CONCEPTS IN FINANCIAL MANAGEMENT

1. Finance.

a. Finance is a simple task of providing the necessary funds (money) required by the business of entities like companies, firms, individuals and others on the terms that are most favourable to achieve their economic objectives."

b. Finance is the procurement (to get, obtain) of funds and effective (properly planned) utilisation of funds. It also deals with profits that adequately compensate for the cost and risks borne by the business."

2. Financial decisions:
Financial decisions refers to decisions concerning financial matters of a business firm. There are many kinds of financial management decisions that the firm makes min pursuit of maximizing shareholder's wealth, viz., kind of assets to be acquired , pattern of capitalization, distribution of firm's income etc. we can classify these decisions into three major groups:

- Investment decisions
- Financing decisions
- Dividend decisions

3. Investment Decisions:
Investment decision relates to the determination of total amount of assets to be held in the firm, the composition of these assets and the business risk complexions of the firm as perceived by its investors.
Investment decisions can be classified under two broad groups:
Longterm investment decision and
Short term investment

4. Wealth maximization Definition
A process that increases the current net value of business or shareholder capital gains, with the objective of bringing in the highest possible return. The wealth maximization strategy generally involves making sound financial investment decisions which take into consideration any risk factors that would compromise or outweigh the anticipated benefits.

5. Profit maximization Definition
A process that companies undergo to determine the best output and price levels in order to maximize its return. The company will usually adjust influential factors such as production costs, sale prices, and output levels as a way of reaching its profit goal. There are two main profit maximization methods used, and they are Marginal CostMarginal Revenue Method and Total CostTotal Revenue Method. Profit maximization is a good thing for a company, but can be a bad thing for consumers if the company starts to use cheaper products or decides to raise prices.

6. Time value of money:
The recognition of the time value of money is extremely vital in financial decision making. If the timing of cash flows is not considered the firm may make decisions which may faulter its objectives of maximizing the owner's welfare. The welfare of the owners would be maximised, when net wealth or net present worth is created from making a financial decision.

7. Compound Value: Interest that is paid both on the initial principal as also on the interest earned on the initial principal in previous period/s. The interest earned in one period becomes a part of the principal in the succeeding period.

8. Present value:
The present value of current cash inflow or outflow is the amount of current cash that is of equivalent desirability, to the decision maker, to a specified amount of cash to be received or paid at a future date.

9. Reasons for Time value of money:
Three reasons may be attributed to the individual's time preference for money:
- Risk
- Preference for consumption
- Investment opportunities

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10. Annuity: A series of receipts or payments of a fixed amount for a specified number of years. Alternatively, a pattern of cash flows that is equal in each year, i.e. equal annual cash flows.

11. Capital budgeting: The process of determining which potential longterm projects are worth undertaking, by comparing their expected discounted cash flows with their internal rates of return.
12. Capital Budgeting techniques: The following are the capital; budgeting techniques:

Non Discounted cash flow (DCF) criteria
- Pay back period (PBP)
- Accounting Rate of return

Discounted Cash flow techniques:
- Net present value (NPV)
- Profitability Index (PI)
- Internal rate of return (IRR)

13. Payback Period: The length of time required to recover the cost of an investment. The payback period of a given investment or project is an important determinant of whether to undertake the position or project, as longer payback periods are typically not desirable for investment positions.

Calculated as: Cost of Project

Annual Cash Inflows

14. Accounting rate of return method: The accounting rate of return also known as the return on Investment (ROI) Uses accounting information, as revealed by financial statements, to measure the profitability of an investment. The accounting rate of return is the ratio of the average after tax profit divided by the average investment. The average investment would be equal to half of the original investment if it were depreciated constantly. Alternatively, it can be found out by dividing the total of the investment's book value after depreciation by the life of the project. The accounting rate of return, thus, is an average rate and can be determined by the following equation.

$$ARR = \frac{\text{Average Income}}{\text{Average Investment}}$$

15. Net Present Value – NPVThe 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 an investment or project. NPV analysis is sensitive to the reliability of future cash inflows that an investment or project will yield.

16. Internal Rate Of Return – IRR The IRR of an investment is the discount rate at which the net present value of costs (negative cash flows) of the investment equals the net present value of the benefits (positive cash flows) of the investment. The discount rate often used in capital budgeting that makes the net present value of all cash flows from a particular project equal to zero.

17. Profitability Index (P.I.) or Benefit cost ratio: It is the ratio of the present value of future cash benefits, at the required rate of return to the initial cash flow of the investment".

Formula: $$P.I. = \frac{\text{Present value of cash inflows}}{\text{Present value of initial cash outlay}}$$

18. AcceptReject criterion: Evaluation of capital budgeting proposals to determine whether the project under consideration satisfies the minimum acceptance standard and should be accepted.

