FLC

Finance Learning Center

CHAPTER - 01

Introduction of Finance &

Financial Management

CONTENTS

01. INTRODUCTION

In simple term, Finance is concerned with decisions about money. Financial decision deals with how business, governments, and individuals raise and use money. That's why Finance is said to be the Applied Economics and the field of Finance is closely related with Economics and Accounting. Economics provides a stricter for decision making in such areas as risk analysis, pricing theory through supply and demand analysis, and many other important areas. Economics also provides the broad picture of the Economic environment in which corporations must continually make decisions. A basic knowledge of economics is therefore, necessary to understand both the environment and decision making techniques of financial management. Accounting is something said to be the language of finance because it provides financial data through income statements, balance sheets and the statements of cash flows. The financial manager must know how to interpret and use these statements in allocating firms resources to generate the best return possible in the long run. **So finance links economic theory with numbers of accounting**. At the very beginning of this chapter, readers will get an overall idea about nature, functions, goals of finance and financial management.

02. ORIGIN AND DEVELOPMENT OF FINANCIAL MANAGEMENT

The concept of financial management is not created in a day or a year. It has been created by the influence of time and changing environment. Before 1890, it was considered as a branch of Macro economics. The evolution of financial management is briefly mentioned below:

YEAR	IMPORTANT EVENTS
1890-1900 (Business merging, preparation & analysis of financial management)	***1897:*** Famous writer Thomas L. Green had published a book named **"Corporation Finance".** ***1899:*** J.D Rocky Felar merged the Standard Oil group of companies by establishing the Standard Oil Company in U.S.A. for this merging, a large amount of financing was needed. ***1900:*** Creation of U.S. Steel Company had controlled the 63% market share which had 1.4 billion USD. • Financial Statement was prepared and analyzed only for the need of companies.
1900-1910 (Attention to investors interest)	During this period, the interest of investors was emphasized More than before. So, the control of government had increased. Therefore, business enterprises had been revealed financial information.
1910-1920 (Industrial revolution & technological development)	***1913:*** • For the technological development and the success of Henry Ford created large production which lead to earn profit. • Many new industries were established because of industrial revolution. • Admon Elicson C.W. Garstanbarse published a new book of finance. • Use of computer had been started.
1920-1930 (Application of analytical technique)	Use of computer had been increased for solving multifarious problems.

1930-1940 (Depression & Recovery)	• 89% of the share price of Dow Jone's had been decreased. • The share price of U.S. Steel Company had been decreased from $261 to $21. • General motor: $92 to $7. • RCA: $115 to $3. • Unemployment increased in 5%. • Most of the company of U.S. had become bankrupt for the World War 2.
1940-1960	• Creation of capital budgeting and other related subjects in financial management. • It was called the evolution of modern financial management.
1950-1960	***1952:*** Markowitz published Portfolio Theory. ***1958:*** Sharpe, Linteer, Famaxy used this theory more appropriately in financial management.
1960-2000 (Growth of Modern Finance)	• Many other important subjects were added in the scope of financial management. • Theory: CAPM, Option Model, Arbitrage Pricing Theory. • Use of computer had been increased hugely.

03. FINANCE AND OTHER RELATED SUBJECTS

Financial management itself not an independent discipline. Different related disciplines such as- Economics, Accounting, Marketing, Production management, Quantitative methods etc. are also closely related with the concept of financial management.

Finance & Economics

Macro-economics is concerned with the overall institutional environment in which the firm operates such as-

- ✓ The institutional structure of the banking system.
- ✓ Money and capital markets.
- ✓ Financial intermediaries.
- ✓ Credit and fiscal policies.

The Financial manager should-

- ✓ Understand how monetary policy affects the cost and the availability of fund.
- ✓ Be versed in fiscal policy.
- ✓ Understand the consequences of various levels of economic activity.
- ✓ Understand the changes in economic policy.

Micro-economics deals with the determination of optimal operating strategies. The concepts of Micro-economics relevant to financial management are:

- ✓ Supply and demand relationship and profit maximization strategies.
- ✓ Issues related to optimal sales level and product pricing strategies.
- ✓ The measurement of utility preference, risk and determination of value.
- ✓ The rationale of depreciating assets.

Finance & Accounting

The relationship between Finance and Accounting has two dimensions:

i. They are closely related in financial decision making.
ii. There are key differences between them.

Firstly, Accounting is a sub-function of Finance. The end product of Accounting constitutes financial statements such as the Balance Sheet, Income Statement, Statement of changes in financial position and Cash flow statement and reports, which assists financial managers in assessing-

- ✓ The past performance.
- ✓ The future directions of the firm.

