PRIMER

FINANCIAL MANAGEMENT

Introduction

1. As you prepare to commence your exciting academic pursuit, we welcome you in to the amazing world of finance. Finance, as you would learn during your quest, is the art and science of managing money and can be broadly divided into 'financial services' and 'financial management'. While 'Financial Services' relate to design and delivery of financial advice and financial products, the 'Financial Management' means planning, organising, directing and controlling the financial activities such as procurement and utilisation of funds of the enterprise. The study of FM, therefore, is very closely related to maximisation of efficiency in utilisation of scare resources, which is integral part of your responsibilities.

2. For many of you, it is probably the first time in your career that FM is being introduced formally as a subject in a course curriculum. Given the fact that you would hold positions of strategic leadership in future, it is important to acquaint you with the theoretical and application orientation of FM at this key juncture in your career. Moreover, defence and economics have very close relationship as the fiscal resources consumed in military capability development and sustainment, invariability contribute towards economic development.

Aim and Objectives

3. **Aim**. To enable participants to understand and appreciate relevant Economic and Financial concepts and thereby empower them for qualified decision making in the fiscal space.

4. **Enabling Objectives**. The competencies that the FM curriculum seeks to build are listed below: -

(a) Comprehend Defence Expenditure as a part of National Expenditure and its relation to the finances of a nation in the backdrop of the macroeconomic concepts.

(b) Comprehend linkages between National and Defence Budgets, trends and constraints to ensure accurate forecasting and effective budgeting and expenditure.

(c) Operate effectively within existing financial structure, regulations and procedures to maximize value.

(d) Understand Capital and Revenue Budget models in the Services and effectively apply contemporary techniques and strategies to optimise expenditure.

5. **Learning Objectives**. Accordingly, the learning objectives are listed below:-

(a) Understand fundamental concepts of Macro and Micro Economics and the differences between them.

(b) Understand the Scope of Financial Management and the importance of Economics in managerial decision making.

(c) Analyse the relationship between National Security and total National Resources in terms of the Economy, allocation of resources for defence and management of Defence Expenditure.

(d) Understand the Government Financial System, Financial Administration Structure and various financial Regulations in Defence Forces.

(e) Understand Contemporary Budgeting Techniques, Costing Concepts, Financial Accounting Principles and their possible application in Defence Services and latest trends in Financial Management.

Contents

6. The FM module has carefully selected topics. These topics will be covered in Sem–I over 88 periods including various guest lectures, exercises, panel discussion and evaluation. The topics and their sequence are listed below: -

(a) Overview to Fin Mgt & Economics of Def
(b) Basic Concepts of Economics
(c) Macroeconomic Theories
(d) National Income
(e) Eco Stability and Growth
(f) Banking System and Monetary Controls
(g) Govt Financial System
(h) Financial Administration Defence Services
(j) GFR & DFPDS
(k) National Budget Process & Techniques

(l) Direct & Indirect Taxation
(m) Financial Accounting, Preparation and Analysis of Financial Statements
(n) Management Accounting including Costing & Benchmarking
(o) Concepts of Time Value and its application
(p) Capital Budgeting

Recommended Reading Material

7. College of Defence Management has a very well-stocked library that is stocked with a very wide range of reading material including books, journals and subscriptions to online resources. We are confident that this library will be extremely useful to you during your academic pursuit here.

8. However, as you await your move to CDM, it is recommended that you familiarise yourself with the following online material/resources related to the topics listed below for better comprehension of the Financial Management curriculum: -

(a) Macroeconomic Theories, National Income, Inflation, Economic Stability & Growth, Public Finance & Fiscal Policies (suggested material includes NCERT Class XII books, Investopedia.com can be visited for meaning of various economic and financial terms).

(b) Banking System and Monetary Policies (suggested material includes financial literacy material on RBI website.

