Unit 3 – Introduction to Financial Management and Ratio Analysis

Introduction

Financial Management is the managerial activity which is concerned with the planning and controlling of the firm's financial resources.

The subject of financial management is of immense interest to both academicians and practicing managers. It is of great interest to academicians because the subject is still developing, and there are still certain areas where controversies exist for which no unanimous solutions have been reached as yet. Practicing managers are interested in this subject because among the most crucial decisions of the firm are those which relate to finance, and an understanding of the theory of financial management provides them with conceptual and analytical insights to make those decisions skillfully.

Scope of Finance

What is finance? What are firm's financial activities? How are they related to the firm's other activities? Firms create manufacturing capacities for production of goods; some provide services to customers. They sell their goods or services to earn profit. They raise funds to acquire manufacturing and other facilities. Thus, the three most important activities of a business firm are:

- Production
- Marketing
- Finance

A firm secures whatever capital it needs and employs it (finance activity) which generate returns on invested capital (production and marketing activities).

Real and Financial Activities

A firm requires real assets to carry on its business. Real assets can be tangible. Plant, machinery, office, factory, furniture and buildings are examples of tangible real assets, while technical know-how, technological collaborations, patents and copyrights are intangible assets. The firm sells financial assets or securities, such as share s and bands or debentures, to investors in capital markets to raise necessary funds. A financial asset also includes lease obligations and borrowing from banks, financial institutions and other sources. Funds applied to assets by the firm are called capital expenditures or investment. The firm expects to receive return on investment and distribute return as dividends to investors.

Equity and Borrowed Funds

There are two types of funds that a firm can raise: equity funds and borrowed funds. A firm sells shares to acquire equity funds. Shares represent ownership rights of their holders. Buyers of shares are called shareholders, and they are the legal owners of the firm whose shares they hold. Shareholders invest their money in the shares of a company in the expectation of a return on their invested capital. The return on the shareholder's capital consists of dividend and capital gain. Shareholders make capital gains by selling their shares.

Shareholders can be two types: ordinary (or common) and preference. Preference shareholders receive dividend at fixed rate and they have priority over ordinary shareholders.

The dividend rate of ordinary shareholder's is not fixed, and it can vary from year to year depending on the decision of the board of directors. The payment of dividends to shareholders is not a legal obligation; it depends on the discreet of the board of directors. Since ordinary shareholders receive dividend (or re-payment of invested capital, only when the company is wound up) after meeting the obligations of others, they are generally called owners of residue. Dividends paid by a company are not deductible charges for calculation corporate income taxes.

Equity funds can also be obtained by a company by retaining a portion of earning available for shareholders. This method of acquiring funds internally is called earnings retention. Retained earnings are undistributed profits of equity capital; they are, therefore, rightfully a part of the equity capital. The retention of earnings can be considered as a form of raising new capital from the same sources (existing shareholders) by issuing new shares called a right issue. Also, a public issue of shares may be made to attract new shareholders.

Another important source of securing capital is creditors or lenders. Lenders are not the owners of the company. They make money available to the firm on a leading basis and retain title to the funds lent. The return on loans or borrowed funds is called interest. Loans are furnished for a specified period at a fixed rate of interest. Payment of interest is a legal obligation. The amount of interest is allowed to be treated as expense for computing corporate income taxes. Thus the payment of interest on borrowing provides tax shield to a firm. The firm may borrow funds from a large number of sources, such as banks, financial institutions, public or by issuing bonds or debentures. A bond or a debenture is a certificate acknowledging the money lent by a bondholder to the company. It states the amount, the rate of interest and the maturity of the band or debenture.

Finance and Other Management Functions

There exist an inseparable relationship between finance on the one hand and production, Marketing and other functions on the other. Almost all kinds of business activities, directly or indirectly, involve the acquisition and use of funds. For example, recruitment and promotion of employees in production is clearly a responsibility of the production department; but it requires payment of wages and salaries, and other benefits, and thus, involves finance. Similarly buying a new machine or replacing an old machine policies come within the purview of marketing, but advertising and other sales promotion activities require outlays of cash and therefore, affect financial resources. Where, then, is the separation between production and marketing functions and the finance function of making money available to meet the cost of production and marketing operations? Where do the production and marketing functions end and the finance function begin? There are no clear cut answers to these questions. The finance function of raising and using money although has a significant effect on other functions, yet it needs not necessarily limit or constraint the general running of the business. A company in a tight financial position will, of course, give more weight to financial considerations, and devise its marketing and production strategies in the light of the financial constraint. On the other hand, management of a company, which has a regular supply of funds, will be more flexible in formulating its production and marketing policies. In fact, financial policies will be devised to fit production and marketing decisions of a firm in practice.

Finance Functions

Although it may be difficult to separate the finance functions from productions, marketing and other functions, yet the functions themselves can be readily identified. The functions of raising funds, investing them in assets and distributing returns earned from assets to shareholders are respectively known as financing, investment and dividend decisions. While performing these functions, a firm attempts to balance cash inflows and outflows. This is called liquidity decisions, and we may add it to the list of important finance decisions or functions. Finance functions or decisions include:

- Investment or long term asset mix decision
- Financing or capital mix decision
- Dividend or profit allocation decision
- Liquidity or short term asset-mix decision

A firm performs finance functions simultaneously and continuously in the normal course of the business. They do not necessarily occur in a sequence. Finance functions call for skillful planning, control and execution of a firm's activities.

