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Diploma in Management

(DIM)

DIM-5

FINANCE AND ACCOUNTING FOR MANAGEMENT

Block

1

Unit-1

Introduction to Finance

Unit-2

Basic Terminologies of Finance

Unit-3

Principles of Finance

Unit – 1
Introduction to Finance

Learning Objectives

After completion of the unit, you should be able to:

- Explain the meaning and functions of finance.
- Describe the characteristics and objectives of financial management.
- Know the criteria for evaluating the profit maximization and wealth maximization objectives.
- Assess the responsibilities of modern finance manager.
- Also understand the various sources for obtaining the financial information.

Structure

1.1 Introduction
1.2 Meaning of Finance
1.3 Finance Function
1.4 Finance Function - Approaches
1.5 Business Finance
1.6 Finance Decisions
1.7 Financial Management
1.8 Characteristics of Financial Management
1.9 Objectives of Financial Management
1.10 Profit Maximization v/s Wealth Maximization
1.11 Finance Organization
1.12 Responsibilities of Modern Finance Manager
1.13 Financial Information
1.14 Let’s Sum-up
1.15 Key Terms
1.16 Self-Assessment Questions
1.17 Further Readings
1.18 Model Questions

1.19 Introduction

Finance is the life blood of every business. To initiate the process of commencing a business finance is required. Various financial decisions need to be taken such as how much capital will be required, from where the finance will be arranged, what should be the appropriate mix of debt and equity, how much is the risk bearing capacity, what is the required rate of return and so on. Finance acts as a bottom line for all business related activities.

1.20 Meaning of Finance

Finance is the art as well as science of managing money and matters related to money with the objective of maximizing the wealth of the business owners. It includes capital, cash flow, funds and money related aspects. Every business requires the seed of finance to be sown at its conception as well as at varied stages of growth. The organizational activities need the nurturing of finance whether they are related to production, marketing, human resource or sales.

According to **F. W. Paish**,
'Finance may be defined as the position of money at the time it is wanted.'

According to **Howard and Upton**,
'Finance may be defined as that administrative area or set of administrative functions in an organization which relates with the arrangement of cash and credit so that the organization may have the means to carry out the objectives as satisfactorily as possible.'

1.21 Finance Function

Finance function means activities relating to planning, procurement, control and administration of funds used in business.

According to R. C. Osborn,

'The Finance function is the process of acquiring and utilizing funds of a business.'

According to Bonneville and Dewey,

'Financing consists of raising, providing, and managing of all the money, capital or funds of any kind to be used in connection with the business.'

The nature of finance function is illustrated as follows:

- Finance function is centralized in majority of the organizations so as to have a better control.
- Finance function is prevalent in all types of organizations whether it is a public or private organization, profit or non-profit organization.
- The central function of finance is to enhance the value of the firm.
- Finance function is related to all basic activities of the business.
- Finance function automatically imbibe the control functions also.

1.22 Finance Function – Approaches

The role of finance was limited in the initial stages but gradually its scope widened with the passage of time. Thus, finance function can be understood under the following two approaches:

Traditional Approach	**Modern Approach**
The Traditional Approach of financial management has limited the role of finance manager in initial stages during 1920s and 1930s. According to this approach, the main function of finance was confined to the procurement of funds. **Features:** • Focus was on raising funds • Long term financing perspective • Descriptive in nature • Deals with procurement of funds	According to Modern Approach, finance function means activities relating to planning, procurement, control and administration of funds used in business. **Features:** • Three major decisions are taken: Financing Decision, Investment Decision, and Dividend Decision. • Focuses on efficient allocation of resources to various assets.

by the corporate enterprises which was referred as corporation finance. **Limitations:** • Outside looking approach as it uses external sources of funds only. • Concentrates on only procurement of funds. • Ignores the concept of working capital	• Deals with obtaining the best mix of financing via corporate securities. • Determines the total fund requirement of the firm. • Deals with analytical ways to solve the financial problems. **Limitations:** • Difficult for the finance manager to fulfil many responsibilities at a time. • Decision making requires use of rigorous analytical methods.

1.23 Business Finance

Business finance encompasses the procurement and management of funds needed for business activities. It includes financial management related to Sole trade, Partnership and Companies.

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.'

According to the **Guthumann and Dougall**,

'Business finance can broadly be defined as the activity concerned with planning, raising, controlling, administering of the funds used in the business.'

In the words of **Parhter and Wert**,

'Business finance deals primarily with raising, administering and disbursing funds by privately owned business units operating in nonfinancial fields of industry.'

Where finance is managed by corporations, it is called corporation finance. Corporate finance is concerned with the activities such as budgeting, financial forecasting, cash management, credit administration, and investment analysis and fund procurement.

✓ **Check your progress**

Exercise 1

Suppose you are appointed as a finance manager in a pharmaceutical company. List out the basic functions which you will be required to perform as a part of your work profile.

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1.24 Finance Decisions

Finance decisions refers to the decisions concerning financial matters of a business enterprise. These decisions should be taken in such a way that wealth of owners is maximized. These decisions have an impact on the valuation of business assets and owner’s net worth. Following are the important finance decisions:

* Financing Decision * Investment decision * Dividend decision

Financing decision

This is the most significant decision that a finance manager has to take. He has to decide about the amount of capital required, appropriate mix of debt & equity capital (capital structure) & selection of apt sources of funds. It requires a rigorous analytical study of varied sources of finance including the corporate securities.

Investment decision

This pertains to the allocation of funds raised with a view to acquire assets. Decisions regarding investment in fixed or long term assets are based on the cost, benefits or returns arising from these assets. These are called capital budgeting decisions. It also includes sensitivity analysis for selecting the projects or assets in which prior investment should be made.

