Lecture Notes

On

FINANCE AND RELATED DISCIPLINES

MBA – 2nd sem

BBA – 2nd sem

Subject – Financial Management

By : Dr Monisha Gupta

Department of Management, NGB (DU)

FINANCE AND RELATED DISCIPLINES

Financial Management is not an independent area, but an integral part of overall management. As a subject too, Financial Management had been a branch of Economics till 1890. Later, it has evolved into a separate discipline. It draws heavily on Economics to explain its theoretical concepts, even today. The subject is of immense interest to academicians and practicing managers. Academicians take interest as there are several controversies and no unanimous opinion is, still, found. Again, the subject is a matter of great challenge to practicing managers as business affords a lot of scope to expand, with ever-growing competition. Every decision-making process involves finance, demanding new innovative products and techniques to use them to the utmost advantage of the firm. Finance managers often do feel in real life why this subsequent thinking did not come to them earlier, to solve their problems. Threat to survive sharpens the thinking process.

Finance and Economics

Economics has two broad areas, viz. Macroeconomics and Microeconomics.
Macroeconomics is concerned with overall institutional and international environment in which the firm must operate. In other words, macroeconomics is the environment in which an industry operates, which is not controllable by any individual firm. They are the external factors, which are beyond the control of the company. They relate primarily to

• State of the economy

• Government policy

When we analyze our problems from the viewpoint of the whole economy, it is a macro economics. Institutional environment encompasses banking system, capital markets, financial intermediaries, credit policies of The Reserve Bank of India, structure and growth of financial system, monetary and economic policies of the government, which vary periodically. Their awareness and adoption to change for the firm is vital. Business firms operate in the macroeconomic environment. Unless the finance managers understand the implications of the policy and assess the impact they make to the business, and change accordingly, business firms cannot survive, let alone grow. Finance managers have to understand the broad economic environment in which their firms work. To be successful, they cannot afford to function in isolation. They should recognize the impact of each decision, be it monetary or credit policy, in terms of their relative cost and availability of funds. For example, when the economy faces slump, it is not advisable to go for expansion activities. Similarly, when the economy experiences an uptrend, firm can opt for trading on equity for financing as larger profits are assured to most of the firms. That policy helps the firm to increase earnings per share. Finance managers have to update their knowledge and make detailed analysis in respect of matters affecting the company to apprise the management for the timely changes to be introduced.

Microeconomics is firm's specific environment and also controllable. Microeconomic factors deal with the internal conditions of the firm. A few important factors are as under:

1. Nature and Size of Enterprise: Firms differ in activities and their size. Their capital structure and methods of financing also depend on their size. A manufacturing firm or public utility organization would require more fixed assets, so their capital structure is large. Small firms can obtain their fixed assets even on lease. But, large firms would construct their own building and assemble their own plants. Unlike big firms, small firms do not enjoy goodwill in the capital market and are largely dependent on internal finances.

2. Level of Risk and Stability in Earnings: Risk influences the financial decisions of the firm. Greater the risk, firm has to retain more profits, rather than adopting a liberal dividend policy. Firms that enjoy stable earnings prefer fixed-cost capital, such as preference shares and debentures as they can pay the fixed amount of interest, without difficulty, from their earnings. Where stable earnings do not exist, financing is done through equity as there is no commitment to pay fixed and regular dividend.

3. Liquidity Position: Dividend, normally, is paid out of cash. Firms with a sound liquidity position can adopt liberal dividend policy. If there is illiquidity in the firm, it affects nature of financing and dividend decisions.

4. Pattern of Ownership: In a closely-held company, ownership lies in a few hands. It is easier to convince them that a conservative dividend policy is good to them, if the policy is in the interests of the company. Where there are many shareholders, their wishes matter the most in decision-making. Their preferences cannot be ignored, while designing dividend policy.

5. Attitude of Management: Though listed last, importance of attitude of management is not the least. If the firm is conservative, greater importance is given to liquidity, rather than the profitability. More investment is made in current assets. The finance manager tries to tread a beaten path, preferring to avoid fixed obligations for raising additional capital, even if debt capital is advantageous. On the other hand, finance manager in an aggressive firm stresses profitability, sacrificing importance of liquidity. Additional capital is raised by debt, accepting the risk of debt to take advantage of the debt. Alternatively, preference may be given to conduct the business with lesser current assets.

Finance and Accounting

Much of the modern business is not possible without accounting information. It is an accepted fact that business is finance oriented. It is the process of using money to make money. Accounting generates information/data related to activities/operations of a firm, dealing in goods or services. Necessary input is provided by accounting for finance function. Accounting is a source of most information, which management uses for decision-making. Management is heavily dependent on accounting for operating facts.