(c) Union Budget (indiabudget.gov.in)

(d) Standing Committees of Parliament (loksabha.nic.in)

(e) Financial & Management Accounting (online material of Institute of Chartered Accountants of India, NCERT Class XII books)

FINANCIAL MANAGEMENT - SCOPE AND NATURE

Introduction

1. Needs always outpace our means. It is a fact that resources that are at the disposal of an organisation would always be scarce with respect to requirements and the Armed Forces are no exception. Management has been defined as the optimum utilisation of resources to achieve an organisation's objectives. Seen from a different perspective, it is a process that converts resources into desired results. The resources that are at the disposal of an organisation could be grouped under, human, physical (weapon, equipment, material and finance) and informational resources.

2. Of all the resources at the disposal of an organisation, finance has certain unique properties. Firstly, it is scarce perennially; 'Scarce' - with reference to our wants. Secondly, it is considered the most basic of all resources, in that; it is through this resource that all other resources are obtained. Last, but not least, it has alternative uses. The fact that it is scarce and it has alternative uses, requires an understanding of financial and economic concepts.

Financial Management

3. Financial Management refers to the efficient and effective management of this scarce resource i.e. money (funds) in such a manner as to accomplish the objectives of the organisation. It is a specialised function directly associated with top management. The significance of this function is not only seen in the 'Line' but also in the capacity of 'Staff' in overall administration of an organisation.

4. To put in simple words, Financial Management means planning, organising, directing and controlling the financial activities such as procurement and utilisation of funds of the enterprise. It means applying general management principles to financial resources of the organisation. It's major scope includes investments in fixed assets (called as capital budgeting). Investment in current assets is also a part of investment decisions called as working capital decisions. The Objectives of Financial Management are: -

(a) To ensure regular and adequate availability of funds.

(b) To ensure optimum funds utilisation. Once the funds are allocated/ procured, they should be utilised in maximum possible way at least cost.

(c) Raising and allocation of Capital i.e. Capital Budgeting. Not only long-term budgeting but also how to allocate short-term resources like current assets.

5. Financial Management comprises the following: -

(a) **<u>Financial Planning</u>**. One of the most important functions of the financial manager is that of planning. Financial Planning should be directed at aiding the management in achieving its objectives and implementing its policies. This involves determining the quantum of funds required by an organisation to meet its goals. This is done at the top policy-making level.

(b) **<u>Financing</u>**. The financing function consists of obtaining necessary funds, allocating them, their custody and disbursement. This is a routine function and is performed at the lower levels of the financial hierarchy in an organisation.

(c) **<u>Financial Control</u>**. Having allocated the funds, it is essential to ensure that they have been utilised for the purpose for which allotted, and that they have helped in achieving the objectives as planned. This is done through Accounting, Costing, Budgeting and analysing the financial effect of an operation/mission and Audit.

<u>Economics</u>

6. Economics is defined by Prof. Lionel Robbins, as a science that studies human behaviour as a relationship between **'ends and scarce means that have alternative uses'**. The application of scarce resources amongst competing demands is the basis of all economic concepts. 'Economics' is a social science that studies the broader management of goods and services, including their production and consumption, and the factors affecting them whereas 'Finance' is the science of managing available funds.

7. Economics explains the factors involved in scarcity or surplus of goods and services that affect and can be applied to almost every sphere in society, business in general, and governments. Finance mainly involves saving and lending money, keeping in mind the time available, cash at hand, and the risk involved. Finance can thus be considered a small subset of economics.

8. Economic concepts can be studied under the following two heads: -

(a) **<u>Macro-Economics</u>**. It is the study of the economic problem at the level of economics as a whole. Macroeconomics covers the aggregate performance of the economy such as national income, general price policy, unemployment levels, government budgets, exchange rates and so on. We shall take a broad look at macroeconomics during the course and cover the concepts of macroeconomic theory, national income, economic stability and growth and economic development in India.

(b) **<u>Micro-Economics</u>**. Micro-economics analyses the parts or the components of the economy. It examines how the individual decision-making units, such as consuming units (individual consumers, households), producing units (firms, farms) individual factors of production (labour, capital), individual industries (textiles, machine tools) etc., act and react. It is basically concerned with determination of output and price for an individual unit.