Dividend decision

Dividend decision is related to the allocation of income. The finance manager has to decide about the portion of profit which should be distributed to the shareholders in the form of cash dividend. The dividend policy should be such that it has a positive impact on the wealth of the shareholders. It also affects the retained earnings of a business concern which acts as a reserve for future.

1.25 Financial Management

Financial management refers to the planning, organizing, directing and controlling of the procurement, utilization of funds and disposal of profit so that individual, organizational and social objectives are achieved.

"Financial management is the application of the planning and control of the finance function"

According to **Solomon**,

'It is concerned with the efficient use of an important economic resource namely, capital funds.'

According to **S. C. Kuchal,**

'Financial Management deals with procurement of funds and their effective utilization in the business.'

According to **Howard and Upton,**

‘Financial management is the application of general managerial principles to the area of financial decision-making.’

According to **Joshep and Massie,**

‘Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations.’

Thus, financial management is mainly concerned with the effective funds management in the business. It also focuses on the procurement of funds from the right source, investing it in such a manner which maximizes the shareholders wealth and establishing appropriate check points in order to control the finance.

1.26 Characteristics of Financial Management

Financial management is an essential and unique function in every business organization. The peculiar features of financial management are discussed as follows:

- **Essential part of business management:** The financial management is a significant part of business management because each activity of business is directly or indirectly linked with finance. Without management of finance, no business can survive. Every department whether it is production, marketing, accounting and pay roll or sales, need finance to be run smoothly.
- **Continuous administrative function:** It is a continuous process and for the successful running of business, the finance manager performs all the activities of business continuously. It is not a one day affair. The finance needs to be managed continuously round the year and thus it is a stationary function of every business concern which needs a permanent set up.
- **Less Descriptive and More Analytical:** Unlike traditional financial management, the modern financial management is less descriptive and more analytical. Today the statistical and mathematical models have been developed, by which the best alternatives can be easily chosen under given internal and external conditions. Traditional financial management focuses on the description of the

finance problems whereas modern financial management finds out the root causes of the financial problems and try to solve those using analytical methods.

★ **Centralized in nature:** In different areas of modern business management, the finance function is usually centralized. Varied functional areas such as marketing and production are decentralized in the modern industry concern, but financial co-ordination and controls are achieved through centralization. Thus, irrespective of the size of the organization, the management of finance is concentrated at one place only.

★ **Different from accounting function:** In accounting function, the collection of financial and related statistics is done followed by its recording in a systematic manner. On the other hand, in finance function these documents are used for analysis, interpretation and act as a base for financial decision making.

★ **Wide scope:** The scope of financial management is quite wide. The purview of financial management covers accounting, auditing, cost accounting, business budgeting, financial statement analysis, management of receivables, management of working capital, cash and credit.

★ **Applicable to all types of organization:** It is applicable on all types of organization whether it is a manufacturing organization or service organization or sole proprietorship organization. It is also applicable on non-profit organizations. Thus, financial management is universally applicable in all forms of organizations.

✓ **Check your progress**

Exercise 2

Suppose you are running a non-profit organization. Explain with reasons which one of the three finance decisions – finance decision, investment decision or dividend decision, will be most critical in your organization?

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1.27 Objectives of Financial Management

For better working and continuous success, every organization focus on effective planning, management and implementation. This requires clarity in the objectives to be achieved through management of finance. Following are the significant objectives of financial management:

★ **To ensure adequate and regular supply of funds to the business:** This is necessary for the smooth functioning of the business. It includes adequate working capital arrangement as well as capital required for long term investment in the business.

★ **Provide fair rate of return on capital:** It refers to the required rate of return on the capital employed in the business. It should be above or in line with the rate of return earned by the other companies in the same industry. All financial decisions should be based on this criteria as it will have a direct impact on the earning per share and the market price of the shares.

★ **Efficient utilization of capital by ensuring profitability & safety:** The capital should be invested rationally after making appropriate analysis of risk and return trade off. The risk appetite of every business is different and therefore safety should be ensured in the sense that it does not cross the specified risk level. Profitability and safety must go hand in hand.

★ **To minimize cost of capital:** One of the important objective of financial management is the minimization of the cost of capital. It means that appropriate mix of debt and equity should be planned so that the judicious blend of fixed as well as variable cost of funds lead to trading on equity. Trading on equity will eventually result in enhancing the earning per share and maximization of shareholder's wealth.

★ **To maximize economic welfare of its owners:** The primary aim of every business is to maximize the owner's economic welfare by increasing the return on investment, maximizing the wealth and market price of the shares.

1.28 Profit Maximization v/s Wealth Maximization

The primary objective of every organization is to maximize the economic welfare of the owners. This may be done through maximizing the profits or maximizing the wealth. Traditional financial management focuses on profit maximization whereas modern financial management emphasizes on wealth maximization. There is always a conceptual demarcation between the two concepts.

Profit maximization

Profit maximization objective of financial management states that all those projects and decision making actions that increases profit should be undertaken & those that decrease profit are to be avoided. Basically it focuses on the absolute figure of profit which is arrived at by subtracting costs from the revenue.

Advantages of Profit Maximization

This objective is considered beneficial on the following grounds:

1. Rational: - A rational human being performs any economic activity with the objective of utility maximization & always strives to finalize those actions which escalate the profit ladder of the business.

2. Principal source of motivation: - Profit is the priority source of inspiration for putting more efforts and working with extreme efficiency. It helps to fight competition and put a step ahead towards leadership. In the absence of this inspiration, the speed of development & progress will be at stand still.

3. Social welfare: - It ensures maximum social welfare by disseminating maximum dividend to the shareholders, prompt payment to the creditors and debenture holders, satisfactory wages along with fringe benefits to the workers, supreme quality products at economical prices to consumers & maximum return to the business owners.

