SEMIS 2017

FINANCE FUNCTIONS

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Definition

- Finance is the branch of economics that deals with generation and allocation of scarce resources primarily funds or money to the most efficient user or competing projects through a market pricing system.
- It is the application of economic principles and concepts to business decision making and problem solving .

Branches of finance

- Corporate finance/Financial management
- Investment analysis and portfolio management.
- Financial institutions and markets
- Finance theory
- Public finance
- International finance

Financial Management

- Financial Management is nothing but management of the limited financial resources the organisation has, to its utmost advantage.
- Resources are always limited, compared to its demands or needs.
- Financial management deals with the study of procuring funds and its effective and judicious utilisation, in terms of the overall objectives of the firm, and expectations of the providers of funds.
- The basic objective is to maximise the value of the firm. The purpose is to achieve maximisation of share value to the owners i.e. equity shareholders.

Financial Management

The term financial management has been defined, differently, by various authors. Some of the authoritative definitions are given below:

1. "Financial Management is concerned with the efficient use of an important economic resource, namely, Capital Funds" **—Solomon**

2. "Financial Management is concerned with the managerial decisions that result in the acquisition and financing of short-term and long-term credits for the firm"**—Phillioppatus**

3. "Business finance is that business activity which is concerned with the conservation and acquisition of capital funds in meeting financial needs and overall objectives of a business enterprise" **—Wheeler**

Scope of Finance Function

- **Traditional Approach-Procurement of Funds**
- **Modern Approach-Effective Utilisation of Funds**

Traditional Approach-Procurement of Funds

- Estimation of requirements of finance,
- Arrangement of funds from financial institutions,
- Arrangement of funds through financial instruments such as shares, debentures, bonds and loans, and
- Looking after the accounting and legal work connected with the raising of funds.

Scope of Finance Function

Limitation of Traditional Approach

- **No Involvement in Application of Funds:** The finance manager had not been involved in decision-making in allocation of funds. He had been treated as an outsider. He had been ignored in internal decision making process and considered as an outsider.

- **No Involvement in day to day Management:** The focus was on providing long-term funds from a combination of sources. This process was more of one time happening. The finance manager was not involved in day to day administration of working capital management. Smooth functioning depends on working capital management, where the finance manager was not involved and allowed to play any role.
- **Not Associated in Decision-Making Allocation of Funds:** The issue of allocation of funds was kept outside his functioning. He had not been involved in decision- making for its judicious utilisation.

Scope of Finance Function

Modern Approach-Effective Utilisation of Funds

- **The emphasis of Financial Management has been shifted from raising of funds to the effective and judicious utilisation of funds.**
- **The modern approach is analytical way of looking into the financial problems of the firm.**

Objectives of Finance Function

- **Acquiring Sufficient and Suitable Funds:** The primary aim of finance function is to assess the needs of the enterprise, properly, and procure funds, in time.

- **Proper Utilisation of Funds:** Raising funds is important, more than that is its proper utilisation. If proper utilisation of funds were not made, there would be no revenue generation. Benefits should always exceed cost of funds so that the organisation can be profitable.

Objectives of Finance Function

- **Increasing Profitability:** Profitability is necessary for every organisation. The planning and control functions of finance aim at increasing profitability of the firm. To achieve profitability, the cost of funds should be low.
- **Maximising Firm's Value:** The ultimate aim of finance function is maximising the value of the firm, which is reflected in wealth maximisation of shareholders. The market value of the equity shares is an indicator of the wealth maximisation.

Finance Functions

- Investment Decision or Long-term Asset mix decision
- Finance Decision or Capital mix decision
- Liquidity Decision or Short-term asset mix decision
- Dividend Decision or Profit allocation decision

Finance Functions

❖ Investment Decision or Long-term Asset mix decision

- **Investment decisions relate to the total amount of assets to be held and their composition in the form of fixed and current assets.** Both the factors influence the risk the organisation is exposed to. The more important aspect is how the investors perceive the risk.
- The investment decisions result in purchase of assets. Assets can be classified, under two broad categories:

(i) Long-term investment decisions – Long-term assets

(ii) Short-term investment decisions – Short-term assets

Finance Functions

- Finance Decision or Capital mix decision
- **Finance decision is concerned with the mix or composition of the sources of raising the funds required by the firm.**
- **In other words, it is related to the pattern of financing.**

Impact of Leverage on Returns

	Firm U	Firm L
EBIT	$3,000	$3,000
Interest	0	1,200
EBT	$3,000	$1,800
Taxes (40%)	1 ,200	720
NI	$1,800	$1,080
ROE	9.0%	10.8%

Why does leveraging increase return?

- More EBIT goes to investors in Firm L.
  - Total dollars paid to investors:
    - U: NI = $1,800.
    - L: NI + Int = $1,080 + $1,200 = $2,280.
  - Taxes paid:
    - U: $1,200; L: $720.
- Equity $ proportionally lower than NI.

Finance Functions

❖ Liquidity Decision or Short-term asset mix decision

- Liquidity decision is concerned with the management of current assets. Basically, this is Working Capital Management.
- Working Capital Management is concerned with the management of current assets. It is concerned with short-term survival. Short term-survival is a prerequisite for long-term survival.
- A proper balance must be maintained between liquidity and profitability of the firm. This is the key area where finance manager has to play significant role. The strategy is in ensuring a trade-off between liquidity and profitability.

Finance Functions

❖ Dividend Decision or Profit allocation decision

- Dividend decision is concerned with the amount of profits to be distributed and retained in the firm.
- **Dividend:** The term 'dividend' relates to the portion of profit, which is distributed to shareholders of the company. It is a reward or compensation to them for their investment made in the firm. The dividend can be declared from the current profits or accumulated profits.