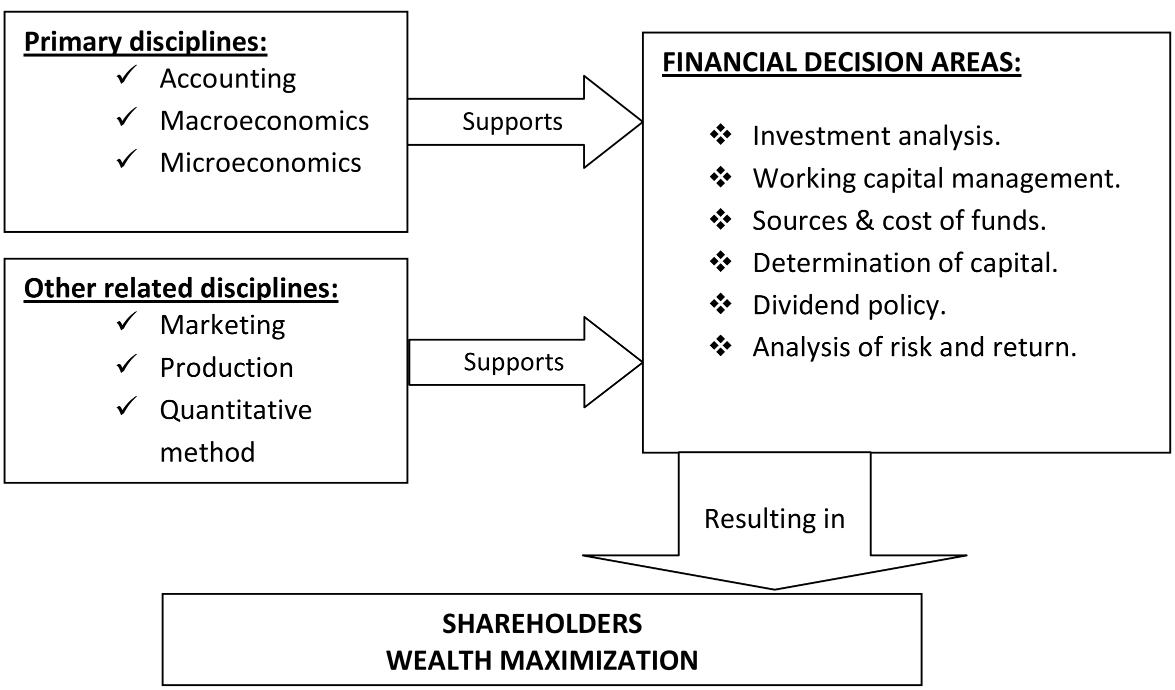
Thus, Accounting and Finance are closely related.

Secondly, the key differences between Finance and Accounting are:

POINTS	ACCOUNTING	FINANCE
Treatment of fund	The measurement of funds in Accounting is based on accrual principle. Here, revenue is recognized at the period of sale and not when collected.	The treatment of funds is based on cash flows. Here, the revenue is recognized only when actually received in cash.
Decision making	The primary focus of the functions of accountants is collection and presentation of financial data.	The financial manager's major responsibilities are- ✓ Financial planning. ✓ Controlling. ✓ Decision making.

Finance & Other Related Subjects

The relationship between financial management and other related disciplines are depicted below:



04. DEFINITION OF FINANCE

Generally, whenever we discuss about finance we mean only the sources of fund. For example - Sometimes people say, "*We want to do this business but who will finance us*?" That means there finance refers to the sources of fund.

Again sometimes we mean finance as deployment of fund. For example - Sometimes we hear that people say, "*I have sufficient fund but I don't understand where to finance for maximizing my return?*" That means there finance refers to the proper selection of investment or uses of fund.

Thus we can say that, Finance refers the activities consisting selection of sources of fund at a minimum cost and utilization of funds for maximum return.

Finance concerns itself with the actual flows with the:

- ✓ Actual flows of money.
- ✓ As well as any claims against money.

05. DEFINITION OF FINANCIAL MANAGEMENT

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise. The decision function of financial management can be broken down into three major areas:

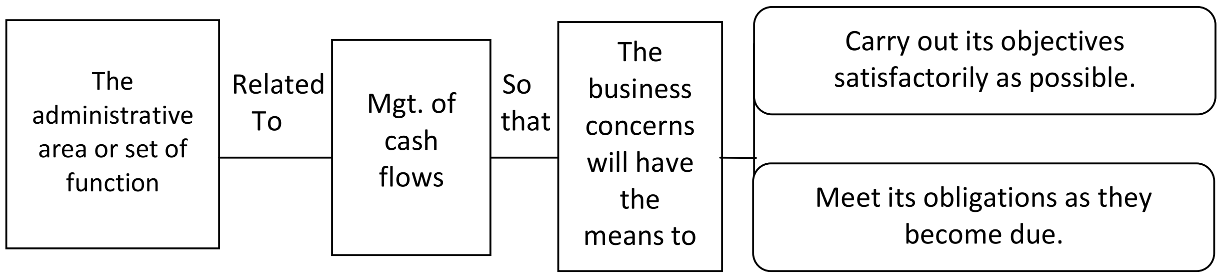
- ✓ Investment.
- ✓ Financing and
- ✓ Asset management.