4. Basis of decision making: - All strategic & tactical decisions in a business concern are taken keeping in view the profit earning objective. In the absence of

this objective, it would be very difficult to judge the priority of the projects to be undertaken.

Limitations of profit maximization

Despite of the above stated advantages of profit maximization objective, it suffers from the following limitations:

1. Vague: - The term profit is vague i.e. it does not offer conceptual clarity. Different people can derive different interpretation from it. This is because profit may be of varied types like Gross Profit, Net Profit, Operating Profit, Profit Before tax, Profit After tax etc. Which profit should be maximized and under what circumstances, it is not specified under this objective.

2. Ignores time value of money: - Profit maximization action criterion does not make any distinction between the profits earned during different time periods. The value of a rupee received today will never be equivalent to the worth of a rupee to be received after one or two years. It takes into consideration the absolute amount of profit to be earned at different time periods treating their time value at par. Thus, it overlooks the purchasing power of money which is a sign of irrational decision making.

3. Ignores risk: - Profit maximization objective overlooks risks involved in prospective earnings. It considers only the volume of profit involved in undertaking a project without giving any weightage to the foreseen and unforeseen risk involved in it.

4. Ignores social responsibility: - It ignores the interest of workers, consumers, government & public in general because of the exclusive attention on profit maximization objective. When a firm focuses on profit maximization, then the other objectives are automatically ignored.

Wealth maximization

The profit maximization objective ignores two significant underlying factors of financial management i.e. risk and time value of money. Wealth maximization takes into consideration not only risk involved in the investment decision but also

the time value of money. It focuses on the maximization of firm's net present value. Therefore, it is regarded as the basic objective of financial management rather than profit maximization. Wealth maximization is also referred as Value Maximization or Net Present value Maximization. Wealth can be maximized in the following ways:

★ Avoid high level of risks as it might lead to heavy losses which may further shake the confidence of the stakeholders.

★ The firm should strive on reducing the cost. This will lead to increase in profits and on the other hand it will pave the path for cost leadership.

★ Appropriate amount of dividend should be paid to the shareholders. This will satisfy their needs as well as prospective investors will gain confidence in the company.

★ The firm should accept those projects and take such decisions which gives better growth prospects for the company. This is because the growth of the company will lead to the growth of all the stakeholders.

★ The firm should try to maintain the market price of shares as it is an indicator of goodwill of the firm and its stability in all prospects.

Superiority of Wealth Maximization

Wealth maximization objective is considered better than profit maximization objective on the following grounds:

1. Wealth maximization objective is clear in the sense that it specifies that wealth can be maximized by increasing the net present value of the firm.
2. It is not in conflict with other objectives as it is a comprehensive objective which covers all aspects related to social responsibility, satisfaction of stakeholders, maintaining market price etc. which will automatically lead to increase in the overall profits of the business.
3. It considers the time value of money which is the most significant limitation of profit maximization objective.

4. Wealth maximization takes into consideration the interest of all sections of society including consumers, debtors, creditors, shareholders and society at large.
5. It takes risk factor into consideration in the investment decision. If probable risk and expected profits both are very high, then this investment should be dropped.

✓ **Check your progress**

Exercise 3

Wealth Maximization objective is the most appropriate objective as compared to profit maximization objective. But in today's context where the product life cycle is reducing day by day, the profit maximization objective has regain its importance. Do you agree? Support your answer with appropriate reasons.

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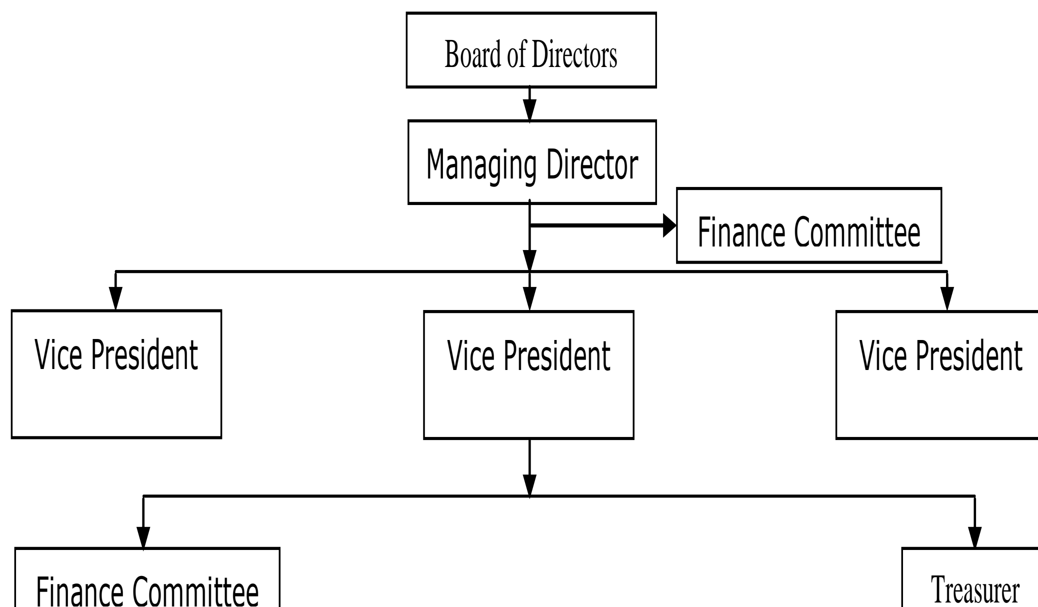
1.29 Finance Organization

Organization of financial management means the structure, division and the classification of various functions which are to be performed by the finance department of a business concern. There are numerous factors which affect the kind of finance organization a firm should have. These factors are illustrated as under:

1. **Ability of finance officer**: Where the finance officers possess less ability then ordinary accounting and reporting organization is developed. On the other hand, if capable finance officers are there, then full-fledged finance department can be set up with multifaceted finance functions.
2. **Need of the company:** The financial requirements of different organizations are not similar. It depends upon the nature, size and speed of financial activities taking place in the organization, for e.g. a start-up organization needs huge amount of capital for its growth and fight against competition

whereas in service organizations less capital is needed for stability and growth. Thus, firms develop their financial organization in accordance with their needs.