19. Capital Rationing: RiskReturn Trade off A situation in which due to financial constraints, the limited funds are allocated a number of mutually exclusive capital budgeting projects.

20. Definition of Risk: The chance that an investment's actual return will be different than expected. Risk includes the possibility of losing some or all of the original investment. Different versions of risk are usually measured by calculating the standard deviation of the historical returns or average returns of a specific investment. A high standard deviation indicates a high degree of risk.

21. Risk premium: The difference between expected rate of return on a risky project and the rate of return on a risk less project.

22. RiskReturn Tradeoff: The relationship between the risk and the required Rate of return.

23. Definition of RiskAdjusted Return: A concept that defines an investment's return by measuring how much risk is involved in producing that return, which is generally expressed as a number or rating. Riskadjusted returns are applied to individual securities and investment funds and portfolios.

24. CertaintyEquivalents: The return required with certainty to make investors indifferent between this certain return and a particular uncertain (risky) return.

25. Coefficient of variation: A relative measure of the variability of the outcomes associated with an event. It is calculated by dividing the standard deviation of a distribution by the mean.

26. Sensitivity Analysis: The analysis of the effect of change in certain variable on an outcome, to estimate the variability of the outcome, or risk associated with a project or a situation.

27. Decision Tree: A decision tree is a graphic display of the relationship between a present decision and future events, future decisions and their consequences. The sequence of events is mapped out over time in a format similar to the branches of a tree.

28. Leverage: A General Dictionary meaning of the term ‘Leverage’ refers to an increased means of accomplishing some purpose.” Leverage allows us to accomplish certain things which are otherwise not possible, viz; Lifting of heavy objects with the help of leverage. The concept of leverage is valid in business also.

In Financial Management, the term ‘leverage’ is used to describe the firm’s ability to use fixed cost assets or funds to increase the return to its owners; i.e. equity shareholders. James Home has defined leverage as “the employment of an asset or sources of funds for which the firm has to pay a fixed cost or fixed return”. The fixed cost and fixed return remain constant irrespective of the changes in volume of output or sales. Thus, the employment of an asset or source of funds for which the firm has to pay a fixed cost or return has a considerable influence on the earnings available for equity shareholders.

24. Financial Leverage/Trading on Equity:

The ability of fixed financial charges magnify the effect of changes in EBIT on the earnings per share(EPS). Also known as Trading on Equity.

To use debt to finance an activity. For example, one usually borrows money in the form of a mortgage to buy a house. One commonly refers to this as leveraging the house. Likewise, one leverages when one uses a margin in order to purchase securities.

The amount of debt that has been used to finance activities. A company with much more debt than equity is generally called "highly leveraged." Too much leverage is often thought to be unhealthy, but many firms use leverage in order to expand operations.

OR

Financial leverage

The extent to which interest on debt magnifies changes in operating income into even greater proportionate changes in earnings after taxes. Financial leverage magnifies increases in earnings per share during periods of rising operating income but adds significant risks for stockholders and creditors because of added interest obligations.

25. Definition of 'Operating Leverage'

A measurement of the degree to which a firm or project incurs a combination of fixed and variable costs.

A business that makes few sales, with each sale providing a very high gross margin, is said to be highly leveraged. A business that makes many sales, with each sale contributing a very slight margin, is said to be less leveraged. As the volume of sales in a business increases, each new sale contributes less to fixed costs and more to profitability.

A business that has a higher proportion of fixed costs and a lower proportion of variable costs is said to have used more operating leverage. Those businesses with lower fixed costs and higher variable costs are said to employ less operating leverage.

26. Capital structure: Capital structure of a company means the composition of long term sources of funds. Such as ordinary shares, preference shares, debentures, bonds, longterm debts etc. It refers to the kind and proportion of securities for raising longterm funds. It implies the determination of form or makeup of a company's capitalization.

27. Optimum capital structure: An optimal or sound capital structure can be properly defined as that combination of debt and equity that attains the stated managerial goal in the most relevant manner the maximization of the firm's market value and the minimization of the firm's cost of capital. The Optimal capital structure is concerned with the two important variables at one time – The minimization of cost as well as maximization of worth.

28. Cost of capital: Cost of capital refers to the opportunity cost of making a specific investment. It is the rate of return that could have been earned by putting the same money into a different investment with equal risk. Thus, the cost of capital is the rate of return required to persuade the investor to make a given investment.

29. Definition of 'Weighted Average Cost Of Capital WACC'

A calculation of a firm's cost of capital in which each category of capital is proportionately weighted. All capital sources common stock, preferred stock, bonds and any other longterm debt are included in a WACC calculation. All else equal, the WACC of a firm increases as the beta and rate of return on equity increases, as an increase in WACC notes a decrease in valuation and a higher risk.