Investments Decision

Investment decision or capital budgeting involves the decision of allocation of capital or commitment of funds to long term assets that would yield benefits in the future. Two important aspects of the investment decisions are: (a) the evolution of the prospective profitability of new investments, and (b) the measurement of a cut off rate against that the perspective return of new investments could be compared. Future benefits of investments are difficult to measure and cannot be predicted with certainly. Because of the uncertain future, investment decisions involve risk. Besides the decision to commit funds in new investment proposals, capital budgeting also involves decisions of recommitting funds when an asset becomes less productive or non-profitable.

There is a broad agreement that the correct cut –off rate is the required rate of return or the opportunity cost of capital. However there are problems in computing the opportunity cost of capital in practice from the available data and information. A decision maker should be aware of these problems.

Financing Decision

Financing decision is the second important function to be performed by the finical manager. Broadly he or she must decide when, where and how to acquire funds to meet the firm's investment needs. The central issue before him or her is to determinethe proportion of equity and debt. The mix of debt and equity is known as the firm's capital structure. The financial manager must strive to obtain the best financing mix or the optimum capital structure for his or her firm. The firm's capital structure is considered to be optimum when the market value of share is maximized. The uses of debt affect the return and the risk of shareholders; it may increase the return on equity funds but it always increase risk. A proper balance will have to be struck between return and risk. When the shareholders' return is maximized with minimum risk, the market value per share will be maximized and the firm's capital structure would be considered optimum. Once the financial manager is able to determine the best combination of debt and equity, he or she must raise the appropriateamount though the best available sources. In practice, a firm considers may other factors such as control, flexibility, loan covenants, legal aspects etc. in deciding its capital structure.

Dividend Decision

Dividend decision is the third major financial decision. The financial manager must decide whether the firm should distribute all profits, or retain them, or distribute a portion and retain the balance. Like the debt policy, the dividend policy should be determined in terms of its impact on the shareholder's value. The optimum dividend policy is one that maximized the market value of the firm's share. Thus, if shareholders are not indifferent to the firm's dividend policy, the financial manager must determine the optimum dividend payout ratio. The payout ratio is equal to the percentage of dividends to earnings available to shareholders. The financial manager should also consider the questions of dividend stability, bonus shares and cash dividends in practice. Most profitable companies pay cash dividends regularly, periodically; additional shares called bonus shares (or stock dividend) are also issued to the existing shareholders in addition to the cash dividends.

Liquidity Decision

Current assets management that affects a firm's liquidity is yet another important finance function, in addition to the management of long term assets. Current assets should be managers efficiently for safeguarding the firm's profitability, liquidity and insolvency. Investments in current assets affect the firm's profitability, liquidity and risk. A conflict exist between and liquidity while managing current assets. If the firm does not invest sufficient funds in current assets, it may become illiquid. But it would lose profitability as idle current assets would not earn anything. Thus, a proper trade off must be achieved between profitability and liquidity. In order to ensure that neither insufficient nor unnecessary funds are invested in current assets, the financial manager should develop sound techniques of managing current assets. He or she should estimate firm's needs for current assets and make sure that funds would be made available when needed.

It would thus be clear that financial decisions directly concern the firm's decision to acquire or dispose off assets and require commitment or recommitment of funds on a continuous basis. It is in this context that finance functions are said to influence production, marketing and other functions of the firm. This, in consequence, finance functions may affect the size, growth, profitability and risk of the firm and ultimately, the value of the firm.

The function of financial management is to review and control decisions to commit or recommit funds to new or ongoing uses. Thus, in addition to raising funds, financial management is directly concerned with production, marketing and other functions, within an enterprise whenever decisions are made about the acquisition or distribution of assets.

Financial Procedures and Systems

For the effective execution of the finance functions, certain other functions have to be routinely performed. They concern procedures and systems and involve a lot of paper work and time. They do not require specialized skills of finance. Some of the important routine finance functions are;

- Supervision of cash receipts and payments and safeguarding of cash balances;
- Custody and safeguarding of securities, insurance policies and other valuable papers;
- Taking care of the mechanical details of new outside financing;
- Record keeping and reporting.

The finance manager in the modern enterprise is mainly involved in the managerial finance functions; the routine finance functions are carried out by executives at lower levels.

Financial managers' involvement in the routine function is confined to setting up of rules of procedures, selecting forms to be used establishing standards for the employment of competent personnel and to check up the performance to see that the rules are observed and that the forms are properly used.

The involvement of the financial manager in the managerial financial functions is recent. About two or three decades ago, the scope of finance function has winded or the role of the finance manager has changed.

Financial Manager's Role

A financial manage is a person who is responsible in significant way to carry out the finance functions. It should be noted at the outset that, in a modern enterprise, the financial manager occupies a key position. He or she is one of the members of the top management team, and his or her role, day-by-day, is becoming more pervasive, intensive and significant in solving the complex management problems. Now his or her functions are neither confide to that of a score keeper maintaining records, preparing reports and raising funds when needed nor is he or she a staff officer in a passive role of an advisor. The finance manager ids now responsible for shaping the fortunes of the enterprise, and is involved in the most vital decisions of the allocation of capital. In his or her new role, he or she needs to have a broader and far sighted outlook, and must ensure that the funds of the enterprise are utilized in the most significant manner. He or she must realize that his or her action have far reaching consequences for the firm because they influence size, profitability, growth, risk and survival of the firm, and as consequence , affect the overall value of the of the firm. The financial manager, therefore, must have clear understanding and a strong grasp of the nature and scope of the finance functions.

The financial manager has not always been in dynamic role of decision making. Till recently, he or she was considered to be an unimportant person, as far as the top management decision making was concerned. He or she became an important management person only with the advent of the modern or contemporary approach to the financial management.