3. **Financial System:** The traditional financial system in the country is replaced by modern financial system. The financial system is affected by the economic structure of the country which includes the working of financial institutions and financial markets. Hence, the organization should adopt such a financial structure which can fulfill its financial requirements and is compatible with the financial system prevailing in the country.
4. **Size of the firm:** A small firm will have a tiny finance organization with a couple of finance officers performing multiple tasks. If the organization is large enough, then it can create a financial set up with experts in various financial functions.
5. **Nature of business:** The finance organization depends upon the nature of business. If it is a public utility business, then more cash inflow is there and less funds are required. Thus, a small financial organization is sufficient. On the other hand, if any manufacturing organization is there and the credit terms are very stringent, then more financial complications are there. Thus, it will need a well settled finance department to handle all issues.
6. **Type of financial operation:** Certain businesses involves only cash transactions. They will require a small finance department and businesses which involve all types of financial transactions like cash, credit, leasing, hire purchase etc., it will require a big finance department.
7. **Financial philosophy:** The kind of financial philosophy or outlook of the top management also guides the structure of the finance organization in a business.



1.30 Responsibilities of Modern Finance Manager

Modern financial manager is the officer of the highest rank in the finance department of a business organization. In corporate enterprises he is also popularly known as Chief Financial Manager/Controller. The role of finance manager is to perform all the finance functions efficiently and effectively so that the firm's objectives are achieved.

The important tasks & responsibilities of a financial manager are stated below:-

1. **Financial planning and forecasting: -** One of the significant responsibility of chief financial officer in a big business concern is to prepare a sound financial plan which is based on reliable financial forecasting. It is the financial manager who decides the time when the funds will be required based on the forecasting, the varied sources of money supply & the assets in which investment will be made.
2. **Funds Management: -** This is among the primary function of the financial manager. Funds management includes the effective & efficient raising of funds, allocating it appropriately keeping in mind the profitability and security of funds & utilizing them in a rational manner.
3. **Disposal of Profit: -** Disposal of profit refers to the division of profit among dividend distribution and retained earnings. Finance manager has to maintain harmony between the expectations of investors & the desire to retain earnings for acquiring additional assets or future growth.
4. **Interpretation & Reporting: -** The finance manager compares the actual financial performance with the financial plan and locate the deviations. He then analyzes the amount of variation and report it along with their causes. He also suggests the ways of correcting the variances.
5. **Legal formalities: -** The task of finance manager also include compliance with the legal obligations which the firm is required to fulfil.
6. **Financial Public Relation:-**This involves the management of firm's financial image & its relationship with financial community. It is the duty of the finance manager to maintain cordial relations with the banks and

financial institutions, so that in case of need there is no hurdle in arranging for funds for short term as well as long term.

- ✓ **Check your progress**

Exercise 4

Which type of finance organization would you suggest for the following businesses?

a) Start-up of organic foods

b) Private finance company

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1.31 Financial Information

The financial manager has to take numerous finance related decisions which have an impact on different departments and functional areas of a business concern. Therefore, these decisions should be taken with utmost care so that their probability of going wrong is negligible. For this, they should be based on reliable financial information. There are variety of sources for obtaining the financial information about money, stock and commodity markets, industries and individual companies. The available information may be related to past performance of the individual company or current performance in terms of market prices, annual reports etc. The various sources of financial information in India can be grouped in the following categories:

- ➢ Daily newspapers
- ➢ Magazines in the field of banking and finance
- ➢ Other sources

Daily newspapers

Economic times and financial express newspapers publish relevant financial news, market reports, quotations etc., though the extent and coverage of financial news in these newspapers are usually limited in nature. These daily newspapers also cover the information like summaries, economic indicators etc.

Magazines in the field of banking and finance

A number of magazines and journals are published in India, which contains multifaceted aspects of the Indian Economy as a whole and about individual companies as well. These publications may be weeklies, fortnightlies, monthlies, quarterly and year lies. They provide important insights into the banking and financial sector, on the basis of which reliable financial decisions could be taken.

Other sources

Apart from the sources mentioned above, there are other publications also which are quite helpful in disseminating various information about trade and industry. Now a days, there are financial services also which provide financial data and other supplementary data needed.

Important financial documents which provide financial data about individual companies and summary statistics about selected industries are:

- Kothari's economic guide and investors hand book of India
- Investor's guide
- Stock exchange year books
- Investor's encyclopedia
- Investor's year book
- Company publications
- Publications by trade associations and group

1.32 Let's Sum-up

The finance function is the most significant function performed in every business organization. It is a process of acquiring and utilizing funds of a business. Finance functions are always related to the overall objectives of an organization. Finance function focuses on the policy decisions which determines the size of the profitability and risk appetite of the business firm. The main objectives of financial management are to assess the financial needs of the business, minimize the cost of capital, arrange for the required funds, and plan the investment pattern considering the return on investment and to maximize the overall wealth of the owners. The term 'business finance' is very comprehensive. It is a process of raising, providing and managing of all the money to be used in connection with business activities. The finance organization of a business concern should be in accordance with the financial needs, kind of financial dealings, prevalent financial system in the country and the financial philosophy of the top management. The head of the finance department is the chief financial officer whose main task is financial planning, control and taking decisions regarding the raising of funds and investment pattern to be followed in the organization. The finance decisions taken by him may be correct only if they are based on reliable financial information. Financial information may be obtained from various sources including newspapers, stock indices, industry publications etc.