<u>Accounting</u>

9. The language of finance is 'Accounting'. Accounting may be defined as the process of identifying, measuring and communicating economic information to permit informed judgment and decisions. The type of information recorded, the detail to which it is recorded as well as the method of processing will depend on the need for recorded information, the extent to which other controls are available and legal requirements. Accounting can be divided into several areas of activity. These can certainly overlap and they are often closely intertwined. We shall study accounting during the course under three main heads as follows: -

(a) Financial Accounting and Financial Analysis.

(b) Management Accounting.

(c) Government Accounting and Budgeting System.

10. **<u>Financial Accounting</u>**. It is the periodic reporting of an organisation's financial position and the results of operations to external parties through financial statements, which ordinarily include the balance sheet (statement of financial condition), income statement (the profit and loss statement, or P&L), and statement of cash flows.

11. **<u>Financial Analysis</u>**. It involves analysing the health and activities of an organisation from the financial angle. We will confine our studies in this series to the interpretation and analysis of the Profit and Loss Account and the Balance Sheet.

12. **<u>Management Accounting</u>**. Whilst financial accounting focuses on external users, management accounting emphasises the preparation and analysis of accounting information within the organisation. According to the Institute of

Management Accountants, it includes "…designing and evaluating business processes, budgeting and forecasting, implementing and monitoring internal controls, and analysing, synthesising and aggregating information to help drive economic value."

13. A primary concern of management accounting is the allocation of costs; indeed, much of what now is considered management accounting used to be called cost accounting. Although a seemingly mundane pursuit, how to measure cost is critical, difficult and controversial. In recent years, management accountants have developed new approaches like Activity-Based Costing (ABC) and target costing, but they continue to debate how best to provide and use cost information for management decision-making.

14. In the series on financial management we will study some of the tools of management accounting like Budgeting, Costing, Profit-Volume and Break-Even Analysis, Ratio Analysis, etc.

15. **Government Accounting and Budgeting System**. Under this we shall study the financial structure, accounting and auditing system of the Government of India with special reference to defence services. We shall also examine the scope for application of modern budgeting concepts like Performance Budgeting, Planning Programming and Budgeting System (PPBS), Outcome Budgeting and the Zero-Base Budgeting (ZBB) in defence.

Relationship of Finance to Economics and Accounting

16. Financial management has a close relationship to economics on the one hand and accounting on the other. Nuances of the same is explained in subsequent paragraphs.

17. **Relationship to Economics**. The following are relevant: -

(a) There are two important linkages between economics and finance. The macroeconomic environment defines the setting within which a firm operates and micro-economic theory provides the conceptual underpinning for the tools of financial decision-making.

(b) Key macro-economic factors like the growth rate of the economy, domestic savings rate, the role of the government in economic affairs, the tax environment, the nature of external economic relationships, the availability of funds to the government/ corporate sector, the rate of inflation, the real rate of interests and the terms on which the government/firm can raise finances define the environment in which the firm operates. No finance manager can afford to ignore the key developments in the macro-economic sphere and the impact of the same on the organisation.

(c) While an understanding of the macro-economic developments sensitises the finance manager to the opportunities and threats in the environment, a firm grounding in micro-economic principles sharpens his analysis of decision alternatives. Finance, in essence, is applied microeconomics. For example, the principle of marginal analysis – a key principle of micro-economics according to which, a decision should be guided by a comparison of incremental benefits and the cost is applicable to several managerial decisions in finance.

(d) To sum up, a basic knowledge of macroeconomics is necessary for understanding the environment in which the organisation operates and a good grasp of micro economic principles is helpful in sharpening the tools of financial decision making.

	Economics	**Finance**
Definition	Economics is a social science that studies the management of goods and services, including their production, consumption and the factors affecting them.	Finance is the science of managing funds keeping in mind the time, cash at hand and the risk involved.
Branches	Branches of economics include macro and micro economics.	Branches of finance include personal finance, corporate finance and public finance.
Management	Professional economists are hired as consultants by private and public sector.	Finance is managed by individuals in families or by banks or other institutions.
Related Courses	Philosophy of Economics, Laws of Economics, Political Economics.	Accountancy, Chartered Financial Analyst and other

18. **Relationship to Accounting**. Finance and accounting functions are closely related and it is not surprising that in popular perception finance and accounting are often considered indistinguishable or at least substantially over lapping. However, as a student of finance you should know how the two differ and how the two relate. The following discussion highlights the difference and relationship between the two: -

(a) **Score Keeping vs. Value maximising**. Accounting is concerned with score keeping, whereas finance is aimed at value maximising. The primary objective of accounting is to measure the performance of the firm, assess its financial condition, and determine the base for tax payment. The principal goal of financial management is to create shareholder value by investing in positive net present value projects and minimising the cost of financing. Of course, financial decision making requires considerable inputs from accounting.