Rising Of Funds

The traditional approach dominated the scope of financial management and limited the role of the financial manager simply to raising funds. it was during the major events, such as promotion, reorganization, expansion or diversification in the firm that the financial manager was called upon to raise funds. In his or her day to day activities, his or her only significant duty was to see that the firm had enough cash to meet its obligations, because of its central emphasis on the procurement of funds, the finance text books, for example, in the USA, till the mid-1950s covered discussion of the instruments, institutions and practices through which funds were obtained. Further, as the problem of raising funds was more intensively felt in case of an episodic event, these books also contained detailed descriptions of the major events like mergers, consolidations, reorganizations and recapitalizations. The Indian finance books simply followed the American pattern. The notable feature of the traditional view of financial management was the assumption that the financial manager had no concern with the decision of allocation the firm's funds these decisions were assumed to be given to him, and he or she was required to raise the needed funds from a combination of various sources.

The traditional approach did not go unchallenged even during the period of its dominance. Nut the criticism related more to the treatment of various topics rather than the basic definition of the finance function. The traditional approach has been criticized because it failed to consider the day to day managerial problems relating to finance of the firm. It concentrated itself to looking into the problems from management's – the insider's point of view. Thus the traditional approach of looking at the role of the financial manager lacked a conceptual framework for making financial decisions, misplaced emphasis on rising of funds and neglected the real issue relating to the allocation and management of funds.

Allocation of Funds

The traditional approach outlived its utility in the changed business situation since the mid-1950s. a number of economic and environmental factors, such as the increasing pace of industrialization, technological innovations and inventions, intense competition, increasing intervention of government on account of management inefficiency and failure, population growth and widened markets, during and after min 1950s, necessitated efficient and effective utilization of the firm's resources, including financial resources. The development of a number of management skills and decisions making techniques facilitate the implementation of system of optimum allocation of the firm's resources. As a result, the approach to, and the scope of financial management, also changed. The emphasis shifted from the episodic financing to the managerial financial problems, from raising of funds to efficient and effective use of funds the new approach is embedded in sound conceptual and analytical theories.

The new or modern approach is an analytical way of looking into the financial problems of the firm. Financial management is considered a vital and an integral part of overall management.

In this broader view the central issue of financial policy is the wise use of funds, and the central process involved is a rational matching of advantages of potential uses against the cost of alternative potential sources so as to achieve the broad financial goals which an enterprise sets for itself.

Thus, in a modern enterprise, the basic finance function is to decide about the expenditure decisions and to determine the demand for capital for these expenditures. In other words, the financial manager in his or her new role is concerned with the efficient allocation of funds. The allocation of funds is not a new problem. However, it did exist in the past, but was not considered important enough in achieving the firm's long run objectives.

In his or her new role of using funds wisely, the financial manager must find a rational for answering the following three questions.

- How large should an enterprise be, and how fast should it grow?
- In what form should it hold its assets?
- How should the funds required be raised?

The question stated above related to three broad decision areas of financial management: investment (including both long and short term assets); financing and dividend. The modern financial manager has to help marketing these decisions in the most rational ways.

They have to be made in such a way that the funds of the firm are used optimally; we have referred to these decision as managerial finance functions since they require special care and extraordinary administrative ability.

The financial decisions have a great impact on all other business activities. The concern of the financial manager, besides his traditional function of raising money, will be on determining the size and technology of the firm, in setting the pace and direction of growth and in shaping the profitability and risk complexion of the firm by selecting the best asset mix and by obtaining the optimum financing mix.

Profit Planning

The function of the financial manager may be broadened to include profit planning function. The term profit planning refers to the operating decisions in the areas of pricing, costs, volume of output and the firm's selection of product lines. Profit planning is, therefore, a pre-requisite for optimizing investment and financing decisions. The cost structure of the firm, i.e. the mix of fixed and variable costs has a significant influence on a firm profitability. Fixed costs remain constant while variable cost change in direct proportion to volume changes. Because of the fixed costs, profits fluctuate at a higher degree than the fluctuations in sales. Profit planning helps to anticipate the relationships between volume, costs and profits and develop action plans to face unexpected surprise.

Understanding Capital Markets

The financial manager has to deal with capital markets where the firm's securities are traded. He or she would fully understand the operation of capital markets and the way in which securities are values. He or she should also know how risk is measured in capital markets and how to cope with it as investment and financing decisions often involve considerable risk. For example, if a firm uses excessive debt to finance its growth, investors may perceive it as risky. The value of the firm's share may, therefore, decline, similarly, investors may not like the decisions of a highly profitable, growing firm to distribute dividend. They may like the firm to reinvest profits in attractive opportunities which would enhance their prospects for making high capital gains in the future. Investments also involve risk and return. It is through their operations in capital markets that investors continuously evaluate the action of the financial manager.

Financial Goal: Profit versus Wealth

The firm's investment and financing decisions are unavoidable and continuous. In order to make them rationally, the firm must have a goal. It is generally agreed in theory that the financial goal of the firm should be maximized of owner's economic welfare. Owner's economic welfare could be maximized by maximizing the shareholder's wealth as reflected in the market value of shares.

Profit Maximization

It means maximize the rupee (or any other currency such as dollar, pound or baht) income of firms. Firms produce goods and services. They may function in a market economy, or in a government controlled economy. In a market economy, prices of goods and services are determined in competitive markets. Firms in a market economy are expected to produce goods and services desired by society as efficiently as possible.

