CHAPTER 2

FINANCIAL MANAGEMENT

CONCEPTUAL FRAMEWORK
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1.0 INTRODUCTION

Finance is a scarce resource and it has to be managed efficiently for the successful functioning of an enterprise. Inefficient finance management has resulted in failure of many business organizations. "Irrespective of any difference in structure, ownership and size, the finance organization of the enterprise caught to be capable of ensuring that the various finance functions – planning and controlling are carried out at the highest degree of efficiency". It is the lifeblood of every business activity without which the wheels of modern business organization system cannot be greased. Thus, the finance function assumes an important role in the affairs of business management. The profitability and stability of the business depends upon the manner how the finance functions are performed and related with other business functions.

Financial system may be made up through various channels, which savings become available for investment. The major institutions include: (i) Financial institutions/intermediaries like banks, insurance organizations and so on which collect

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capital from savers, investors and distribute them to entrepreneurs/ productive enterprises; (ii) Financial markets comprising of capital / securities market (i.e., Stock Exchange and the new issue market), money market and the foreign exchange (Forex) market; and (iii) Financial Assets/ Instruments (Securities) such as Shares, Debentures, Units, Derivatives and so on.4

India has been witnessing a stable and attractive growth based on strong economic fundamentals which has led to an increasing interest and desire in the international investors' community to participate in the India Growth story across sectors including real estate. The sector is witnessing increased commitments from real estate’s focused private equity funds, HIN (High Net Worth) investors, Non-Resident Indians (NRIs) as well as public equity through various domestic and international capital markets.5

2.0 OBJECTIVES OF FINANCIAL MANAGEMENT

Financial Management is that managerial activity, which is concerned with the planning and controlling of the firm’s financial resources. As a separate activity or discipline, it is of recent origin. It was a branch of economics till 1890. The discipline of finance has evolved significantly over the last five decades. Before 1950’s finance was primarily descriptive and financial management relied heavily on institutional descriptions rather than on scientific observation and analysis. Along with the changing role of a financial manager, the objectives of financial management have also been undergoing a change depending on the underlying objective of the firm.

Since a company is a separate legal entity, its management vests in the hands of Board of Directors who are answerable to several groups like financial institutions, banks, government, creditors, shareholders and society. There may be conflicts between the interests of the managers and those of the stockholders. Agency theory

studies these conflicts and their resolution. In resolving these and other potential conflicts, management must always act in the best interest of the Shareholders.\(^6\)

### 3.0 PROFIT MAXIMIZATION VS WEALTH MAXIMIZATION

The first and foremost important goal of the firm is to maximize profits. This objective can be achieved by minimizing the overall cost of capital \(K_o\) and by keeping the selling price at the prevailing market price. It is easily understood as a rational goal for a business and focuses the firm’s effort towards making money.\(^7\)

Profit maximization fails to serve as an operational criterion for maximizing the owners’ economic welfare. It fails to provide an operationally feasible measure for ranking alternative courses of action in terms of their economic efficiency.\(^8\) It suffers from the following limitation:

- it is vague,
- it ignores the timing of returns, and
- it ignores risk.

The precise meaning of the profit maximization objective is unclear. The definition of the term profit is ambiguous. What does it mean; short term or long term? It ignores the time value of money, which means that the value of a rupee received today is not similar to the value of a rupee to be received a year after. Lastly, the stream of benefits may possess different degrees of certainty and uncertainty. The combination of expected returns with risk variations and related capitalization rate cannot be considered in the concept of profit maximization.

The second objective of a firm is to maximize the value of the firm over the long run. According to Ezra Solomon, it provides an unambiguous measure of what financial management should seek to maximize in making investment and financial

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decisions. The maximization of wealth objective is the long term profit of the firm. Maximization of wealth is also known as net present worth of the firm. This goal emphasizes the impact of profits on the current market value of the firm’s securities, notably its common stock.

Maximization of wealth implies other factors in addition to profits. Long run value is affected by the firm’s growth, the amount of risk acceptable to investors, the market price of the stock, and the cash dividends paid.