Finance is closely related to accounting. Accounting is the data collection process, dealing with accurate reporting, while finance is a managerial or decision-making process. Accounting provides the input for finance. Finance is wide, while accounting is its part. Finance is referred to with greater respect than accounting. In many organizations, finance is entrusted only to those who enjoy the trust of the top management. End products of accounting—profit and loss account, balance sheet, sources and application of funds statement and cash flow statement—assist finance managers in assessing the past performance and understanding the future directions of the firm.

There are two key differences between accounting and finance. One relates to treatment of funds and the other relates to decision-making.

Treatment of Funds: Accrual system of accounting is the backbone of accounting, which forms the basis for determination of operating results. Revenue is recognized at the point of sale, irrespective of its realization of sale proceeds. In other words, collection of cash has no significance. Similarly, expenses are recognized when they are incurred, not at the time of payment. Payment of expense is not relevant at all. A firm may be quite profitable in the accounting sense, but, still, struggling, even, to make small cash payments due to liquidity problems. In fact, such a book profit firm cannot survive very long. Solvency is always a challenge, if it is not the focus of the firm. For treatment of funds, finance is based on cash flows. Funds mean inflow and outflow of cash. Sales, when actually realized, are inflows and expenses when paid are outflows. Here, the importance is on solvency, i.e. ability to maintain cash obligations as and when they fall due for payment. Insolvency situation is avoided. The goal of the firm is to maintain the necessary cash flows, to meet its obligations and finance the assets needed for the firm.

Decision-making: Accounting and finance differ in their purpose. The purpose of accounting is collection and presentation of data. The data so made available is used by the finance manager for decision-making. It does not mean that accountants never make decisions and finance managers never collect data. Their focus is different. Accountants collect accurate data and finance managers plan, control and make decisions. In a way, finance begins where accounting ends.

Finance and Other Related Disciplines

Finance also draws support from other related disciplines, such as production, marketing and quantitative methods. Finance is a service function to meet the needs of production and marketing. If the firm decides to produce and sell more, capital expenditure projects may be needed, for which finance manager has to arrange funds. Such a decision also would have impact on the projected cash flows. In those areas, production and finance managers need to work closely for optimum investment in plant and machinery. Finance is becoming a complex area and so tools of analysis developed in the quantitative methods area are helpful in analyzing the complex financial management problems.

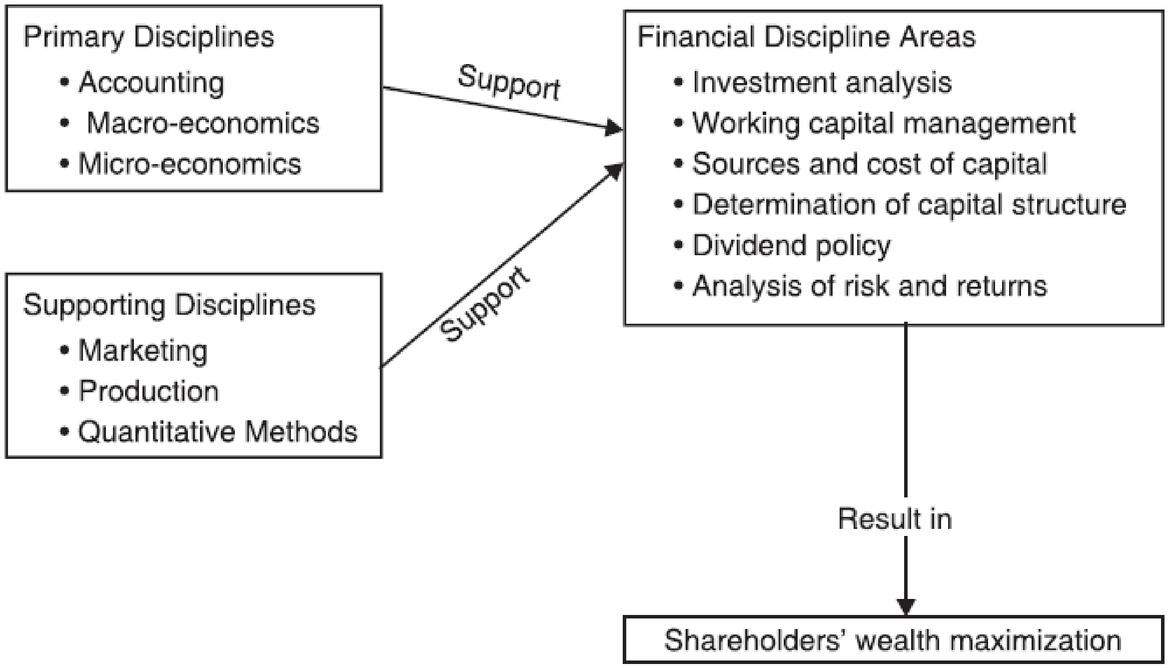

Fig. 1.1: Impact of important disciplines on financial management