**FINANCIAL MANAGEMENT**

**BBA N-402**

**UNIT 1**

**INTRODUCTION**

**MEANING OF FINANCE**

Finance may be defined as the art and science of managing money. It includes financial service and financial instruments. Finance also is referred as the provision of money at the time when it is needed. Finance function is the procurement of funds and their effective utilization in business concerns.

The **concept of finance** includes capital, funds, money, and amount. But each word is having unique meaning. Studying and understanding the concept of finance become an important part of the business concern.

**DEFINITION OF FINANCE**

According to Khan and Jain, “Finance is the art and science of managing money”.

According to Oxford dictionary, the word ‘finance’ connotes ‘management of money’. Webster’s Ninth New Collegiate Dictionary defines finance as “the Science on study of the management of funds’ and the management of fund as the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of banking facilities.

**DEFINITION OF BUSINESS FINANCE**

According to the Wheeler, “Business finance is that business activity which concerns with the acquisition and conversation of capital funds in meeting financial needs and overall objectives of a business enterprise”.

**TYPES OF FINANCE**

Finance is one of the important and integral part of business concerns, hence, it plays a major role in every part of the business activities. It is used in all the area of the activities under the different names. Finance can be classified into two major parts:

1. **Private Finance**

* Individual Finance
* Partnership Finance
* Business Finance

1. **Public Finance**

* Central Government
* State Government
* Semi Government

**DEFINITION OF FINANCIAL MANAGEMENT**

Financial management is an integral part of overall management. It is concerned with the duties of the financial managers in the business firm. The term financial management has been defined by Solomon, “It is concerned with the efficient use of an important economic resource namely, capital funds”. The most popular and acceptable definition of financial management as given by S.C. Kuchal is that “Financial Management deals with procurement of funds and their effective utilization in the business”.

**SCOPE OF FINANCIAL MANAGEMENT**

Financial management is one of the important parts of overall management, which is directly related with various functional departments like personnel, marketing and production. Financial management covers wide area with multidimensional approaches. The following are the important scope of financial management:

1. Financial Management and Economics Economic concepts like micro and macroeconomics are directly applied with the financial management approaches.

2. Financial Management and Accounting records includes the financial information of the business concern. Hence, we can easily understand the relationship between the financial management and accounting

3. Financial Management or Mathematics Modern approaches of the financial management applied large number of mathematical and statistical tools and techniques.

4. Financial Management and Production Management Production management is the operational part of the business concern, which helps to multiple the money into profit.

5. Financial Management and Marketing Produced goods are sold in the market with innovative and modern approaches. For this, the marketing department needs finance to meet their requirements.

6. Financial Management and Human Resource Financial management is also related with human resource department, which provides manpower to all the functional areas of the management.

**OBJECTIVES OF FINANCIAL MANAGEMENT**

Effective procurement and efficient use of finance lead to proper utilization of the finance by the business concern. It is the essential part of the financial manager. Hence, the financial manager must determine the basic objectives of the financial management. Objectives of Financial Management may be broadly divided into two parts such as:

1. Profit maximization

2. Wealth maximization.

**Profit Maximization** Main aim of any kind of economic activity is earning profit. A business concern is also functioning mainly for the purpose of earning profit. Profit is the measuring techniques to understand the business efficiency of the concern. Profit maximization is also the traditional and narrow approach, which aims at, maximizes the profit of the concern. Profit maximization consists of the following important features:

1. Profit maximization is also called as cashing per share maximization. It leads to maximize the business operation for profit maximization.
2. Ultimate aim of the business concern is earning profit, hence, it considers all the possible ways to increase the profitability of the concern.
3. Profit is the parameter of measuring the efficiency of the business concern. So it shows the entire position of the business concern.
4. Profit maximization objectives help to reduce the risk of the business.

**Favourable Arguments for Profit Maximization**

**The following important points are in support of the profit maximization objectives of the business concern**: (i) Main aim is earning profit. (ii) Profit is the parameter of the business operation. (iii) Profit reduces risk of the business concern. (iv) Profit is the main source of finance. (v) Profitability meets the social needs also.

**Unfavourable Arguments for Profit Maximization The following important points are against the objectives of profit maximization:**

1. Profit maximization leads to exploiting workers and consumers.
2. Profit maximization creates immoral practices such as corrupt practice, unfair trade practice, etc.
3. Profit maximization objectives leads to inequalities among the stake holders such as customers, suppliers, public shareholders, etc.

**Drawbacks of Profit Maximization Profit maximization objective consists of certain drawback also:**

1. It is vague: In this objective, profit is not defined precisely or correctly. It creates some unnecessary opinion regarding earning habits of the business concern.
2. It ignores the time value of money: Profit maximization does not consider the time value of money or the net present value of the cash inflow. It leads certain differences between the actual cash inflow and net present cash flow during a particular period.
3. It ignores risk: Profit maximization does not consider risk of the business concern. Risks may be internal or external which will affect the overall operation of the business concern.

**Wealth Maximization**

Wealth maximization is one of the modern approaches, which involves latest innovations and improvements in the field of the business concern. The term wealth means shareholder wealth or the wealth of the persons those who are involved in the business concern. Wealth maximization is also known as value maximization or net present worth maximization. This objective is an universally accepted concept in the field of business.

**Favourable Arguments for Wealth Maximization**

1. Wealth maximization is superior to the profit maximization because the main aim of the business concern under this concept is to improve the value or wealth of the shareholders.
2. Wealth maximization considers the comparison of the value to cost associated with the business concern. Total value detected from the total cost incurred for the business operation. It provides extract value of the business concern.
3. Wealth maximization considers both time and risk of the business concern.
4. Wealth maximization provides efficient allocation of resources.
5. It ensures the economic interest of the society.