Price system is the most important organ of a market economy indicating what goods and services society wants goods and services in a great demand command higher prices. Thus result in higher profit for firms; more of such goods and services are produced. Higher profit opportunities attract other firms to produce such goods and services. Ultimately, with intensifying competition an equilibrium price is reached at which demand and supply match. In the case of goods and service which are not required by society, their price and profits fall. Such goods and services are dropped out by procedures in favors of more profitable opportunities. Price system directs managerial efforts towards more profitable goods and services. Price isdetermine by the demand and supply conditions as well as the competitive force and they guide the allocation of resources for various productive activities.

In the economic theory, the behavior of a firm is analyzed in terms of profit maximization. While maximizing profit, a firm either produces maximum output for a given amount of output. Thus the underling logic of profit maximization is efficiency. It is assumed to cause the efficient allocation of resources under the competitive market conditions, and profit is considered as the most appropriate measure of the firm's performance.

Objections to profit maximizations

It is argued that profit maximization assumes perfect competition, and in the face of imperfect modern market, it cannot be a legitimate objective of the firm. It is also argued that profit maximization, as a business objective; develop in the early 19th century when the characteristic features of the business structure were self-financing, private property and single entrepreneurship. The only aim of the single owner then was to enhance his or her individual wealth and personal power, which could easily be satisfied by the profit maximization objective. The modern business environment is characterized by limited liability and a divorce between management and ownership. The business firm today is financed by shareholders and lenders but it controlled and directed by professional management. The other interested parties are customers, employees, government and society. In practice the objective of these constituents (or stakeholders) of a firm differ and may conflict with each other. the manager of the firm has the difficult task of reconciling and balancing these confliction objectives. In the new business environment, profit maximization is regarded as unrealistic, difficult inappropriate and immoral.

It is also feared that profit maximization behavior in a market economy may tend to produce goods and services that are wasteful and unnecessary from the society's point of view. Also, it might lead to inequality of income and wealth. It is for this reason that governments tend to intervene in business. The price system and therefore, the profit maximization principle may not work due to imperfections in practice. Oligopolies and monopolies are quite common phenomena of modern economics. Firms producing same goods and services differ substantially in terms of technology, cost and capital. In view of such conditions, it is difficult to have a truly competitive price system. And thus, it is doubtful if the profit maximizing behavior will lead to the optimum social welfare.

However, it is not clear that abandoning profit maximization as a decision criterion would solve the problem. Rather government intervention may be sought to correct market imperfections and to promote competition among business firms. A market economy, characterized by a high degree of competition, would certainly ensure efficient production of goods and services desired by society.

Is profit maximization an operationally feasible criterion? Apart from the aforesaid objections, profit maximization fails to server as an operational criterion for maximizing the owner's economics welfare. It fails to provide an operationally feasible measure for ranking alternative course of action in terms of their economic efficiency. It suffers from the following limitations.

- It is vague.
- It ignores the timing of returns.
- It ignores risk.

Definition of profit: The precise meaning of the profit maximization objective is unclear. The definition of the term profit is ambiguous. Does it mean short or long term profit? Does it refer to profit before or after tax? Total profits or profit per share? Does it mean total operating profit or profit accruing to shareholders?

Time value of money: The profit maximization objective does not make a distinction between returns received in different time periods. It gives no consideration to the time value of money, and it values benefits received today and benefits received after a period as the same.

Uncertainty of returns: The streams of benefits may possess different of certainty. Two firms may have same total expected earnings, but if the earnings of one firm fluctuate considerably as compared to the other, it will be more risky. Possibly, owners of the firm would prefer smaller but surer profits to potentially larger but less certain stream of benefits.

Maximizing profit after taxes

Let's put aside the first problem mentioned above, and assume that maximizing profit means maximizing profits after taxes, in the sense of net profit as reported in the profit and loss account (income statement) of the firm. It can easily be realized that maximizing this figure will not maximize the economic welfare of the owners. It is possible for a firm to increase profit after taxes by selling additional equity shares and investing the proceeds in low yielding assets, such as the government bonds. Profit after taxes would go up but earnings per share would go down.

Maximizing earnings per share

If we adopt maximizing earning per shares as the financial objective of the firm, this will also not ensure that maximization of owner's economic welfare. It also suffers from the flaws already mentioned, i.e. it ignores timing and risk of the expected benefits. Apart from these problems, maximization of earnings per share has certain deficiencies as a financial objective.

It is thus, clear that maximizing profits after taxes or earnings per share as the financial objective fails to maximize the economic welfare of owners. Both methods do not take account of the timing and uncertainty of the benefits. An alternative to profit maximization, which solves these problems, is the uncertainty of wealth maximization. This objective is also considered consistent with the survival goal and with the personal objectives of managers such as recognition, power, status and personal wealth.

Shareholder's wealth maximization (SWM)

The objective of SWM is an appropriate and operationally feasible criterion to choose among the alternative financial actions. It provides an unambiguous measure of what financial management should seek to maximize in making investment and financing decision on behalf of owners.

SWM means maximizing the net present value of course of action to shareholders. The net present value of a course of action is the difference between the present value of its benefits and the present value of costs. A financial action that has a positive NPV creates wealth for shareholders and therefore is desirable. A financial action resulting in negative NPV should be rejected sense it would destroy shareholder's we all. Between a numbers of mutually exclusive projects the one with the highest NPV should be adopted. The NPV of s firm's projects add. Therefore the wealth will be maximized if this criterion is followed in making financial decisions.

The objective of shareholder's wealth maximization takes care of questions of the timing and risk of the expected benefits. These problems are handling by selecting an appropriate rate (the shareholder's opportunity cost of capital) for discounting the expected flow of future benefits. It is important to emphasize that benefits are measured in terms of cash flows. In investment and financing decisions, it is the flow of cash which is important, not the accounting profits.