1.33 Key Terms

Finance: It is defined as the position of money at the time it is wanted.

Business Finance: Business finance encompasses the procurement and management of funds needed for business activities.

Working Capital: Working capital refers to the money required to meet the day to day expenses of the business.

Financial Management: Financial management refers to the planning, organizing, directing and controlling of the procurement, utilization of funds and disposal of profit so that individual, organizational and social objectives are achieved.

Finance Organization: Organization of financial management means the structure, division and the classification of various functions which are to be performed by the finance department of a business concern.

1.34 Self-Assessment Questions

1. 'An organization should have an appropriate form of finance organization.' Discuss the factors on which the finance organization of a business depends.
2. Explain the concept of financial management with the help of a diagram.

1.35 Further Readings

- M.Y. Khan and P.K.Jain, *Financial Management*, Tata McGraw Hill.
- Prasanna Chandra , *Financial Management*, Tata McGraw Hill.
- Richard A Brealey, Stewart C Myers, Franklin Allen, Pitabas Mohanty, *Principles of Corporate Finance*, Tata McGraw-Hill Publication.
- I M Pandey, *Financial Management*, Vikas Publishing House.

1.36 Model Questions

1. What do you understand by finance function? Differentiate between traditional and modern approaches of finance function.
2. Illustrate the objectives of financial management. According to you which objective is the most important objective in the today's corporate world?
3. 'Wealth maximization is better than profit maximization objective.' Comment.
4. Explain the functions performed by a financial manager.
5. Discuss the various sources of obtaining financial information for taking appropriate financial decisions.

Answer to Self-Assessment Questions

1. The finance organization of a business depends upon the following factors:
    - **Ability of finance officer**: Where the finance officers possess less ability then ordinary accounting and reporting organization is developed. On the other hand, if capable finance officers are there, then full-fledged finance department can be set up with multifaceted finance functions.
    - **Need of the company:** The financial requirements of different organizations are not similar. It depends upon the nature, size and speed of financial activities taking place in the organization, for e.g. a start-up organization needs huge amount of capital for its growth and fight against competition whereas in service organizations less capital is needed for stability and growth. Thus, firms develop their financial organization in accordance with their needs.
    - **Financial System:** The traditional financial system in the country is replaced by modern financial system. The financial system is affected by the economic structure of the country which includes the working of financial institutions and financial markets. Hence, the organization should adopt such a financial structure which can fulfill its financial requirements and is compatible with the financial system prevailing in the country.
    - **Size of the firm:** A small firm will have a tiny finance organization with a couple of finance officers performing multiple tasks. If the organization is large enough, then it can create a financial set up with experts in various financial functions.
    - **Nature of business:** The finance organization depends upon the nature of business. If it is a public utility business, then more cash inflow is there and less funds are required. Thus, a small financial organization is sufficient. On the other hand, if any manufacturing organization is there and the credit terms are very stringent, then more financial complications are there. Thus, it will need a well settled finance department to handle all issues.
    - **Type of financial operation:** Certain businesses involves only cash transactions. They will require a small finance department and businesses

which involve all types of financial transactions like cash, credit, leasing, hire purchase etc., it will require a big finance department.

- **Financial philosophy:** The kind of financial philosophy or outlook of the top management also guides the structure of the finance organization in a business.

2. Financial management refers to the management of finance for smooth functioning of all the other functions of the business.

   Financial Management is the planning, organizing, directing and controlling of the procurement, utilization of funds and disposal of profit so that individual, organizational and social objectives are achieved.

Unit – 2
Principles of Finance

Learning Objectives

After completion of the unit, you should be able to:

- Explain the meaning and scope of finance.
- Describe the basic principles of finance which forms a fundamental base for taking the finance decisions.
- Know about the intricacies of the various finance principles vis-a-vis time value of money, risk-return relationship, diversification, hedging etc.

Structure

2.1 Introduction
2.2 Meaning & Scope of Finance
2.3 Basic principles of Finance
2.4 Time Value of Money
2.5 Risk-Return Trade off
2.6 Analysis of cash flows
2.7 Market Price – An indicator of Information
2.8 Liquidity and Profitability
2.9 Centralized Finance Function
2.10 Provision for Unforeseen Risks
2.11 Diversification
2.12 Maximize gains from Tax Benefits
2.13 Hedging
2.14 Other Principles
2.15 Let's Sum-up
2.16 Key Terms
2.17 Self-Assessment Questions
2.18 Further Readings
2.19 Model Questions

2.20 Introduction

Finance is the soul of business activities. Financial management is done keeping in mind the various objectives which are further based upon certain principles. These principles act as a guideline for the investment and financing decisions. All financial managers are bound to take certain operating, investing and financing decisions, some of which may be short term and some long term. These decisions will lead to the satisfaction of all the stakeholders only if they are in accordance with the financial principles.

2.21 Meaning & Scope of Finance

Before discussing about principles of finance let us first elaborate the concept of finance. Finance is the process of collecting funds and ensuring its proper utilization. The scope of finance refers to all those activities which are related to procurement of finance, allocation of funds and disposal of profit earned in a systematic and satisfactory manner. Each activity related to finance is undertaken after considering one or more principles of finance.

2.22 Basic Principles of Finance

There can be numerous principles of finance. The basic principles which are fundamental to the financial decisions of all organizations are enlisted below:

- Time value of money
- Risk and return trade off
- Analysis of cash flows
- Analysis of market price
- Profitability and liquidity
- Centralization of finance function
- Provision for unforeseen risk
- Diversification
- Maximize gains from tax benefits
- Hedging

- Others

These principles are explained in the following paragraphs.