06. DEFINITION OF BUSINESS FINANCE

Business finance means finance required for promoting and running trade, commerce or industrial undertakings. It broadly refers to those activities involved in seeing that a manufacturing enterprise or business organization has the cash with which to meet its pay bills, to purchase raw materials, to construct buildings, to equip plant with machinery and to provide many services promptly.

The area of finance dealing with monetary decisions that business enterprises make and the tools and analysis used to make these decisions.

On the other hand, we can say that activities of business concern relevant to financial planning, co-ordination, controlling and their application is called business finance. In other words,



07. FUNCTIONS OF FINANCE

1. **Financial Planning:**

   Individuals and corporations make their plan according to their capability. Financial planning includes these factors:

   - ✓ Selection of sources.
   - ✓ Time period of collection.
   - ✓ Cost of financing.

2. **Identification of Source of Fund:**

   After planning finance manager consider various sources of finance. In a general business organization sources may be of two types:

   a) **Internal source:** Owner's equity, provision for depreciation, retained earnings etc.

   b) **External source:** Bank loan, loan from trade creditors, share debenture etc.

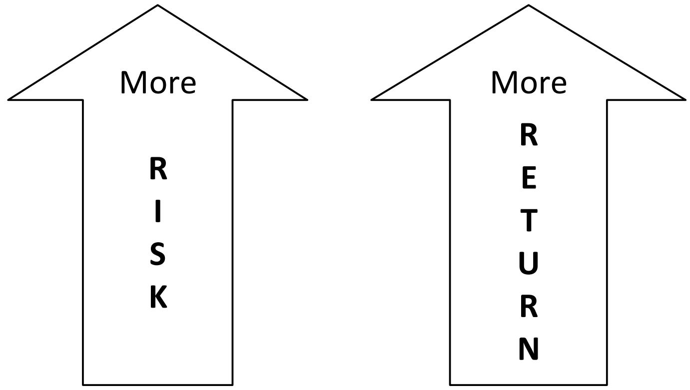
3. **Procurement of Fund:**

   Collecting fund from the identified sources is one of the most crucial task of finance. Financial manager has to consider several factors while collecting funds like:

   - ✓ Size of fund.
   - ✓ Repayment method.
   - ✓ Time period.
   - ✓ Cost.

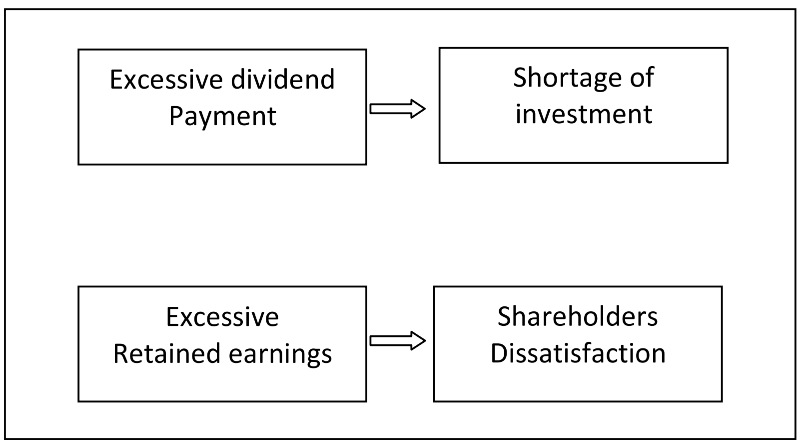
4. **Investment of Fund:**

   According to planning made earlier, finance manager invest the fund in highest profitable project. In order to get profit he/she has to handle risks involved in investment.



5. **Distribution of Profit:**

   From the earned profit firm has to make a balance between dividend and provision for retained earnings.



6. **Risk-Return Trade Off:**

   Where there is no risk, there will be no gain. So facing risk is must to gain profit. But risk should not be such that will hinder capital flow. So it is the most important task of finance to balance between risk and expected return.

7. **Cost Control:**

   Several strategies of finance help to control cost. Producing quality product and services with minimum cost is the complex task of finance.

8. **Protection of Fund:**

   Financial management helps to make balance between cash inflow and outflow. It is done through proper working capital management.

9. **Management of Asset:**

   It is necessary to keep assets with a proper combination of current assets and fixed assets. Firm's asset mix depends on:

- ✓ Firm's liquidity &
- ✓ Profitability.

10. **Other Tasks:**
    - Protection of cash balance and documents.
    - Determining costs.
    - Accounting for funds and financial assets.
    - Preparation of financial statements.
    - Tax planning & analysis.
    - Relationship between various banks & financial institutions.
    - Risk management.
    - Credit management.
    - Employees pension management.
    - Creation & conservation of financial relation.

08. PRINCIPLES OF BUSINESS FINANCE

1. **Principle of Risk & Return Trade-Off:**

   This principle is used to measure the effects of risk and uncertainty on the profitability of a firm.