Maximizing the shareholder's economic welfare is equivalent to maximizing the utility of their consumption over time. With their wealth maximized, shareholders can adjust their cash flows in such a way to optimize their consumption. From the shareholder's point of view, the wealth created by a company through its action is reflected in the market value of the company's shares. Therefore, the wealth maximization principle implies that the fundamental objective of a firm is to maximize the market value of its shares. The value of the company's share is represented by their market price which, in turn is a reflection of the firm's financial decision. The market price serves as the firm's performance indicator. How is the market price of a firm's share determined?

Need for a valuation approach

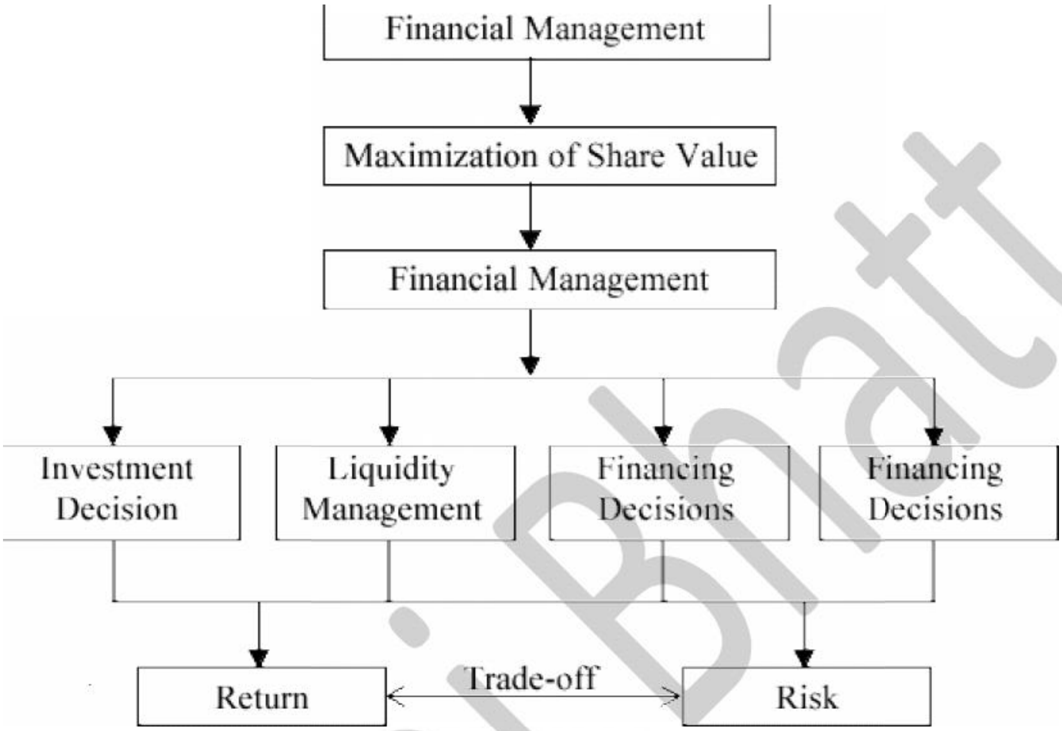
SWM requires a valuation model. The financial manager must know or at least assume the factors that influence the market price of shares; otherwise he or she would find himself or herself unable to maximize the market value of the company's shares. What is the appropriate share valuation model? In practice, innumerable factors influence the price of a share, and also these factors change very frequently. Moreover, these factors vary across shares of different companies. For the purpose of the financial management problem, we can phrase the crucial questions normatively: how much should a particular share be worth? Upon what factors should its value depend? Although there is no simple answer to these questions, it is generally agreed the value of an assets depends on its risk and return.

Risk return trade off

The financial decisions of the firm are interrelated and jointly affect the market value of its shares by influencing return and risk of the firm. The relationship between return and risk can be simply expressed as follows:

Return = Risk-free rate + Risk premium

Risk free rate is compensation for time and risk premium for risk. Higher the risk of an action, higher will be the required return on that action. A proper balance between return risks should be maintained to maximize the market value of the firm's share. Such balance is called risk return trade off and every financial decision involves this trade-off. The interrelation between market value, financial decisions and risk return tradeoff is depicted in following figure. It also gives an overview of the functions of financial management.



An overview of financial management

The financial manager, in a bid to maximize owner's wealth, should strive to maximize returns in relation to the given risk; he or she should seek courses of actions that avoid unnecessary risks. To ensure maximum return, funds flowing in and out of the firm should be constantly monitored to assure that they are safeguarded and properly utilized. The financial reporting system must be designed to provide timely and accurate picture of the firm's activities.

Conflict of Goals: Managementversus Owners

In a company, the decision taking authority lies in the hands of the management. Since the company is a complex organization of various interested parties, management has the difficult role of reconciling objectives of these parties. In doing so, management may not necessary act in the best interest of the owners (shareholders) and may purse its own personal goals. But the possibility of pursuing exclusively its own personal goals is considered remote because the continuous supervision by the company's owners, employees, creditors, customers and government will restrict management's freedom to act in its own interests. It is certain that management will like to survive over the long run. Thus, overall management objective is likely to be directed towards this goal. A management can survive only when it is successful; and it is successful when it manages the company better than someone else, every group connected with the company will evaluate management performance from the point of view of fulfillment of its own objective. The survival of management will be threatened if the objective of any of these groups remains unfulfilled.

The wealth maximization objective may be generally in harmony with the interests of the various groups such as owners, employees, creditors and society. And thus, it may be consistent with the management objective of survival.

