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Faculty of Economics, Business, and Management

Department of Management

3rd Year Financial Management

Scope of Finance

What is finance? What are a firm's financial activities? How are they related to the firm's other activities? Firms create manufacturing capacities for production of goods; some provide services to customers. They sell their goods or services to earn profit.

They raise funds to acquire manufacturing and other facilities. Thus, the three most important activities of a business firm are:

- Production
- Marketing
- Finance

A firm secures whatever capital it needs and employs it (finance activity) in activities, which generate returns on invested capital (production and marketing activities).

1. Real and Financial Assets:

A firm requires real assets to carry on its business. **Tangible real assets** are physical assets that include plant, machinery, office, factory, furniture and building. **Intangible real assets** include technical know-how, technological collaborations, patents and copyrights. **Financial assets,** also called securities, are financial papers or instruments such as shares and bonds or debentures. Firms issue securities to investors in the **primary capital markets** to raise necessary funds. The securities issued by firms are traded – bought and sold – by investors in the **secondary capital markets**, referred to as stock exchanges. Financial assets also include lease obligations and borrowing from banks, financial institutions and other sources. In a **lease**, the lessee obtains a right to use the lessor's asset for an agreed amount of rental over the period of lease. Funds applied to assets by the firm are called capital expenditures or investment. The firm expects to receive return on investment and might distribute return (or profit) as dividends to investors.

2. Equity and Borrowed Funds:

There are two types of funds that a firm can raise—equity funds (simply called equity) and borrowed funds (called debt). A firm sells shares to acquire equity funds.

Shares represent ownership rights of their holders. Buyers of shares are called **shareholders** (or stockholders), and they are the legal owners of the firm whose shares they hold. Shareholders invest their money in the shares of a company in the expectation of a return on their invested capital. The return of shareholders consists of dividend and capital gain. Shareholders make capital gains (or loss) by selling their shares.

Shareholders can be of two types—ordinary and preference. **Preference shareholders** receive dividend at a fixed rate, and they have a priority over **ordinary shareholders**. The dividend rate for ordinary shareholders is not fixed, and it can vary from year to year depending on the decision of the board of directors. The payment of dividends to shareholders is not a legal obligation; it depends on the discretion of the board of directors. Since ordinary shareholders receive dividend (or repayment of invested capital, only when the company is wound up) after meeting the obligations of others, they are generally called **owners of residue**. Dividends paid by a company are not deductible expenses for calculating corporate income taxes, and they are paid out of profits after corporate taxes. As per the current laws in India, a company is required to pay 12.5 per cent tax on dividends.

A company can also obtain equity funds by retaining earnings available for shareholders. Retained earnings, which could be referred to as internal equity, are undistributed profits of equity capital. The retention of earnings can be considered as a form of raising new capital. If a company distributes all earnings to shareholders, then, it can re-acquire new capital from the same sources (existing shareholders) by issuing new shares called **rights shares.** Also, a **public issue** of shares may be made to attract new (as well as the existing) shareholders to contribute equity capital.

Another important source of securing capital is **creditors** or **lenders.** Lenders are not the owners of the company. They make money available to the firm as loan or debt and retain title to the funds lent. Loans are generally furnished for a specified period at a fixed rate of interest. For lenders, the return on loans or debt comes in the form of interest paid by the firm. Interest is a cost of debt to the firm. Payment of interest is a legal obligation. The amount of interest paid by a firm is a deductible expense for computing corporate income taxes. Thus, interest provides tax shield to a firm. The interest tax shield is valuable to a firm. The firm may borrow funds from a large number of sources, such as banks, financial institutions, public or by issuing bonds or debentures. A **bond** or a **debenture** is a certificate acknowledging the amount of money lent by a bondholder to the company. It states the amount, the rate of interest and the maturity of the bond or debenture. Since bond or debenture is a financial instrument, it can be traded in the secondary capital markets.

3. Finance and Management Functions:

There exists an inseparable relationship between finance on the one hand and production, marketing and other functions on the other. Almost all business activities, directly or indirectly, involve the acquisition and use of funds. For example,

recruitment and promotion of employees in production is clearly a responsibility of the production department; but it requires payment of wages and salaries and other benefits, and thus, involves finance. Similarly, buying a new machine or replacing an old machine for the purpose of increasing productive capacity affects the flow of funds. Sales promotion policies come within the purview of marketing, but advertising and other sales promotion activities require outlays of cash and therefore, affect financial resources.

Where is the separation between production and marketing functions on the one hand and the finance function of making money available to meet the costs of production and marketing operations on the other hand? Where do the production and marketing functions end and the finance function begin? There are no clear-cut answers to these questions. Though the finance function of raising and using money has a significant effect on other functions, yet it needs not necessarily limited or constrained to the general running of the business. A company in a tight financial position will, of course, give more weight to financial considerations, and devise its marketing and production strategies in the light of the financial constraint. On the other hand, management of a company, which has a reservoir of funds or a regular supply of funds, will be more flexible in formulating its production and marketing policies. In fact, financial policies will be devised to fit production and marketing decisions of a firm in practice.