**Unfavourable Arguments for Wealth Maximization**

1. Wealth maximization leads to prescriptive idea of the business concern but it may not be suitable to present day business activities.
2. Wealth maximization is nothing, it is also profit maximization, it is the indirect name of the profit maximization.
3. Wealth maximization creates ownership-management controversy.
4. Management alone enjoy certain benefits.
5. The ultimate aim of the wealth maximization objectives is to maximize the profit.
6. Wealth maximization can be activated only with the help of the profitable position of the business concern.

**OBJECTIVES/IMPORTANCE OF FINANCIAL MANAGEMENT**

Some of the importance of the financial management is as follows:

* Financial Planning
* Acquisition of Funds
* Proper Use of Funds
* Financial Decision
* Improve Profitability
* Increase the Value of the Firm
* Promoting Savings

**TIME VALUE OF MONEY**

Time value of money **(TVM)**is the idea that money that is available at the present time is worth more than the same amount in the future, due to its potential earning capacity. This core principle of finance holds that provided money can earn interest, any amount of money is worth more the sooner it is received. One of the most fundamental concepts in finance is that money has a time value attached to it. In simpler terms, it would be safe to say that a dollar was worth more yesterday than today and a dollar today is worth more than a dollar tomorrow.

### Basic Time Value of Money Formula

Depending on the exact situation in question, the TVM formula may change slightly. For example, in the case of annuity or perpetuity payments, the generalized formula has additional or less factors. But in general, the most fundamental TVM formula takes into account the following variables:

* FV = Future value of money
* PV = Present value of money
* i = interest rate
* n = number of compounding periods per year
* t = number of years

Based on these variables, the formula for TVM is:

**FV = PV x [1 + (i / n)] (n x t)**

There are five (5) variables that you need to know:

1. **Present value (PV)** - This is your current starting amount.  It is the money you have in your hand at the present time, your initial investment for your future.
2. **Future value (FV)** - This is your ending amount at a point in time in the future. It should be worth more than the present value, provided it is earning interest and growing over time.
3. **The number of periods (N)** - This is the timeline for your investment (or debts). It is usually measured in years, but it could be any scale of time such as quarterly, monthly, or even daily.
4. **Interest rate (I)** - This is the growth rate of your money over the lifetime of the investment. It is stated in a percentage value, such as 8% or .08.
5. **Payment amount (PMT)** - These are a series of equal, evenly-spaced cash flows.

**Example**

Suppose that you have earned a cash bonus for an outstanding performance at your job during the last year.

Your boss gives you 2 options to choose from:

Option A: Receive $10,000 bonus now ●   
 Option B: Receive $10,800 bonus after one year ●

Further information which you may consider in your decision:  
- Inflation rate is 5% per annum.  
- Interest rate on bank deposits is 12% per annum.

**Which option would you choose?**

**Solution**

Although in absolute terms Option B offer the higher amount of bonus, Option A gives you the choice of receiving bonus one year earlier than Option B. This can be beneficial for the following reasons:

* To start with, you can buy more with $10,000 now than with $10,800 in one year's time due to the 5% inflation.

Secondly, if you receive the bonus now, you could invest the cash in a bank deposit and earn a safe annual return of 12%. in contrast, you stand to lose this interest income if you choose Option B.

* Thirdly, future is uncertain. In worst case scenario, the company you work for could become bankrupt during the next year which would significantly reduce your chances of receiving any bonus. The probability of this happening might be remote, but there would be a slim chance none the less.
* **Discount Rates**
* As the interest rate on bank deposits is higher than the rate of inflation, we should set the discount rate at 12% for our analysis because it represents the highest opportunity cost for receiving the bonus in one year's time rather than today.
* For this example, we may assume that the risk of not getting the bonus after one year (e.g. due to the company becoming bankrupt) is minimal and is therefore ignored. If such a risk is considered significant, we would have to increase the discount rate to reflect that risk.
* Using the 12% discount rate, we could either calculate future value or **present** value of the 2 options to assess which option is better in financial terms. Both are included here for completeness sake although they shall lead to the same conclusion.
* **Future Values**
* The future value of Option A will be the amount of bonus plus the interest income of 12% which could be earned for one year.

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| **Option A** |  |  |
| Bonus | $10,000 |  |
| Interest Income | $  1,200 | ($10,000 x 12%) |
| Future Value | $11,200 after 1 year | ($10,000 + $1,200) |

|  |  |  |
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| **Option B** |  |  |
| Bonus | $10,800 |  |
| Interest Income | \*  - |  |
| Future Value | $10,800 after 1 year |  |

* *\* No interest income shall accrue on $10,800 as it shall be received after one year.*
* Based on the future values, Option A is preferable as it has the highest future value.
* **Present Values**
* The present value of Option B will be the amount required today that shall equal to $10,800 in one year's time after having accrued an interest income of 12%.

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| --- | --- | --- |
| **Option A** |  |  |
| Bonus | $10,000 |  |
| Interest Income | \*  1.0 |  |
| Present Value | $10,000 | ($10,000 x 1.0) |

**Calculation**

Time Value of Money principle is used extensively in financial management to incorporate the financial impact of the timing of cash flows in business decisions.

In order to apply the time value of money principle in complex financial decisions, you need to familiarize yourself with the detailed understanding and calculation of the following key topics:

* Cost of capital (also referred to as WACC and required rate of return);
* Present value of cash flows
* Future value of cash flows