Wealth maximization objective is considered to be superior to profit maximization for many firms. It properly points out that the profit factor should be considered from the long term point of view. At the same time, it balances this single factor with related goals such as growth, stability, risk avoidance, and the market price of the firm’s stock.

4.0 STOCKHOLDERS VS MANAGEMENT

In a company, decision making process is always in the hands of management people. As the company is a complex organization of various interested groups, management has to face numerous problems in reconciling the conflicting objectives of these groups. When operating under shareholders wealth maximization objectives, management has to co-ordinate its profit plan so that stockholders receive the highest combination of dividends (payments from firms’ income) and increase in share value on price for any given period. In other words, a shareholder’s proportional ownership of the firm should be as valuable as possible.

To satisfy its commitments to its shareholders the management should allocate firm’s resources efficiently in order to show a good return on its investments within the appropriate constraints of risk. If the firm wastes money foolishly on risky investment are fails to take the advantage of profitable opportunities, the stockholders will sell the stock, thus, depressing its prices. If the firm (management) chooses the wrong type of financing or overburdens the firm with debt, the stockholders will also sell out, even if the debt was used to finance profitable investments. This corporate

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goal directly affects the policy decisions of what to invest in and how to finance the investments. When this goal is in force, the objectives of the stockholders and management are compatible.\textsuperscript{12}

However, problems may arise resulting in conflict between the shareholders and management goal in the implementation of this objectives as measure of performance. Firstly, the share price is subject to outside influences beyond management’s control. A slump in the economy could depress stock prices, yet, the management has no control over the economy in general. Secondly, daily fluctuations in stock prices sometimes draw too much attention from management and distract them to the detriment of the firm’s profit plan. Further, management may feel frustrated and disillusioned if the stock price performance does not seem to reflect what they considered to be a good effort. While it is a useful goal, shareholder wealth maximization may be something more to strive for, than to achieve.\textsuperscript{13}

Further in big companies whose stock is widely held, stockholders exert very little control or influence over the operations of the company. When the control of a company is separate from its ownership, management may not always act in the best interest of the stockholders. Management sometimes are said to be ‘satisfiers’ rather than maximisers.\textsuperscript{14} They may be confident to “play it safe” and seek on acceptable level of growth, having more concerned with perpetuating their own existence than with maximizing the value of the firm to its shareholders. The most important goal to management of this sort may be its own survival.\textsuperscript{15} As a result, it may be unwilling to take reasonable risk for fear of making a mistake. There by, becoming conspicuous to outside suppliers of capital. In turn, these suppliers may force threat to management survival.

Management of a company can be thought of as an agent for the owners. In essence, the stockholders delegate decision making authority to the agent with the


\textsuperscript{13} Ibid.

\textsuperscript{14} Herbert A. Simon, \textit{Theories of Decision Making In Economies and Behavioural Sciences}, American Economic Review, 49, June 1959, Pp 253-283.

hope that he will act in their best interest. Jensen and Meckling have developed a comprehensive theory of the firm under agency arrangements. They show that the stockholders can assure themselves that the agent (management) will make optional decisions only, if appropriate incentives are given and only if the agent is monitored. Incentives include such things as stock options, bonuses and perquisites which are directly related to how close management decisions are to the interest of the stockholders. Monitoring consists of such things as bonding the agent, systematic reviews of management perquisites, financial statement audit, and explicit limits on management decisions. These monitoring activities necessarily involve costs which are an inevitable result of the separation of ownership and control of corporation. The less the ownership percentage of the manager consistent with maximizing shareholder's wealth, and the greater the need for outside stockholders to monitor his activities. In the words of James C Van Horne, "maximization of shareholder's wealth is an appropriate guide for how a firm should act."

5.0 CORPORATE SOCIAL RESPONSIBILITY

In addition to the wealth maximization, the firm has another important objective to be fulfilled is social responsibility. Both these objectives should go hand in hand even though there are certain controversies. In other words, management of the company should resolve conflicts between wealth maximization objective and goal of social responsibility. The social responsibility of the firm includes the supply of quality products at low prices to the customers, maintaining sound industrial relations, giving a fair deal to employees and seeking their participation in management and contributing towards the social overheads through taxes and donations. There are certain social actions which are very necessary for the survival of the firm and compatible with the objective of wealth maximization.