2.23 Time Value of Money

This principle focuses on the purchasing power of money which reduces with the passage of time. This is because the prices keep on rising and the income cannot keep pace with it. Thus, giving birth to inflation. Inflation reduces the capacity of money to purchase goods. So, before investing or raising funds we have to think about the prevailing inflation rate in the economy and required rate of return, which must be more than the inflation rate so that return can compensate the loss incurred by the inflation.

This principle highlights the following key points:

- Money has a Time Value i.e. A rupee received today is more valuable than a rupee received one year from now.
- Money can be invested today to earn some interest so that after a year we will have more than the money invested.

2.24 Risk-Return Trade off

This principle indicates that investors have to create a judicious blend of risk and return. There is a direct relationship between risk and return i.e. higher the risk, higher the rate of return and lower the risk, lower the rate of return. For the purpose of business financing we have to compare the return with risk. To ensure optimum rate of return to the investors, efforts should be made to bring a trade-off between risk and return. When investment is made there is a risk of loss and also it delays its usage by a particular time period. Thus, the investor expects a reward for taking risk. The risk appetite and expectations of return are different for varied business houses. So, the permissible risk should be matched with the maximum amount of return which can be obtained within the purview of the risk allowed.

✓ **Check your progress**

Exercise 1

Discuss under what circumstances the principle of time value of money will be considered as most desirable?

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2.25 Analysis of cash flows

This principle mainly talks about the cash inflow and outflow. A company's profits can change drastically from its cash flows. It is the cash flows in the business and not the profits that are actually received and which can be reinvested. Therefore, more cash inflow in the earlier period is preferable than later cash flow by the investors. This principle also follow the time value principle i.e. the present value of money in more than its future value.

While making a financial decision, we should consider the incremental cash flows which is the difference between the projected cash flows if the project is chosen and estimated cash flows if the project is not selected.

2.26 Market Price – An indicator of Information

This principle focuses on the fact that the market price is a significant indicator of the company's image and perceived information. A small finance decision may have a huge impact on the market price. Thus, while taking any decision related to procurement of funds, investment of funds and disposal of profits, we should be very cautious in understanding its impact on the market price. Market price is an indicator of company's performance and policies for the prospective investors.

2.27 Liquidity and Profitability

This principle is very important from the investor's perspective as he has to make sure that both profitability and liquidity aspects are dealt rationally. Liquidity indicates the marketability of the investment i.e. how easily and fast can the investment be converted into cash by selling the investment. On the other hand, the investors need to plan their investment in such a manner that maximum profit can be derived with moderate or lower level of risk. Thus, liquidity and profitability are the two key considerations while taking an investment decision.

2.28 Centralized Finance Function

Finance is the common element which is required in every function of the business. Finance is a very sensitive issue also, as the decisions related to finance are taken with utmost care. Most of the business frauds are targeted towards finance only. Thus, finance function should be centralized in nature. It will help in monitoring and controlling the financial activities in the business organization. The objectives of financial management can be achieved only if this principle is religiously applied in the business.

2.29 Provision for Unforeseen Risks

Risk may be of two kinds – foreseen risk and unforeseen risk. Foreseen risk may be estimated and managed with the help of insurance or making specific purpose provisions for the same. But unforeseen risks are those which cannot be estimated neither can be insured. Despite of the best efforts, every business faces unforeseen emergencies. This principle emphasizes on the significance of making provisions in the form of general reserves or provisions which may be used in case of such exigencies. The financial soundness of a business is judged by its financial backup it has to meet the unforeseen risks. Thus, every business must make appropriate provisions for unforeseen risks so that it does not derail the long-term goals.

✓ **Check your progress**

Exercise 2

Give five examples of unforeseen risks which a business organization may be encountered in its future endeavors.

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2.30 Diversification

This principle helps to minimize the risk through building an optimum portfolio. Never put all your eggs in the same basket because if it falls then all the eggs will broke, so put eggs by separating in different basket so that your risk can be minimized. This principle says that the investors should bifurcate the amount of their investment by putting some portion in risk free investment and some in risky investments so that the overall risk may be minimized. Diversification of investment ensures minimization of risk.

2.31 Maximize gains from Tax Benefits

Increasing profits by increasing sales or reducing costs is not always feasible in all business circumstances. This principle focus upon the tactfulness of utilizing the available tax benefits to maximize the gains in the business. A business can invest in such areas where tax concessions are given or which are tax free. It can also channelize the profits in such activities which will lead to tax benefits. It also focuses on the use of appropriate debt-equity mix, to get the tax benefit in the payment of interest on debt. Thus, such techniques should be deployed to increase the effective rate of return.

✓ **Check your progress**

Exercise 3

Find out and state at least ten areas in which a business organization can invest to avail tax benefits.

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2.32 Hedging

Hedging means protection against risk. The funds invested in the long term and short term assets should be financed in an appropriate manner. Hedging principle indicates that we have to take loan from appropriate sources, for short term fund requirement we have to finance from short term sources and for long term fund requirement we have to manage fund from long term sources. The short term assets must be financed by short term sources of finance and long term assets must be financed by long term sources of finance.

2.33 Other Principles

The following principles may be followed to achieve the financial efficiency in the business operations:

- Create an annual budget broken down into monthly detail to identify expected income and expenses, including savings. This will serve as a guide to help you live within your means and prepare for the future.
- Before committing to significant expenditures, calculate how much income is likely to be available for you. Net income, after all mandatory deductions, is far more appropriate to use when considering new purchases and expenses than gross income before deductions.
- Your credit past is your credit future. Be aware that credit bureaus maintain credit reports, which record borrowers' histories of repaying loans and credit. Negative information in credit reports will adversely affect your ability to borrow at a later point.
- Manage cautiously the ethical dilemmas in financial decisions.
- Periodically gather research so you do not miss excellent investment opportunities. Every business should continuously educate itself and be updated.