2. **Principle of Time Value of Money:**

   Money has a time value. That is value of money changes over time. A rational person is not indifferent between having a taka today or a taka in the future. So to determine the proper value of investment, it is necessary to determine its time value by calculating future value.

3. **Principle of Valuation of Asset (Investment):**

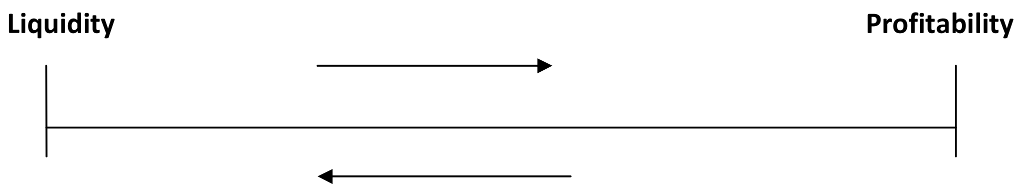
   The value of an asset is equal to the present value of its future cash flows. The rate is used for the present value calculation should be the minimum acceptable return, given the risk of the investment.

   Value = Present Value of Future Cash Flow or

   Value = Future cash flow × Present Value Factor

4. **Liquidity Vs. Profitability:**

There is a trade-off between liquidity and profitability, gaining more of one ordinarily means giving up some of the other.



5. **Principle of Diversification (Portfolio):**

As assets are added to a group (portfolio), the risk of the total portfolio decreases. If funds are investment in such way, profit of one project will offset the loss of others.

6. **Principle of Maximization of Asset:**

Net cash inflow from various investment projects should be used to maximize value of assets. Here net inflow means inflow after deducting provision for depreciation and risk. This principle helps to maintain qualitative measurement of asset.

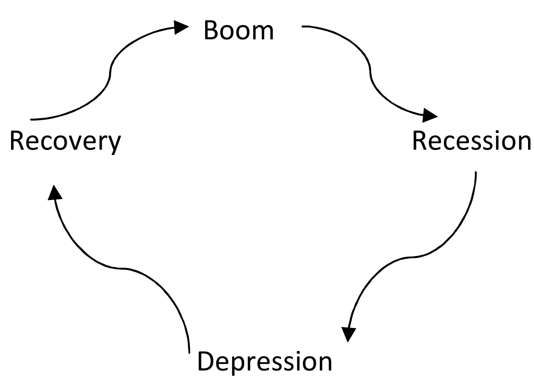
7. **Principles of Perfection:**

This principle implies that:

- Current asset should be funded from short-term sources like; Trade credit.
- Fixed asset should be financed through long and mid term sources of finance like; Issuing share, debenture etc.

8. **Principle of Business Cycle:**

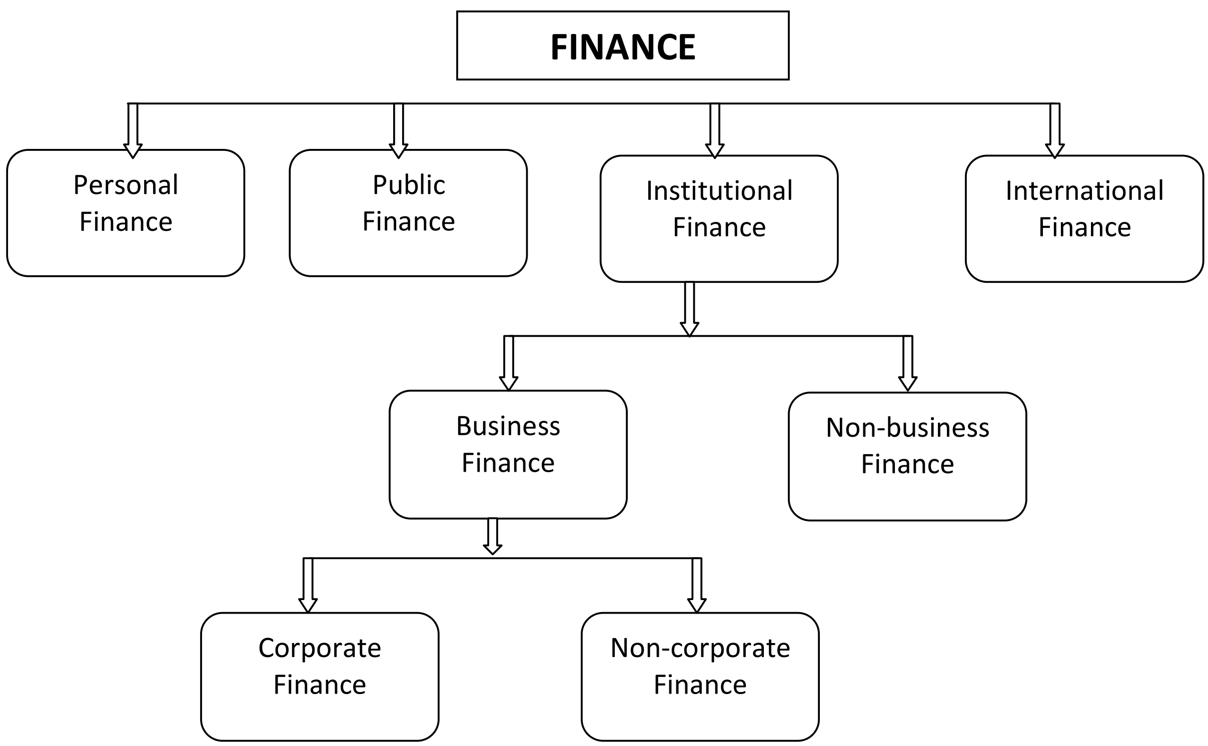
In taking financial decision overall economy of the country should be taken into account.