There is also a conflict between the corporation as an entity in society and as a device for maximizing shareholder's wealth. The traditional view maintains that the corporation's sole responsibility is to maximize the stockholder's welfare, because

the firm will then achieve the most efficient allocation of resources for society as a whole. The argument assumes in its more complete form that certain resources, such as, air and water are held in common ownership by all citizens and that society should therefore, bear the cost of these resources when the firm uses them. In turn, the company contributes to the general welfare by producing goods and services in the most efficient manner.18

The opposing view sees the corporation as a grant or trust from the State designed to be a relatively efficient way of increasing productivity. As such, it has duties to fulfill to its employees, suppliers, consumers, stockholders and the general public. Like any individual, it must be a good citizen. It must not pollute the air or foul the streams, and it must not injure the position of any of its constituents. It must be forced to take on this social responsibility since the competitive system of free enterprise no longer forces corporations to absorb the cost, but allows them to pass such expenses on to the society through oligopoly (a few firms who control their industry) and monopoly pricing.19 In addition, it is sometimes argued that the corporation owes a debt to society and should bear the cost of some of the external resources it enjoys, such as the reads and the education of its employees.

Exactly how far the corporation's social responsibility should go is debatable.20 It could range anywhere from self-regulation designed to avoid injuring the position of any of its constituents to the championing of political and moral causes. It has been suggested that there exists at least a 'moral minimum', which implies that the corporation must at least avoid consciously creating moral and social injury. Perhaps, this includes taking affirmative action to connect that which is already present, but it certainly excludes the formulation of any new social injury. Corporate social responsibility can also include refusing to cooperate with the government when its requests conflict with "moral right causeness" and making

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reforms within the corporation that alleviate social injury to one of the corporation's constituents.\textsuperscript{21}

Regardless of what the corporation finally decides as its social responsibility, there will be a conflict among the goals. Any action which the corporation takes to alleviate social injury will cost the firm, for it will now bear the cost that society formerly bore for what the firm formerly used as a free resource. This cost conflicts with profit maximization, shareholder wealth maximization, managerial welfare maximization and satisfying objectives.\textsuperscript{22} People responsible for financial management in an undertaking should at least weigh social responsibility in their investment and financing decision without seriously impairing the objective of shareholders wealth maximization objective.

6.0 FUNCTIONS OF FINANCIAL MANAGEMENT

The function of Financial Management is not a standardized operation.\textsuperscript{23} The functions vary from firm to firm depending upon the size of the company, nature of industry and tradition. In small scale business units all the decisions regarding the procurement and utilization of funds are taken by the owner, while in the medium-sized company, the financial officer may be concerned with the financial management. In big organizations, the financial manager takes the decisions on various aspects of finance such as dividend policy, refinancing of maturing debt, introduction of a new product, managing the firm's working capital etc.

To quote Ezra Solomon again, “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.”\textsuperscript{24}

\textsuperscript{21} Ibid.
\textsuperscript{22} Steven E. Bolton, op. cit., P. 20.
In his new role the financial manager must find a rational basis for answering the following three questions.25

How large should an enterprise be and how fast should it grow?

- In what form should it hold its assets?
- What should be the composition of its liabilities?

The above three questions relate to three broad decision - areas of financial management - investment, financing and dividend decisions. The contemporary financial management is broad enough to include the following:

- financial forecasting, planning and controlling;
- raising, managing and investing of funds;
- measuring and controlling the cost of funds and operations;
- profit planning and pricing; and
- insurance, labour welfare, tax management.

7.0 INVESTMENT DECISION

A firm needs to invest in real assets in order to produce goods or services. Therefore, decisions must be made on what assets to own, what mix of fixed assets (plant, equipment and land), and what mix of current assets (cash, accounts receivables and inventories) will best facilitate the firm’s production of goods and services. In other words, how much should the firm invest, and in which specific assets should it invest? The answers to these questions involve the firm’s investment decision.26 The investment decision is of two types: (i) Capital budgeting and (ii) Working capital management.

