INTRODUCTION TO FINANCIAL MANAGEMENT

Learning objectives:

The purpose of this lecture is to provide you with an overview of financial management. After finishing this lecture, you would be able to have a better understanding of the following.

- Definition of financial management
- Significance of financial management for non-finance students and professionals
- Important concepts and areas in financial management
- The position of financial managers in organizational hierarchy and their respective work domains.
- Different business legal entities, their advantages and limitations.
- The external and internal business environments and their relevance to financial management.
- Different types of financial and real assets markets.

What is FM?

FM is the management of financial resources – how to best find and use investments and financing opportunities in an ever-changing and increasingly complex environment.

Why should CS majors study FM?

First of all, financial management is a core life skill; almost every one needs to understand some concepts of finance to manage his/her business & personal finances.

It is generally and quite rightfully said, “Money makes the world go round”. Finance is like a life-blood for a company. Even the best of the companies and CEOs go out of the business because of poor financial management policies.

Management Information Systems (MIS) and Information Technology (IT) are just a part of the overall corporate strategy which runs on finances, the major resource. So the computer sciences professionals need to have an understanding of the financial concepts to understand and contribute to the overall corporate strategy.

Financial Engineering is an upcoming field that requires people with CS, math/science, and finance background. Financial engineering is the application of engineering methods to finance. One important area of study is the design, analysis, and construction of financial contracts to meet the needs of enterprises. This field is experiencing an increased demand for professionals, especially those who are trained in both the underlying mathematics/computer technologies and finance.

Definitions

Finance:

Finance is the science of managing financial resources in an optimal pattern i.e. the best use of available financial sources. Finance consists of three interrelated areas:

1) Money & Capital markets, which deals with securities markets & financial institutions.
2) Investments, which focuses on the decisions of both individual and institutional investors as they choose assets for their investment portfolios.
3) Financial Management, or business finance which involves the actual management of firms.

Major Areas & Concepts of Financial Management

Following are some of the important areas and concepts of financial management, which would be discussed in detail in the lectures to come.

- **Analysis of Financial Statements:**

  Analysis of financial statement is one of the most common techniques of financial analysis, in which the financial performance and financial health of a company are analyzed based on its past performance.`

  The following financial statements are used in the analysis process.

  - **Profit & Loss Statement or Income Statement**

    Income statement reflects the operating efficiency or profitability of a company as a result of its operations along with the net profit available to the shareholders for a given year (usually one accounting period). This statement provides the analyst with some insight into the financial performance of the company.

  - **Balance Sheet**

    Balance Sheet is a snap-shot of an organization’s financial health at a particular time. It shows what assets are owned by the business and the sources of acquiring these assets.

- **Statement of Shareholders' equity**
  Statement of shareholders' equity provides the share of the owners in the business.
- **Statement of Cash Flows**
  Statement of cash flows explicitly reflects the cash movement (inflows and outflows) during the operations in an accounting period.

Taken together, these statements give an accounting picture of the firm's operations and financial position. Financial statements report what has actually happened to the assets, earnings, and dividends over the years. The analysis of the information contained in these statements help management of the organization to evaluate the performance and activities of the concern; it also helps the investors and creditors to have an idea of the profitability potential and creditworthiness of the business.

- **Investment Decisions & Capital Budgeting:**

Investment decisions are the most critical as they usually involve huge sums of money and these decisions are likely to bring prosperity or doom to a business. A company's future income depends on how much investment is made, in what type of assets, and how these assets add to the overall value of the company.

Capital budgeting is a term strictly related to investment in fixed assets; here, the term capital refers to the fixed assets that are used in production, while budget is a plan which details projected cash inflows and outflows over some future period. The following concepts and techniques are employed while analyzing investment decisions.

- Interest rate formulas
- Time Value of Money
- Discounted Cash Flows
- Net Present Value
- Internal Rate of Return

- **Risk & Return:**

Investors, individual or institutional, invest their money with the expectations of earning a return on their investment. While investors wish and attempt to earn maximum return, they are constrained by risk. How the risks and returns are related and how do investors make a choice of their portfolios is important for investment decision making. Following concepts and theories would be discussed while discussing the risk-return choices of the investor:

- Uncertainty
- Risk
- Portfolio Theory
- Capital Asset Pricing Model

- **Corporate Financing & Capital Structure:**

When a firm plans to expand, it needs capital or funds. Acquisition of funds is considered to be a primary responsibility of a finance department in an organization. There are numerous ways to acquire funds, i.e., finances can be raised in the form of debt or equity. The proportion of debt and equity constitutes the capital structure of the firm. Financial experts attempt to find a combination of debt and equity that could increase the overall value of the company, i.e., they try to find the optimal capital structure. The following concepts would be used to understand how an optimal capital structure could be attained.

- Cost of Capital
- Leverage
- Dividend Policy
- Debt Instruments

- **Valuation:**

Asset or company valuation is important not only for financial managers, but also for creditors and investors. It is important to know the value of the company or its assets to make important financing and investment choices. Different valuation techniques and factors that influence the value of a company or its financial instruments would be discussed in this section.

- Share
- Bond
- Option
- Corporate

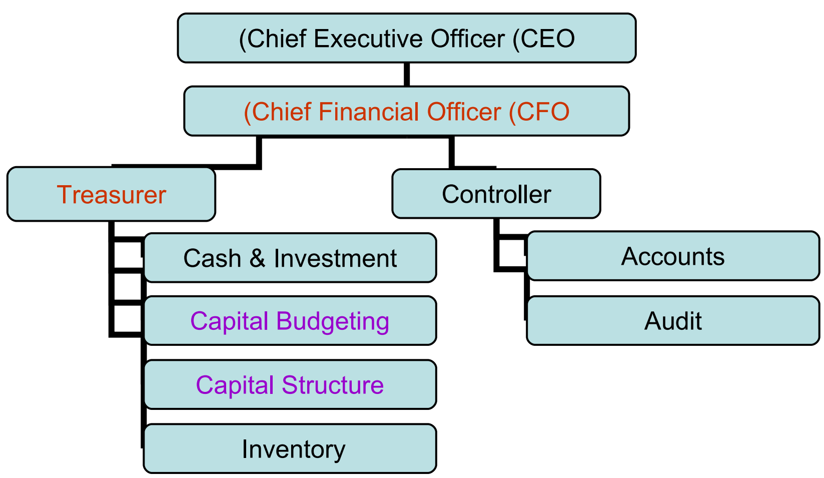
- **Working Capital & Inventory Management:**
  Working capital and inventory management pertains to the effective management of current assets. As we will see, an optimal and effective utilization of working capital and inventory increases the operating efficiency of the firm.

- **International Finance & Foreign Exchange:**

  With the increasing importance of international trade and global markets, the role of international finance has increased manifold. In a global environment, the finance managers have more choices pertaining to investing and financing than ever before. However, it is important to understand the implications of working in a global environment, since fluctuations in the currency rates can convert a good financing or investment decision into a bad one. This section of the course would discuss the international financial environment and the financial implications of working in a global environment.

Organizational Structure

(Who does the FM work?)



Business Legal Entities

- **Sole Proprietorship :**
  It is an unincorporated business owned by one individual. Going into a business as a sole proprietor is simple – one merely has to begin business operations. Proprietorship consists of 80%of the total number of businesses worldwide.

Advantages:

i. It is easily & inexpensively formed.
ii. It is subject to few government regulations.
iii. The business pays no corporate income tax; only personal income tax is paid by the proprietor.