9. **Other principles:**

- Principle of internal financing.
- Principle of priority.
- Principle of minimum flotation cost.
- Principle of minimum cost of capital.
- Principle of debt payment.
- Principle of transparency and accountability.
- Principle of firm's goal congruence.
- Principle of consistency.

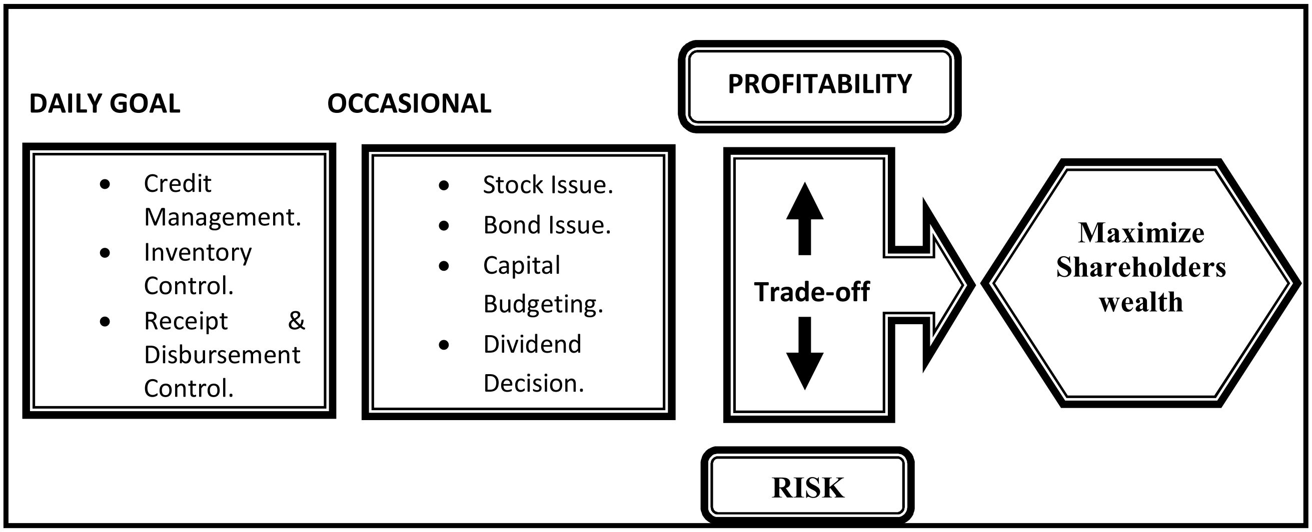
09. CLASSIFICATION / SCOPE OF FINANCE



Brief description is given under each category in following table:

1.	Personal Finance	**User:** Individual practices strategies of finance in handling day to day and speculative expenditures. **Source:** Business, job, inherent wealth, loan from relatives, banks, co-operative society.
2.	Public Finance	**User:** Government uses this to finance development & non-development expenditures and also expenditure for its own administration. **Source:** Revenue income, fees, loan from banks, foreign countries, foreign grants, income from government business etc.
3.	Institutional Finance	**User:** Mills and factories, banks, insurance, post office, hospital, religious, educational, cultural, legal institutions.
3.1	Business Finance	**User:** Used by institutions run with a view to earning profit like banks, insurance, mills, other business organizations etc.
3.1.1	Corporate Finance	**User:** Public and private limited companies. **Source:** Issuing share, debenture, and loan from banks and financial institutions.
3.1.2	Non-Corporate Finance	**User:** Used by business institutions other then joint stock companies like: sole proprietorship, partnership, co-operative societies etc. **Source:** Own capital, loans from banks
3.2	Non-Business Finance	**User:** Used by hospitals, charitable, religious, educational institutions, public administration, postal office, non-profit organizations etc.
4.	International Finance	**User:** Used by various countries and international organizations while granting aid, providing loan, taking export-import decision etc. Foreign exchange market, international stock markets, exchange rate determination etc are some instruments used by international finance.

10. GOALS OF FINANCE



In determining the soundness of owners financial position there are two several approaches:

- **Profit/EPS Maximization:**

In short run main objective of a firm is to maximize profit. Classical economist supports this approach.

Generally, **Profit= Total Revenue - Total Expense.**

So it can be said that, profit is the income which can be gained by providing quality product and services at a lower cost and the process of increasing profit by boosting up production and selling is called profit maximization.