30. EBIT Earnings Before Interest and Taxes. Accountants like to use the term Net Operating Income for this income statement item, but finance people usually refer to it as EBIT (pronounced as it is spelled – E.B.I. T). Either way, on an income statement, it is the amount of income that a company has after subtracting operating expenses from sales (hence the term net operating income). Another way of looking at it is that this is the income that the company has before subtracting interest and taxes (hence, EBIT).

31. EAT Earnings After Taxes. Accountants call this Net Income or Net Profit After Taxes, but finance people usually refer to it as EAT (pronounced E. A. T).

32. EPS Earnings Per Share. This is the amount of income that the common stockholders are entitled to receive (per share of stock owned). This income may be paid out in the form of dividends, retained and reinvested by the company, or a combination of both. (It is pronounced E. P. S).

33. Book value: The value of an asset, a liability or equity, as recorded in the accounts of A firm. The book value of ordinary shares is equal to the paidup capital plus retained earnings i.e. net worth.

34. Par value: The stated or face (nominal) value of a security.

35. Market value: It is determined on the basis of the stock market quotations of the company's securities.

36. Flotation costs: Costs incurred in issuing securities, e.g., underwriting and brokerage costs, printing, legal, publicity and so on.

37. Equity share capital: Long term funds provided by the owners of a firm and consist of ordinary share capital and retained earnings.

38. Retained Earnings: The portion of the aftertax profits that are not paid out to the shareholders as dividends.

39. Preference shares: Preference shares have a fixed percentage dividend before any dividend is paid to the ordinary shareholders. As with ordinary shares a preference dividend can only be paid if sufficient distributable profits are available, although with 'cumulative' preference shares the right to an unpaid dividend is carried forward to later years. The arrears of dividend on cumulative preference shares must be paid before any dividend is paid to the ordinary shareholders.

40. Definition of 'Dividend Policy': The policy a company uses to decide how much it will pay out to shareholders in dividends.

41. Dividend Relevance: Walter's Models: Professor James E. Walter argues that the choice of dividend policies almost always affect the value of the firm. His model, one of the earlier theoretical works shows the importance of the relationship between the firm's rate of return, r and its cost of capital, k in determining the dividend policy that will maximize the wealth of shareholders.

42. Dividend Irrelevance: The Miller Modgiliani (MM) approach: According to Modgiliani and Miller (MM), under a perfect market situation, the dividend policy of a firm is irrelevant, as it does not affect the value of the firm. They argue that the value of the firm depends on the firm's earnings that result from its investment policy.

43. Gordon Model: A valuation model in which the value of a firm is equal to the present value of all future dividends expected over the life of the firm.

44. Inventory management: Definition: Activities employed in maintaining the optimum number or amount of each inventory item. The objective of inventory management is to provide uninterrupted production, sales, and/or customerservice levels at the minimum cost. Since for many companies inventory is the largest item in the current assets category, inventory problems can and do contribute to losses or even business failures.

45. Economic Order Quantity: The optimum quantity of inventory to order or to produce based on tradeoff between carrying and ordering costs.

46. Accounts Receivable Management: The term receivables is defined as debt owed to the firm by customers arising from sale of goods or services in the ordinary course of business.

47. Receivables management: Receivables Management means planning, organising, directing and controlling of receivables.

48. Collection period:
The average period taken to collect receivables. It is equal to the average credit sales divided by the number of days in a year.

49. Definition of Cash Management: The corporate process of collecting, managing and (short term) investing cash. A key component of ensuring a company's financial stability and solvency. Frequently corporate treasurers or a business manager is responsible for overall cash management.

50. Cash management: Successful cash management involves not only avoiding insolvency (and therefore bankruptcy), but also reducing days in account receivables (AR), increasing collection rates, selecting appropriate shortterm investment vehicles, and increasing days cash on hand all in order to improve a company's overall financial profitability.

51. Cash cycle: The length of time from the point a firm purchases raw materials to the point when cash is collected from the sale of the resulting finished goods. In other words, it represents the time during which cash is tied up in operations.

52. Liquidity/Solvency: Ability of a firm to meet its obligations when they become due.

53. Current assets: Assets which can be converted into cash within a year.

54. Current liabilities: Liabilities that are payable within a year.

55. Cash Budget: A Cash budget is an estimate of cash receipts and disbursements of cash during a future period of time. In the words of Solomon Ezra, a cash budget is “an analysis of flow of cash in a business over a future, short or long period of time. It is a forecast of expected cash intake and outlay.

56. Value Based Management: Definition of value based management: Value Based Management is the management approach that ensures corporations are run consistently on value (normally: maximizing shareholder value).