2.34 Let's Sum-up

Finance is the most sensitive function which forms the foundation of every business organization. The finance function is based on certain finance principles. The significant principles of finance includes time value of money, taking care of liquidity and profitability while investing, establishing risk and return trade off, diversification of investment, finance decisions affect the market price, hedging, making appropriation for unforeseen risks and others. These principles help the business organization to achieve its business objectives.

2.35 Key Terms

Time value of money: Time value of money means that the purchasing power of money reduces with the passage of time.

Liquidity: Liquidity indicates the marketability of the investment i.e. how easily and fast can the investment be converted into cash by selling the investment.

Diversification: Diversification means dividing the amount of investment and putting it into different categories of investment with varying degrees of risk.

Hedging: Hedging means protection against risk. The funds invested in the long term and short term assets should be financed in an appropriate manner.

2.36 Self-Assessment Questions

1. Suppose you are the finance manager of a company. You are required to make an investment decision of Rs. 20 lakhs. What factors will you analyze before making the investment decision?
2. Why does the finance function be centralized in nature?

2.37 Further Readings

- Richard A Brealey, Stewart C Myers, Franklin Allen, Pitabas Mohanty, *Principles of Corporate Finance*, Tata McGraw-Hill Publication.
- Robert F. Bruner, *Case Studies in Finance*, Tata McGraw Hill.
- Dr. R. P. Rustagi, *Fundamentals of Financial Management*, Taxmann.

- V. K. Bhalla, *Contemporary Issues in Finance*, MacMillian Publishers.

2.38 Model Questions

1. What do you understand by principles of finance?
2. Explain the principle of diversification with the help of a hypothetical example.
3. Why does an investor need to consider the liquidity and profitability aspect before making every investment?
4. If time value of money is not considered while taking financial decisions, what will happen?
5. 'Market price is an indicator of company's performance'. Discuss the factors which affect the market price of the share of a company.

Answers to Self-Assessment Questions

1. The following factors will be analyzed before making an investment decision:

- Risk
- Expected rate of return
- Liquidity of investment
- Impact on market price of share
- Impact on financial soundness

2. Finance is the common element which is required in every function of the business. Finance is a very sensitive issue also, as the decisions related to finance are taken with utmost care. Most of the business frauds are targeted towards finance only. Thus, finance function should be centralized in nature. It will help in monitoring and controlling the financial activities in the business organization. The objectives of financial management can be achieved only if this principle is religiously applied in the business.

Unit - 3
Basic Terminologies of Finance

Structure

3.1 Amortization
3.2 Annuity
3.3 Arbitrage
3.4 Asset Allocation
3.5 Balance Sheet
3.6 Capital Employed
3.7 Cash Flow
3.8 Cash Flow Statement
3.9 Capital Structure
3.10 Collateral
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3.30 Mortgage
3.31 Mutual Fund
3.32 Net Present Value
3.33 Net Worth
3.34 Securities
3.35 Share
3.36 Working Capital
3.37 Yield

3.38 Amortization

It means to gradually write off the initial cost of an asset over a period of time. Conceptually, amortization is similar to depreciation and depletion. Amortization also applies to asset balances, such as discount on notes receivable, deferred charges, and some intangible assets.

3.39 Annuity

A financial product designed to grow an individual's funds and then upon annuitization, pay a fixed payment for the designated number of periods. Annuities are used primarily as a way to secure cash flow during retirement years.

3.40 Arbitrage

It refers to the simultaneous buying and selling of securities, currency, or commodities in different markets or in derivative forms in order to take advantage of differing prices for the same asset.

3.41 Asset Allocation

Asset allocation is the implementation of an investment strategy that attempts to balance risk versus reward by adjusting the percentage of each asset in an investment portfolio according to the investor's risk tolerance, goals and investment time frame.

3.42 Balance Sheet

It is a statement of the assets, liabilities, and capital of a business or other organization at a particular point in time, detailing the balance of income and expenditure over the preceding period.

3.43 Capital Employed

Capital employed, also known as funds employed, is the total amount of capital used for the acquisition of profits. It is the value of all the assets employed in a business and can be calculated by adding fixed assets to working capital or subtracting current liabilities from total assets.

3.44 Cash Flow

It is one of the main indications of a company's overall financial health. It is calculated by subtracting cash payments from cash receipts over a period of time (month, quarter, year). Cash flow is the inflow and outflow of cash in an organization.

3.45 Cash Flow Statement

A cash flow statement, also known as statement of cash flows, is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents, and breaks the analysis down to operating, investing and financing activities.

3.46 Capital Structure

The capital structure is how a firm finances its overall operations and growth by using different sources of funds. Debt comes in the form of bond issues or long-term notes payable, while equity is classified as common stock, preferred stock or retained earnings.

3.47 Collateral

It refers to something pledged as security for repayment of a loan, to be forfeited in the event of a default. It refers to the additional security given to the finance providers apart from the principal security.

3.48 Compound Interest

Interest that is calculated not just on the initial principal but also on the accumulated interest from previous periods. As interest is added back to the principal, the rate of return applies to the entire balance, making the balance grow even faster than simple interest (simple interest is when the

interest is applied only the initial principal, not the accumulated interest as well).

3.49 Credit Limit

A credit limit is the maximum amount of credit that a financial institution or other lender will extend to a debtor for a particular line of credit (sometimes called a credit line, line of credit, or a trade line).