7.1 Capital Budgeting

Capital budgeting may be defined as a decision to invest the currently available funds in various investment alternatives, in expectation of future estimated benefits. This decision is one of the most important investment decisions a business

firm has to take. Capital budgeting may be defined as the decision making process by which firms evaluate the purchase of major fixed assets. It is a complex process that involves several activities such as searching for new profitable investments, marketing and production analysis to determine economic attractiveness, careful cash flow estimation, preparation of cash budgets, evaluation of proposals, and the control and monitoring of past projects. Since commitment of funds in capital assets is for long periods, these alternatives must be evaluated very carefully, because, once funds are committed, it becomes irrecoverable. In the words of Robichak, "There is broad, but not yet universal agreement, that the correct standard to use for this purpose is the company's cost of capital." The major aspect of investment decision relates to the selection of firm's cost of capital.

7.2 Working Capital Management

Management of working capital involves decisions relating to the amount and the composition of the current assets and finding the best way to finance these assets. Therefore, proper management of working capital is very important for the success of any enterprise. One aspect of the working capital management is the trade off between risk and return. In other words, there is a conflict between profitability and liquidity. To be precise, the management of working capital has two basic ingredients, namely (i) an overview of working capital management as a whole and (ii) efficient management of the individual current assets such as inventory, receivables and cash.

There are two concepts of working capital viz., gross working capital and the net working capital. In the words of Walker, "The gross working capital refers to the amount of funds invested in current assets that are employed in the business

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process." Net working capital as Guthmann says is, "the excess of current assets over current liabilities."

8.0 FINANCING DECISION

Once, the firm has committed itself to investment, it must select the best means of financing these commitments. Since firms regularly make new investments, there is continuous need for financing. As a practical matter, firms keep making financing decisions constantly. Through the judicious use of financial leverage, a firm attempts to increase the returns to its stockholders. Leverage, however, increases the variability of these returns by magnifying stockholders' potential losses as well as potential gains. In other words, the financial manager should strive hard in obtaining the best possible financing mix or optimum capital structure. Optimum capital structure is that combination of various forms of capital or financing mix, where the overall cost of capital (Ko) is kept at its minimum level and hence profits are maximized. To conclude, a company needs to finance its assets by acquiring cash from the financial markets. Decision must, therefore, be made about what securities to issue and what mix of short term credit, long term debt and equity best facilitates and what mix of the effort to meet the firm's objectives.

8.1 Sources of Procurement of Capital in the IREI

(A) Public Equity: The maturity of the Indian real estate industry is reflected in the increased access to public equity, both domestic as well as overseas, over the last few years. The Indian real estate sectors have raised equity in the past one year out of which close to 60 per cent has been raised through public offerings in the domestic and foreign markets. These include reality majors such as DLF, Sobha, and Omaxe etc. From a handful of real estate companies that were listed in the last decade on the Indian bourses, today there are over 35 listed real estate companies with

Optimum Capital Structure denotes best combination of Loan and Equity Capital.
a total market capitalization. In the last one year, 23 Indian real estate companies have raised through public equity offerings. Domestic mutual funds focused on the reality stocks are in conception and in line with that, ICICI Real Estate Securities Fund. Indian real estate has also equally tapped the overseas capital markets with reality firms listed on the Alternate Investment Market-AIM (London Stock Exchange and Singapore Exchange).\(^5\)

(B) **Private Equity:** As the Indian real estate market matures, the scope of private equity in real estate projects has gained greater prominence. The industry is progressing up the learning curve which is reflected in the number and diversity of transactions investors have also shown an appetite for investment across asset classes. The sources of private equity are:

(i) Foreign direct investment: FDI in India, in accordance with the positive sentiment towards the market have seen steep upward trend over the past few years.

(ii) Portfolio Management Services (PMS): Various real estate funds and private banking divisions of retail banks have raised funds through the concept of PMS from domestic High Net worth Individual (HNI) investors who show interest in the real estate growth story have lower tickets. These investors pool in the money to form a fund which then invested in various real estate project/assets.

(iii) Non-Resident Indian (NRI): The NRI community has evolved as one of the most prominent investment communities for real estate in India. The underlying reason for such an interest is high returns. NRIs have been following the Indian real estate market closely and are looking at options to park their funds in real estate development in the country. NRIs with investments in real estate in India, can now not only cash out on the property they hold, but also enjoy incentives to invest in real estate. This has been made possible by the RBI which allows NRIs to remit the proceeds from the sale of immovable property.