It is useful to understand that Value Based Management includes all three of the following:

Creating Value: ways to actually increase or generate maximum future value ≈ strategy.Value Based Management VBM

Managing for Value: (governance, change management, organizational culture, communication, leadership

Measuring Value: valuation.

57. Corporate governance: Corporate governance refers to the set of systems, principles and processes by which a company is governed. They provide the guidelines as to how the company can be directed or controlled such that it can fulfil its goals and objectives in a manner that adds to the value of the company and is also beneficial for all stakeholders in the long term. Stakeholders in this case would include everyone ranging from the board of directors, management, shareholders to customers, employees and society. The management of the company hence assumes the role of a trustee for all the others.

58. Merger: The combining of two or more entities into one, through a purchase acquisition or a pooling of interests

59. Acquisition: The act of contracting or assuming or acquiring possession of something; "the acquisition of wealth"; "the acquisition of one company by another"

60. Takeover: Takeover is a term referring to transfer of control of a firm from one group of shareholders to another group of shareholders. Change in the controlling interest of a corporation, either through a friendly acquisition or an unfriendly, hostile, bid. A hostile

takeover (with the aim of replacing current existing management) is usually attempted through a public tender offer.

61. Concentric merger: Concentric mergers take place when two firms from different but "adjacent" industries merge. For example, if an auto manufacturer and a motorcycle manufacturer merge, the merger is a concentric one. Although both industries serve the transportation needs of their customers, the two are quite unique in their competitive structures.

62. Conglomerate mergers: A conglomerate merger is one where two or more companies with different businesses merge to diversify the products marketed. The companies may not be related to each other horizontally

A conglomerate merger is a type of merger whereby the two companies that merge with each other are involved in different sorts of businesses. The importance of the conglomerate mergers lies in the fact that they help the merging companies to be better than before.

63. Vertical Merger: Merger between a company that supplies goods and services and a company that buys those goods and services. For example, if a publishing company buys a paper producer, it is considered a vertical merger because the publisher buys large amounts of paper. In some cases, vertical mergers may be challenged by the government if they are found to violate antitrust laws.

64. Operating cycle concept : Maximization of share holder's wealth of a firm is possible only when there are sufficient return from the operations. Successful sales activity is necessary for earning profit. Sales do not convert into cash immediately There is invisible time gap between the sale of goods and receipt of cash . The time taken to convert raw material into cash is known as operating cycle .

Conversion of cash into raw material Conversion of raw material into work in progress Conversion of Work in progress into finished goods Conversion of finished goods into Sales Sales into Debtors Debtors into cash.

65. Certainty: Certainty is a situation in which investor is certain about the future price. Certainty has two characteristics.

a . Availability of full information

b. Uniqueness of Outcomes

Ex: Suppose investor knows that the security will definitely be sold at Rs. 120.

66. Uncertainty: There is an inability to forecast the future accurately and reliably. It has two **characteristics:**

In adequate information

Multiple outcomes.

Ex: Suppose he expects that the price of the security could be Rs. 80, Rs. 110 or Rs. 120.

67. Risk: Definitions:

Uncertainty of future outcome Or Probability of an adverse Outcome Or Risk is defined as the variability of return around the expected average.

Risk has three **characteristics:**

Knowledge of Probability of each outcome

Possession of probability distribution

Replicability of past experiment.

Ex: Suppose the investor possesses information that permits him to assign probabilities to each oif the above likely prices of the security. He assigns a probability of 60% to the prioce being Rs. 12, 30% to the price being Rs. 110 and 10% to the price being Rs.80. The investor faced with a risky situation.

68. The Hedging approach / Matching approach: In this approach maturity of source of fund should match the nature of asset to be financed . Hedging approach refers to a process of matching maturities of debt with the maturities of financial need. The hedging approach suggests that the permanent working capital requirement should be financed with fund from long term sources while the temporary working capital requirement should be financed with short term funds. This approach is also known as matching approach.

69. Conservative Approach : This approach suggested that the entire estimated investments in current asset should be finance from long term source and short term should be use only for emergency requirement . Distinct features of this approach ¬

Liquidity is greater

Risk is minimized

The cost of financing is relatively more as interest has to be paid even on seasonal requirement for the entire period.

70. Aggressive approach: This approach make the finance mix . The aggressive approach suggests that the entire estimated requirement of current asset should be financed from shortterm sources and even a part of fixed asset investment be financed from short term sources. Distinct features of this approach :

More Profitable

Less costly

More Risky

71. Definitions of Financial Management: According to S.N. Maheswari:

Financial management is concerned with raising financial resources and their effective utilisation towards achieving the organizational goals

According to Richard.A. Brealey: Financial management is the process of putting the available funds to the best advantage from the long term point of view of business objectives."