Rational of Profit Maximization:

- ✓ Profit is the yard stick of measuring efficiency.
- ✓ Proper utilization of resources is possible.
- ✓ Social well-fare can be ensured.

Criticism:

- ✓ **Partly true:** This approach is mainly applicable for:
  - **Sole proprietorship business.**
  - **Fully competitive market.**
- ✓ **Ignore time value of money:** This is the major shortcoming of this concept that it doesn't take into account the value of money under different time period.

- ✓ **Ignore risk:** This approach does not consider the relationship between risk and profit.
- ✓ **Small interest:** It considers only the interest of owner not the other stakeholders.

- **<u>Wealth Maximization:</u>**

This approach was introduced at the beginning of 20th century. Wealth maximization means increasing the firm's net present value in long time period. In other words, it means maximizing the net present value of a course of action to shareholders. This is the difference between present value of its benefits and costs. In fact wealth maximization provides an unambiguous measure in making investment and financing decision.

<u>Rational of Wealth Maximization:</u>

- ✓ Clear concept.
- ✓ Consideration of Time Value of Money.
- ✓ Both quantitative and qualitative consideration.
- ✓ Emphasize on increase in the share price.

11. WHY WEALTH MAXIMIZATION IS CONSIDERED AS BETTER THAN PROFIT MAXIMIZATION?

In current academic literature, value maximization is almost universally accepted as an appropriate operational decision criterion for financial management decision. Because it removes the technical limitations of profit maximization approaches.

Its operational features satisfy three requirements of a suitable operational objective of financial course of action, namely,

- ✓ Exactness.
- ✓ Quality of benefits.
- ✓ Time value of money.

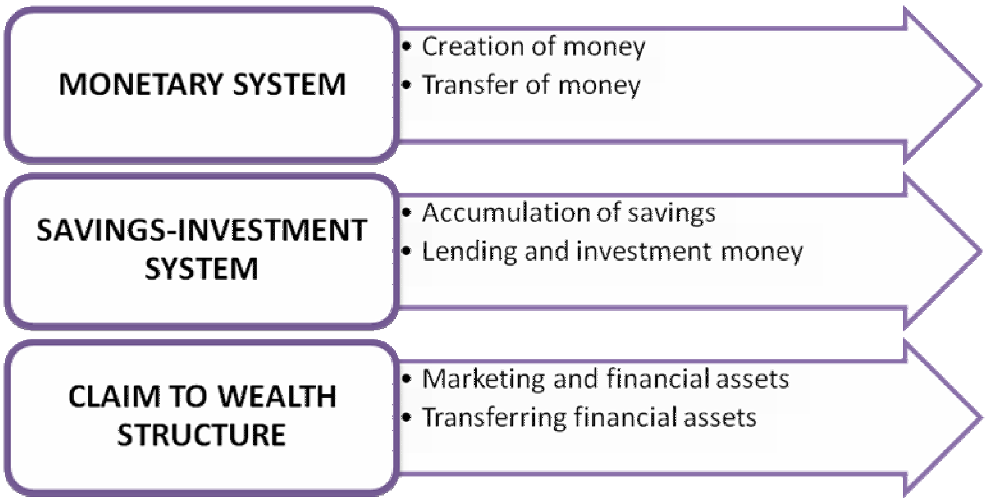
Further, value maximization approach is based on the concept of cash flows generated by the decision rather than accounting profit.

12. IMPORTANT ROLE OF AN EFFECTIVE FINANCIAL SYSTEM

Three important features are needed for an effective financial system, these are:

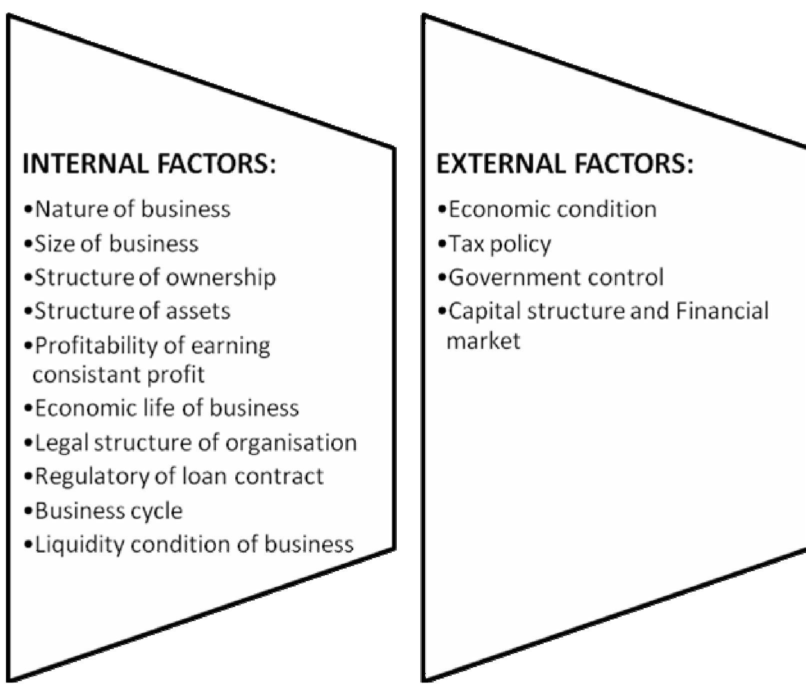
1. Monetary system.
2. Savings-investment system.
3. Claim to wealth structure.