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Domestic Real Estate Funds: Domestic funds enjoy over foreign funds in the flexibility of entering into real estate projects at any stage of development. Domestic funds do not have to comply with specifications which are laid down for FDI investment in the real estate sector, thereby, opening a vast arena of opportunities for the Domestic Players.

9.0 DIVIDEND DECISION

The third important decision of financial management is dividend Policy. The dividend policy has a direct bearing on the aims and objectives of a business firm i.e., maximizing the welfare or wealth of the members. One of the most important considerations in selecting a dividend policy is its impact on the firm’s cost of capital, its growth and share price. Dividends are that portion of the firm’s retained earnings paid out to the stockholders. A company cannot pay dividends except when it has made a profit or it has accumulated sufficient reserves from post profits. A firm’s dividend policies affect these two aspects i.e., (i) Funds to finance long term growth and (ii) Funds to be distributed to shareholders. In other words, they are two possible approaches to dividend decisions.

9.1 (i) As a Long Term Financing Decision

Any firm would like to retain its earnings (i.e., profits after tax), as long as either of the following two conditions exists. (a) Sufficient profitable projects are available. (b) Capital structure needs equity funds.

9.2 (ii) As Maximization of Wealth Decision

As per this approach, higher dividends increase the value of the stock, the result of which is maximization of wealth to the shareholders.

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10.0 PROFIT PLANNING AND CONTROL

Profit is said to be an engine that drives the business enterprise. The main objective of every business is to secure a fair return on the capital employed, and to manage the enterprise as profitably as possible. Profit is not only remuneration on capital employed but, also a measure of efficiency of the funds employed. To quote Gilchrist, “Profit is the ultimate measure of effectiveness.”

Control involves the use of budgets and establishment of company’s objectives. After getting the results, they are verified with the budgeted objectives, in order to measure as to how the company’s performance has confirmed with its expectations. Last step is to take action to correct deviations and deficiencies if any.

11.0 FINANCIAL STATEMENTS

Financial statements represent the snapshot of concern’s activities at the end of a particular period. The result of financial statements reflects a combination of recorded facts; accounting conventions and personal judgements.

Financial statements comprising income statements, balance sheet and other statements reveal the financial position of a firm. Financial statements are prepared from the accounting records maintained by the firm. These statements are nothing but the end products of the accounting process derived from the maintenance of accounts. In the words of Hampton, “A financial statements is an organized collection of data organized according to logical and consistent accounting procedures. The generally accepted accounting principles and procedures are followed in the preparation of these statements. Anthony, viewed that financial statements are the interim reports presented annually and that they reflect a division

22 Ibid.
of the life of an enterprise into more or less arbitrary accounting periods — more frequently a year.\(^4^4\)

Financial statements present the financial data relating to a company’s current financial health, business results for the previous period and other indicators that are used by the company’s stakeholders to assess the health of the company. Usually, the broadest requirement is that financial statements should be true and fair. Financial statements can also be the representations of business structures as recorded in a double-entry bookkeeping system and are used to support internal record-keeping and decision-making. While, businesses are not obligated to use this format internally, most do keep its basic structure because, well-understood by employees and well supported by information systems. Business concerns view their financial conditions in terms of assets, liabilities and liquidity.\(^4^5\)

12.0 SUMMING UP

Financial system may made up of all those channels through which savings become available for investment. Maximization of wealth is the long term profit of the firm. Its objective is considered to be superior to profit maximization. Shareholders’ wealth maximization is an appropriate guide for how a firm should act. There are certain social actions which are very necessary for the survival of the firm and compatible with the objective of wealth maximization. The major aspect of investment decision relates to the selection of firm’s cost of capital. Proper management of working capital is very important for the success of any enterprise. The dividend policy has a direct bearing on the aims and objectives of a business firm. Profit is the ultimate measure of effectiveness.


\(^{4^5}\) [www.financialmodelingguide.com](http://www.financialmodelingguide.com)