There can, however, arise situations where a conflict may occur between the shareholders' and management's goals. For example, management may plan safe and create satisfactory wealth for shareholders than the maximum. Such "satisfying" behavior of management will frustrate the objective of SWM as normative guide to management.

Financial Goal and Firm's Objectives

In the shareholder's wealth maximization criterion, wealth is defined in terms of wealth or value of the shareholders' equity (capital funds). The basis of the theory of financial management is same as that of the classical theory of the firm: maximization of owners' interests. In the professionally managed firms of our times, management is the agent of owners and acts on their behalf.

The wealth maximization is a criterion for financial decision; and therefore, valuation models provide the basic theoretical and conceptual framework. A question can be raised: is wealth maximization the objective of the firm? Does a firm exist with the sole objective of serving the interests of owners? Firms do not exist with the primary objective of maximizing the welfare of owners. The main focus of a firm is always on the satisfaction of its customers through the production of goods and services needed by them.

What is our business is not determined by the producer, but by the customer. It is not defined by the company's name, statutes or articles of incorporation, but by the want the consumer satisfies when he buys a product or a service. The question can therefore be answered only by looking at the business from the outside, from the point of view of the customer and the market.

Firms in practice state their vision, mission and values in broad terms, and are also concerned about technology, leadership, productivity, market standing, image, profitability, financial resources, employees satisfaction etc. The financial goals of the firm are: (a) sales growth; (b) reasonable return on capital; and (c) internal financing.

Objectives and decision criteria should be distinguished. Wealth maximization is more appropriately a decision criterion, rather than a goal. Goals are mission and basic purposes. They direct the firm's course of actions. A firm may consider itself a provider of high technology, a builder of electronic base, or a provider of best and cheapest transport services. The firms design its strategy around such basic objectives and accordingly, define its markets, products and technology. To support its strategy, the firm lays down policies in the areas of production, purchase, marketing, technology, finance and so on.

The first step in making decision is to see that it is consistent with the firm's strategy and passes through the policy screening. The wealth maximization is the second level criterion ensuring that the decision meets the minimum standard of the economic performance. It is important to note that the management is not only the agent of owners, but also trustee for various stakeholders (constituents) of an economic unit. It is responsibility of the management to harmonies the interest of owners with that of the employees, creditors, government, or society. In the final decision making, the judgment of management plays the crucial role. The wealth maximization criterion would simply indicate whether an action is economically viable or not.

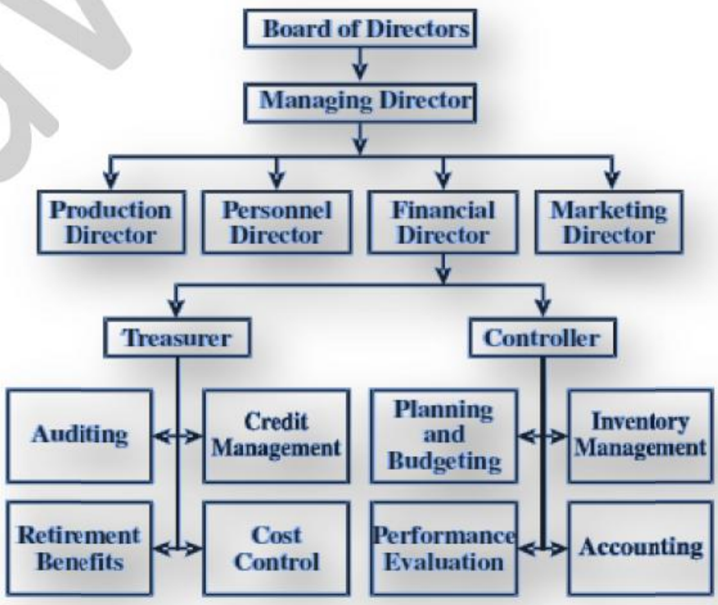
Organization of the Finance Functions

The vital importance of the financial decisions to a firm makes it imperative to set up a sound and efficient organization for the finance functions. The ultimate responsibility of carrying out the finance functions lies with the top management. thus a department to organize financial activities may be created under the direct control of the board of directors. The finance department may be headed by a committee or an executive, while the routine activities are delegated to lower levels.

The reason for placing the finance function in the hands of top management may be attributed to the following factors: first, financial decisions are crucial for the survival of the firm. The growth and development of the firm is directly influenced by the financial policies. Second, the financial actions determine solvency of the firm. At no cost can a firm afford to threaten its solvency. Because solvency is affected by the flow of funds which is a result of the various financial activities, top management being in a position to coordinate these activities retains finance functions in its control. Third, centralization of the finance functions can result in a number of economics to the firm. For example, the firm can save in terms of interest on borrowed funds, can purchase fixed assets economically or issue shares or debentures efficiency.