3.50 Credit Policy

A company's policy on when its customers should pay for goods or services they have ordered a government's policy at a particular time on how easy or difficult it should be for people and businesses to borrow and how much it should cost.

3.51 Debenture

It is a long-term security yielding a fixed rate of interest, issued by a company and secured against assets. It's an acknowledgement of debt by a company. It does not carry right of control and right to vote.

3.52 Debt

An amount owed to a person or corporation for funds borrowed. It refers to borrowed capital of the companies, repayable after a fixed period. It may carry a fix sum of interest to be paid every year.

3.53 Diversification

Diversification is the process of allocating capital in a way that reduces the exposure to any one particular asset or risk. A common path towards diversification is to reduce risk or volatility by investing in a variety of assets. It means spreading risk by investing in a range of investment tools such as securities, commodities, real estate, CDs, etc. Thus, it is a risk

management technique that mixes a wide variety of investments within a portfolio.

3.54 Dividend

It is that part of profit which is distributed to the shareholders. It means divisible profits which are distributed among the members of a company in proportion to their shares in a manner prescribed by law. Dividend Policy is the plan of action adopted by directors whenever the dividend decision is to be made. It determines the division of earnings between payout to shareholders & retained earnings.

3.55 Financial Report

It refers to the set of documents prepared at the end of the accounting period. A financial report may include – Income statement, Balance Sheet, Fund flow statement, cash flow statement and any other statement which an organization would like to report for the knowledge of its stakeholders.

3.56 Financial Statements

A financial statement is a formal record of the financial activities and position of a business, person, or other entity. A balance sheet, also referred to as a statement of financial position, reports on a company's assets, liabilities, and owners equity at a given point in time.

3.57 Fund Flow Statement

Fund flow is the net of all cash inflows and outflows in and out of various financial assets. Fund flow is usually measured on a monthly or quarterly basis; the performance of an asset or fund is not taken into account, only share redemptions, or outflows, and share purchases, or inflows.

3.58 Future Value

Future value (FV) refers to a method of calculating how much the present value (PV) of an asset or cash will be worth at a specific time in the future.

3.59 Income Statement

An income statement is a financial statement that reports a company's financial performance over a specific accounting period. Financial performance is assessed by giving a summary of how the business incurs its revenues and expenses through both operating and non-operating activities.

3.60 Inflation

Inflation refers to a gradual increase or rise in the price of goods over a period of time. Inflation reduces the purchasing power of money thereby reducing the value of money. To minimize the adverse impacts of inflation, the income or rate of return should be higher than the rate of inflation.

3.61 Initial Public Offering (IPO)

An initial public offering (IPO) is the first time that the stock of a private company is offered to the public. IPOs are often issued by smaller, younger companies seeking capital to expand, but they can also be done by large privately owned companies looking to become publicly traded.

3.62 Investment

It is the action or process of investing money for profit. Investment may be made in short term assets or long term assets. Before making an investment, there are certain factors which must be taken into account like liquidity, profitability, risk involved etc.

3.63 Inventory

Inventory refers to the stock pile of the product a firm is offering for sale and the components that make up the product. In other words, the inventory is used to represent the aggregate of those items of tangible

assets which are held for sale in ordinary course of the business or in process of production for such sale or to be currently consumed in the production of goods or services to be available for sale. Inventory may be of three items namely raw material and supplies, work in progress and finished goods.

3.64 Leverage

Leverage is the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment. It means the employment of assets or funds for which the firm pays a fixed cost or fixed return. Leverage may be defined as a relative change in profit due to change in sales. Leverage may be of three types – operating leverage, financial leverage and combined leverage.

3.65 Liquidity

The ability of an asset to be converted into cash quickly without sacrificing value or giving a discount on the price. Liquidity is an important parameter which is kept in mind before making an investment decision in an organization.

3.66 Market Capitalization

It is the market value of a company's outstanding shares. This figure is found by taking the stock price and multiplying it by the total number of shares outstanding. The worth of a company is found by calculating its market capitalization.

3.67 Mortgage

It is a legal agreement by which a bank, building society, etc. lends money at interest in exchange for taking title of the debtor's property, with the

condition that the conveyance of title becomes void upon the payment of the debt.

3.68 Mutual Fund

An investment that is made up of a pool of funds from multiple investors who want to invest in securities like stocks, bonds, money market accounts, and other assets. Mutual funds are operated by money managers who invest capital and try to create gains for the investors.

3.69 Net Present Value

Net Present Value (NPV) is the difference between the present value of cash inflows and the present value of cash outflows. NPV is used in capital budgeting to analyze the profitability of a projected investment or project.

3.70 Net Worth

Net worth is a concept applicable to individuals and businesses as a key measure of how much an entity is worth. A consistent increase in net worth indicates good financial health; conversely, net worth may be depleted by annual operating losses or a substantial decrease in asset values relative to liabilities.

3.71 Securities

A security is a financial instrument that represents an ownership position in a publicly-traded corporation (stock), a creditor relationship with governmental body or a corporation (bond), or rights to ownership as represented by an option.

3.72 Share

One unit of ownership in a corporation, security, or limited partnership. Shares can be of two types – Equity share and Preference share. Preference share carries two preferential rights - the payment of dividend at a fix rate & payment of capital at the time of liquidation.

3.73 Working Capital

It refers to the amount of capital required to meet the day to day expenses of the business. Working capital is also called circulating capital or revolving capital or short term capital or liquid capital. Working capital may be of two types: Gross working capital and Net working capital. Gross working capital is the sum of current assets. Net working capital is the difference between current assets & current liabilities.

3.74 Yield

The yield is the income return on an investment, such as the interest or dividends received from holding a particular security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value or face value.