The following chart is given to explain it:



13. FACTORS ARE INFLUENCING IN FINANCIAL DECISION

Financial manager has to take decision in three criteria such as investment, financing and dividend decision in financial management. Many factors influence while taking such decisions. These are:



i. **Nature of Business:** It influences financing and dividend policy.

For example,

- In manufacturing and public welfare organization→ Financing in fixed assets is necessary.
- In utility service organization→ Financing in current assets is necessary.

ii. **Size of Business:** Sole proprietorship and partnership business are small in size. So, they cannot invest in fixed assets largely. Thus size of business is a necessary factor influencing financial decision.

iii. **Structure of Ownership:** It influences largely in taking financial decision.

iv. **Structure of Assets:**

- In manufacturing and welfare organization→ large amount of fixed asset→ financing in fixed assets through pledging.
- In utility service organization→ small amount of fixed asset→ financing in current assets.

v. **Profitability:** The financial manager can finance the business organization which has the profitability of earning constant profit.

vi. **Economic Life of Business:** Investment opportunity in new business organization is less than the old organization.

vii. **Legal Structure of Organization:**

- In case of sole proprietorship and partnership→ Weak legal structure→ Less credit opportunity.
- In case of Joint stock company→ Strong legal structure→ More credit opportunity.

viii. **Regulatory of Loan Contract:** Regulatory loan contract influences financial decision of a financial manager.

ix. **Business Cycle:** Business phases like recession or pick period influence greatly in adopting financial decision.

x. **Liquidity Conditions of Business:** Before taking dividend policy, a financial manager has to consider the importance of the amount of cash, funds needed for the repayment of debt and working capital.

xi. **Economic Conditions:** If the economic condition of a country remains uncertain, then it discourages investment.

xii. **Tax Policy:**

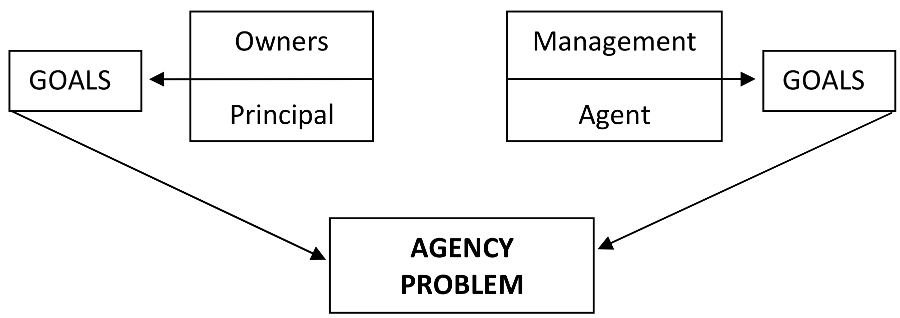
- Rigid tax policy → Discourages investment.
- Free tax policy → Encourages investment.

xiii. **Government Control:** Control of government in economy largely influences financial decision of a manager.

xiv. **Capital Structure and Financial Market:** If the financial institutions and the financial markets of a country are controlled, upgraded and well-established, then it is possible for the financial manager to take risk for short-term and long-term financing from there.

14. AGENCY PROBLEM

Agency problem is the likelihood that managers may place personal goals ahead of corporate goals.



15. TYPES OF AGENCY PROBLEM

Agency problem may be three types:

i. **Managers vs. Owners:** When ownership and management are isolated from each other, this problem creates.

ii. **Creditors vs. Owners:** Creditors invest their assets to the owners. So, they want to investigate the owners. On the other hand, owners also want to direct the creditors and then the problem arises.

iii. **Owners vs. Other Parties:** The purposes of owners and the workers, buyers and social communities are not alike. So, they never come to a single point of purpose. It creates agency problems.