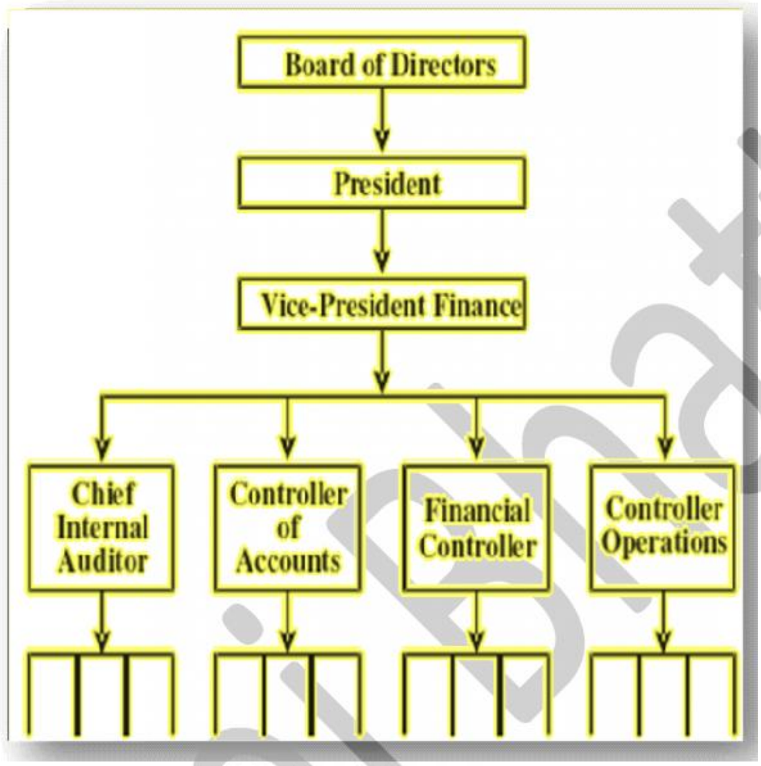
Status and duties of finance executives

The exact mature of the organization for financial management will differ from firm to firm. It will depend on factor such as the size of the firm, nature of the business, financing operations, capabilities of the firm's financial offers and most importantly, on the financial philosophy of the firm. The designation of the financial offer also differs from firm to firm. In some cases he or she may be known as the financial manager, while in others as the vice president of finance or the director of finance or the financial controller. Two or more officers-treasurer and controller-may are appointed under the direct supervision of the chief financial officer to assist him or her. In larger companies, with modern management, there may be vice president or director of finance, usually with both controller and treasure reporting to him.



Organization for finance function

Above figure illustrates the financial organization of a large (hypothetical) business firm. It is a simple organization chart, and as stated earlier, the exact organization for a firm will depend on its circumstances. Figure reveals that the finance function is one of the major functional areas, and the financial manager or director is under the control of the board of directors.



Organization for finance function in a multi-divisional Indian company

Above figure shows the organization for the finance function of a large, multi-divisional Indian company.

CFO has both line and staff responsibilities. He or she is directly concerned with the financial planning and control. He or she is a member of the top management, and he or she is closely associated with the formulation of policies and making decisions for the firm. The treasurer and controller, if a company has these executives, will be under the financial manager's supervision. He or she must guide them and others in the effective working of the finance department.

The main function of the treasure is to manage the firm's funds. His or her major duties include forecasting the financial needs, administrating the flow of cash, managing credits, floating securities, maintaining relations with financial institution and protecting funds and securities. On the other hand, the functions of the controller relate to the management and control of assets. His or her duties include providing information to formulate accounting and costing policies, preparation of financial reports, direction of internal auditing, budgeting, inventory control, taxes etc. it may be stated that the controller's functions concentrate the asset side of the balance sheet, while treasure's functions relate to the liability side.

Controller's and Treasure's Functions in the Indian Context

The controller and the treasure are essentially American terms. Generally speaking, the American pattern of dividing the financial executive's functions into controllership and treasure ship functions is not being widely followed in India. We do have a number company in India having officers with the designation of the controller or the financial controller. The controller or the financial controller in India, by and large, performs the functions of a chief accountant or management accountant. The officer with the title of treasure can also be found in a few companies in India.

The controllership functions, as stated by the financial executive's institute of the USA, can prove to be useful under the Indian context. But presently some of these duties are performed by the company secretary in India. His or her duties, for example, include asset control and protection,maintaining records and preparing reports and government reporting. The economic appraisal function is generally performed at the top level in India. Some companies do have separate economics and statistical departments for this purpose. Some other functions, such as internal audit, can be brought within the fold of the controllership functions, if this concept is developed in the Indian context.

It should be realized that the financial controller does not control finances; he or she develops, se and interrupts information- some of which will be financial-for management control and planning. For this reason, the financial controller may simply be called as the controllers. Management of finance or money is separate and important activity. Traditionally, the accountants have been involved in managing money in India. But the difference in managing money resources and information resources should be appreciated.

In the American business, the management of finance is treated as a separate activity and is being performed by the treasurer. The title of the treasurer has not found favor in India to the extent the controller has. Some of the functions performed by the treasurer in the American context are again discharged by the company secretary in India. Insurance coverage is an example in this regard. The function of maintaining relations with investors (particularly shareholders) may now assume significance in India because of the development in the Indian capital markets and the increasing awareness among investors.

The general title, financial manager, seems to be more popular in India. This title is also better than the title of treasure since it conveys the functions involved. the main function of the financial manager in India should be management of the company's funds. The financial duties may often be combined with others. But the significance of not combining the financial manager's duties with others should be realized. The managing of funds – very valuable resources – is a business activity requiring extraordinary skill on the part of the financial manager. He or she should ensure the optimum use of money under various constraints. He or she should, therefore, be allowed to devote his or her full energy and time in managing the money resources only.

Financial Ratio Analysis

Introduction

The information contained in these statements is used by management, creditors, investors and others to form judgment about the operating performance and financial position of the firm. Users of financial statements can get further insight about financial strengths and weakness of the firm if they properly analyze information reported in these statements. Management should be particularly interested in knowing financial strengths of the firm to make their best use and to be able to spot out financial weakness of the firm to take suitable corrective actions. The future plans of the firm should be laid down in view of the firm's financial strength and weakness. Thus, financial analysis is the starting point for making plans, before using any sophisticated forecasting and planning procedures. Understanding the past is prerequisite for anticipating the future.

