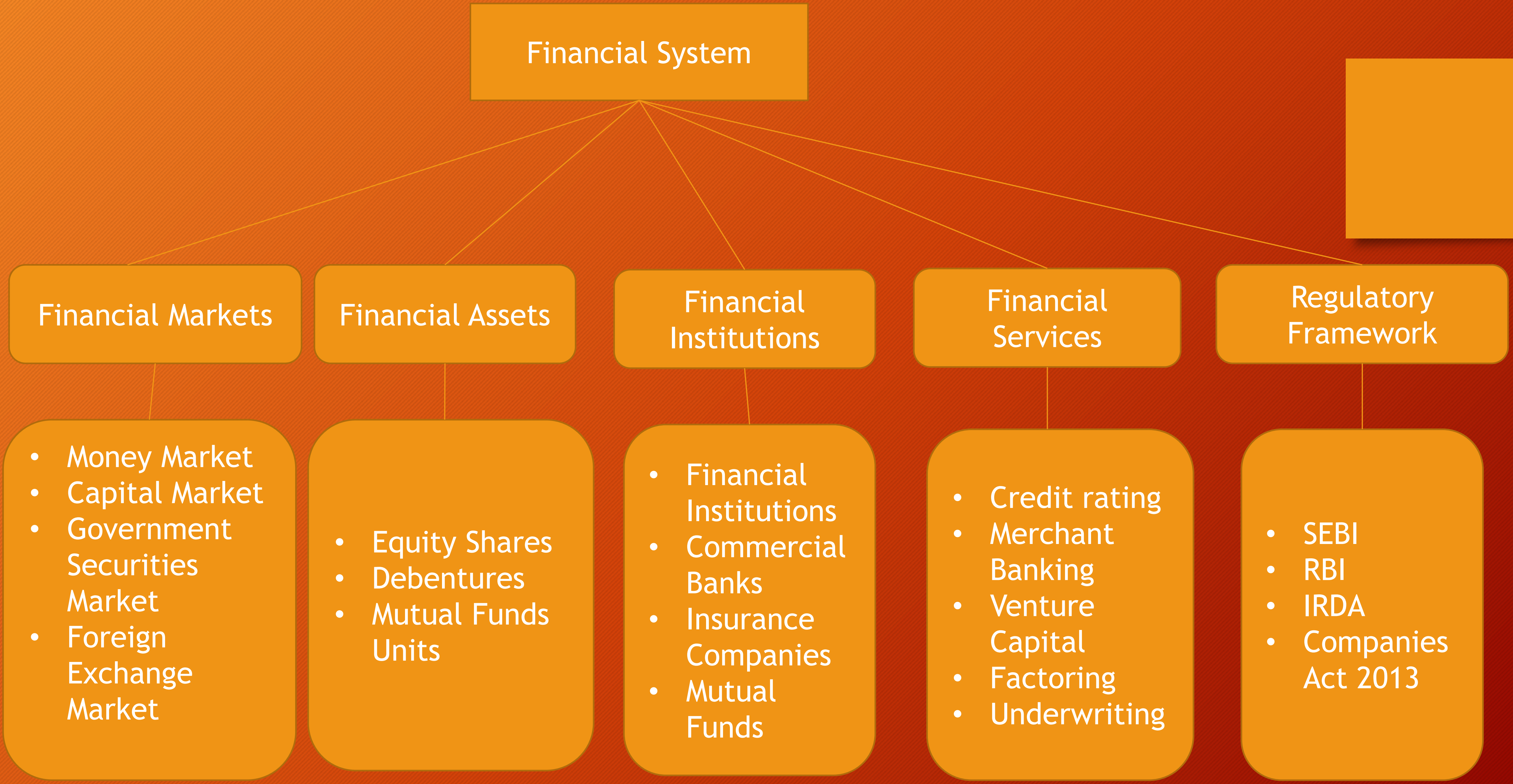
RISK AND RETURN OF FINANCIAL DECISION

- In financial management, the risk is defined as the variability of expected returns from an investment.
- The investment in equity shares is risky as compared to fixed deposits as the returns are variable.
- There is distinction between risk and uncertainty. Risk exists when the decision maker is able to estimate the probabilities associated with the different outcomes. Whereas under uncertainty the decision maker has no past data to develop probabilities
- Returns associated with a decision is measured as the total gain or loss expected over a given period of time by the decision maker. It may be defined as the return on the original investment made in particular asset.
- Every financial decision involves trade off between risk and return and optimize the level where the market price of the share is maximized.


Financial Management
Legal and Procedural constraints
Financial Decisions:
1.Investment Decisions
2. Financing Decisions
3.Dividend Decisions
4.Others
Affect
Risk
Return
Value of Firm

FINANCIAL MANAGEMENT CONCERNS

- The financial management is concerned with various types of decisions (investment, financing, dividend).
- It has the operational goal of shareholders wealth maximization
- It includes the analysis of different types of information
- It evaluates the risk and return perspective of all alternatives
- It encompasses the management of long term as well as short term assets.


Financial System
Financial Markets
Financial Assets
Financial Institutions
Financial Services
Regulatory Framework
Money Market
Capital Market
Government Securities Market
Foreign Exchange Market
Equity Shares
Debentures
Mutual Funds Units
Financial Institutions
Commercial Banks
Insurance Companies
Mutual Funds
Credit rating
Merchant Banking
Venture Capital
Factoring
Underwriting
SEBI
RBI
IRDA
Companies Act 2013