16. AGENCY COST

In order to remove the agency problem, shareholders have to bear some expenses which are called agency cost. Generally four types of agency costs are available namely:

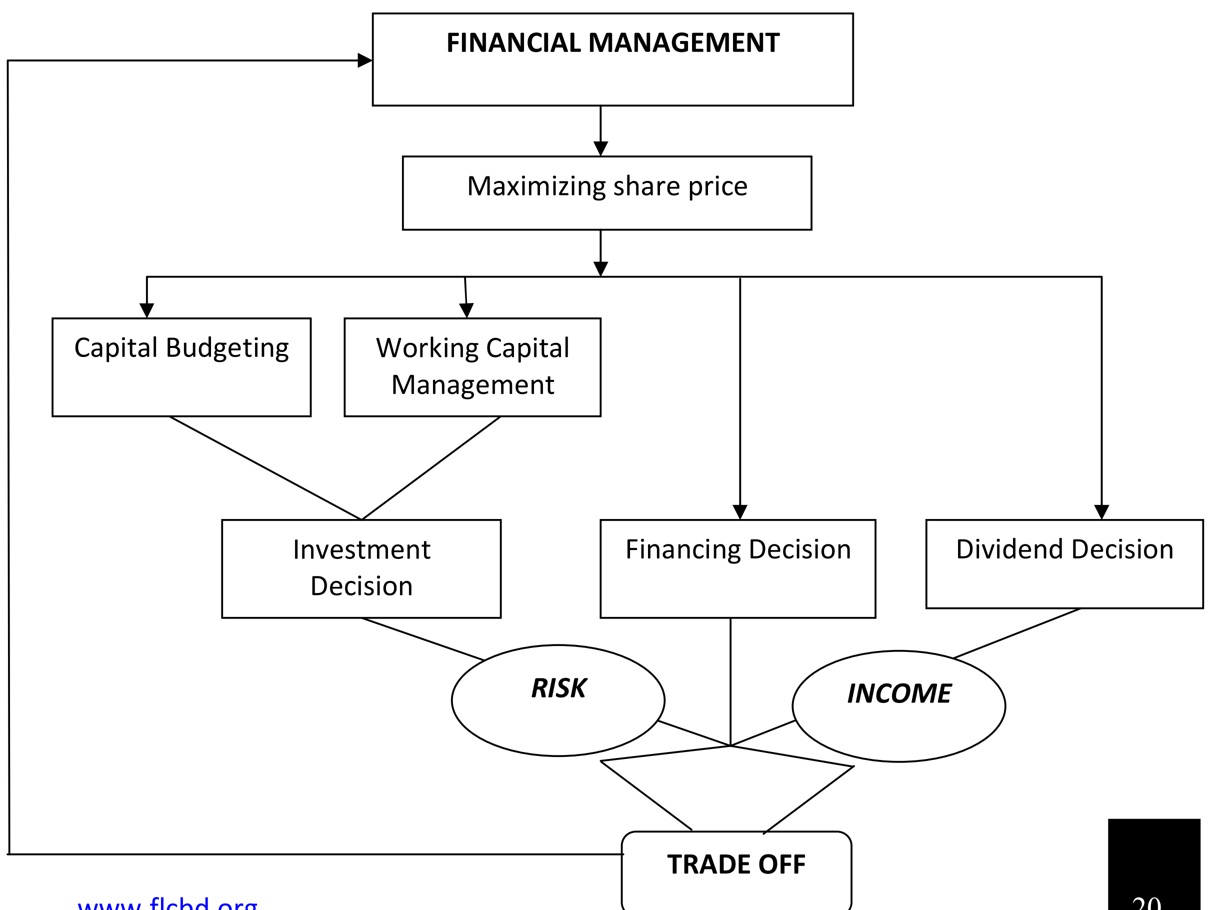
i. Monitoring expenditure.
ii. Bonding expenditure.
iii. Opportunity cost.
iv. Structuring expenditure.

17. HOW TO ADJUST THE INCOME RISK IN MAIN FINANCIAL DECISION OF BUSINESS?

The basic financial decisions of a business enterprise are:

- Investment decision.
- Financing decision.
- Dividend decision.

The financial decisions are interrelated to each other and greatly affect on market price of share. In every business, there is risk. But this risk has to adjust with the increasing profit. How the financial decisions reconcile with the risk and return is shown in the following diagram and it is called Trade-off:



POINTS TO REMEMBER

01. Finance refers to the act of providing the means of payment.
02. **Finance and other related subjects:**
    - **Economics and Finance:** Knowledge of economics is necessary for a financial manager to understand both the financial environment and decision theories.
    - **Finance and Accounting:** There are two basic things. Firstly, accounting function is a necessary input for the financial function. Secondly, finance begins where accounting ends.
03. **The main goal of finance** is to maximizing wealth of the organization which means increasing the net present value of assets.
04. **Financial management** means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.
05. **Important role of an effective financial system:** The main role of financial system plays in the monetary system, savings-investment system and claim to wealth structure system.
06. **Factors are influencing in financial decision:** Financial decision of every organization cannot be same. Because there are some external and internal factors which affects the decision greatly resulting various types of risk and return.
07. **How to adjust the income risk in main financial decision of business?** The three financial decisions i.e. investment, financing and dividend decision are interrelated to each other. These decisions are reconciled with risk and return. It is called **TRADE-OFF.**
08. **Agency problem:** The problem which arises from the different purposes of owner and management.
09. **Types of Agency problem:** Basically there are three types of agency problem which are:
    - Managers vs. owners.
    - Creditors vs. owners.
    - Owners vs. other parties.
10. **Agency cost:** The cost is used for removing agency problem.