Users of Financial Analysis

It is the process of identifying the financial strengths and weaknesses of the firm by properly establishing relationships between the items of the balance sheets and the profit and loss account. It can be under taken by management of the firm, or by parties outside the firm, owners, creditors, investors and others. The nature of analysis will differ depending on the purpose of the analyst.

- **Trade Creditors** are interested in firm's ability to meet their claims over a very short period of time. Their analysis will, therefore, confine to the evaluation of the firm's liquidity position.
- **Suppliers of long-term debt**, on the other hand, are concerned with the firm's long term solvency and survival. They analyze the firm's profitability over time, its ability to generate cash to be able to pay interest and repay principal and the relationship between various sources of funds (capital structure relationship.) long term creditors do analyze the historical financial statements, but they place more emphasis on the firm's projected, or *pro forma*,financial statements to make analysis about its future solvency and profitability.
- **Investors,** who have invested their money in the firm's shares, are most concerned about the firm's earnings. They restore more confidence in those firms that show steady growth in earning. As such, they concentrate on the analysis of the firm's financial structure to the extent in influences the firm's earnings ability and risk.
- **Management** of the firm would be interested in every aspect of the financial analysis. It is their overall responsibility to see that the resources of the firm are used most effectively and efficiently, and that the firm's financial condition is sound.

Utility of Ratio Analysis

It is the most powerful tool of the financial analysis. Many diverse groups of people are interested in analyzing the financial information to indicate the operating and financial characteristics of the firm in which they are interested. With the help of ratios, one can determine:

- the ability of the firm to meet its current obligations;
- the extent to which the firm has used its long term solvency by borrowing funds;
- the efficiency with which the firm is utilizing its assets in generating sales revenue,
- the overall operating efficiency and performance of the firm.

Performance analysis:A short term creditors will be interested in the current financial position of the firm, while a long term creditors will pay more attention to the solvency of the firm. The long term creditor will also be interested in the profitability of the firm. The equity shareholders are generally concerned with their return and may bother about the firm's financial condition only when their earnings are depressed. In fact, it has to be realized that the short and long term financial position and profitability of the firm are tested in every kind of financial analysis, only the emphasis would differ. Some ratios are more important in one kind of analysis than others. If a short term creditors analyses only the current position and finds it satisfactory, he/she cannot be certain about the safety of his/her claim if the firm's long term financial position or profitability is unfavorable. The satisfactory current position would become adverse in future if the current resources are consumed by the unfavorable long term financial condition. Similarly, the 'good' long term financial position is no guarantee for the long term creditors' claims if the current position or the profitability of the firm is 'bad'.

Credit analysis: The analyst will usually select a few important ratios. He may use the current ratio or quick asset ratio to judge the firm's liquidity or debt paying ability; debt equity ratio to determine the stake of the owners in the business and the firm's capacity to survive in the long run and any one of the profitability ratios, for example, return on capital employed, to determine the firm's earnings prospects. If the profitability is high, the current ratio is low and the debt equity ratio is high (unreasonable), the extension of credit may be approved to the firm, because a profitable company will grow and will have improvement in its current ratio and other ratios.

Security analysis: The major focus in security analysis is on the long term profitability. Profitability is dependent on a number of factors and therefore, the security analyst also analyses other ratios. He would certainly be concerned with the efficiency with which the firm utilizes its assets and the financial risk to which the firm is exposed. Therefore, besides analyzing the profitability ratios meticulously, he will also analyze activity ratios and leverage ratios. The detailed analysis of the earning power is important for security analysis.

Competitive analysis: The ratio of a firm by themselves does not reveal anything. For meaningful interpretation, the ratio of a firm should be compared with the ratios of similar firms and industry. This comparison will reveal whether the firm is significantly out of line with its competitors. If it is significantly out of line, the firm should undertake a detailed analysis to spot out the trouble areas.

Trend analysis: The ratio analysis will reveal the financial conditions of the firm more reliably when trends in ratios over time are analyzed. Ratios at a point of time can mislead the analyst, because they may be high or low for some exceptional circumstances at that point of time. An impressive present financial position may really be eroding over time, while a weak position may be improving at a rapid rate over time. Thus, the trend analysis of the ratios adds considerable significance to the financial analysis because it studies rations of several years and isolates the exceptional instances occurring in one or two periods. Although the trend analysis of the company's ratio itself is informative, but it is more informative to compare the trends in the company's ratios with the trends in industry ratios. This comparison indicates how well the company has been operating over time relative to its competitors and may also help to explain the trends in the company's ratios. For example, if the company's return on capital employed (net assets) shows a declining trend, the comparison can reveal whether this decline is characteristic of the firm only or there is a general declining trend in the industry.

Management has to protect the interests of all concerned parties, creditors, owners and others. They have to ensure some minimum operating efficiency and keep the risk of the firm at a minimum level. Their survival depends upon their operating performance. From time to time, management uses ratio analysis to determine the firm's financial strengths and weakness, and accordingly takes actions to improve the firm's position. Management is in a better position to analyze the firm' financial position as it has access to internal information which is not available to the credit analyst or the security analyst.

Limitation of Ration Analysis

The ratio analysis is a widely used technique to evaluate the financial position and performance of a business. But there are certain problems in using ratios. The analyst should be aware of these problems. The following are some of the limitations of the ratio analysis.

- It is difficult to decide on the proper basis of comparison.
- The comparison is rendered difficult because of differences in situations of two companies or of one company over years.
- The price level changes make the interpretations of ratios invalid.
- The differences in the definitions of items in the balance sheet and the profit and loss statement make the interpretation of ratio difficult.
- The ratios calculated at a point of time are less informative and defectives as they suffer from short term changes.
- The ratios are generally calculated from past financial statements and, thus are no indicators of future.

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