(b) The accountant's role is to provide consistently developed and easily interpreted data about the firm's past, present and future operations. The financial manager uses these data, either in raw form or after certain adjustments and analysis as an important input to the decision-making process

19. **Relation between Accounting and Economics**. Accounting and economics relate to each other in the way that both consider the effective and efficient use of resources, particularly when they are scarce and aim at maximising wealth. However, Accounting is the activity that provides information to the owner of the business firm regarding the effective and efficient use of resources and maximisation of the wealth of the owner of the firm, while economics does all the activities for the nation and not for an individual.

Managerial Economics

20. Managerial Economics is basically a blend of Economics and Management. Two branches of economics i.e., micro economics and macroeconomics are the major contributors to managerial economics.

21. The term manager or in our context, Commander, pre-supposes vesting of certain discretion, which would mean the privilege to choose amongst various alternatives, what in common parlance is called Decision Making. Managerial economics adopts an elective approach and picks out of microeconomics concepts and techniques relevant to management, particularly in its function of decision-making.

22. Managerial economics is economics applied in decision-making. It bridges the gap between abstract theory and management practice. Managerial economics as developed so far is relevant mainly to business management. The government, particularly the defence forces, functions in an environment, which is different from that of business. In business, the market system, price mechanism, competition and so on, compels private firms to attain greater efficiency and seek out profitable innovations. In government, on the other hand, there is no question of profits, markets or competition. Efficiency is not easy to measure objectively. The budget system does not present costs by areas of responsibility which otherwise is feasible.

23. Therefore, we will choose out of the field of managerial economics, concepts and techniques that are of use to us in the defence services in our decision-making

and study them, in some detail. It involves study and analysis of cost, utility and production.

Financial Management in Defence

24. **Defence Management**. One can define defence management as the process of dealing with theories, concepts and techniques of managing human, physical and informational resources for achieving aims of national security. Unlike the industry, in government organisations, the government is the only source of funds. Here the overall availability of funds will primarily depend upon the economic conditions in the country. In the Defence Services, the financial planner would, therefore need to be aware of the general economic trends. He must forecast long and short-term requirements of funds and evaluate alternative proposals for use of funds. The efficient allocation of limited resources at the disposal of the organisation, therefore, assumes great importance. Appreciating this role, separate Directorates / Department of Financial Planning have been created at the Services Headquarters.

25. **Need for Modern Financial Management in Defence**. The reason why the efficient use of military (and other government) resources poses a special problem is that there is no in-built mechanism, as is the case in the private sector of the economy, which leads to greater efficiency. There is, within the government, neither a price mechanism, which points the way to greater efficiency, nor competitive forces, which induce government units to carry out each function at minimum cost. In these circumstances, the best way to obtain the greatest possible national security from a given budget is to adopt modern management concepts and practices. It will need increased recognition and awareness that military decision, whether they specifically involve budgetary allocations or not, are in essence economic decisions. This will require understanding of not only the basic source of our defence effort viz. GNP / GDP and the economic situation in the country and its trend, but also of various accounting techniques for optimum utilisation of resources and the financial accounting processes which are essential to comprehend such techniques.

Geo-Economics

26. Geo-economics is the study of spatial, temporal and political aspects of economies and resources. Most commonly, it is understood as the use of economic tools to advance geopolitical objectives.

27. The formation of Geo-economics as a branch of Geopolitics is often attributed to Edward Luttwak, an American economist and consultant, and Pascal Lorot, a French economist and political scientist. China is arguably the world's most prominent practitioner of geo-economics, but Russia and the US are also major players. Beijing had repeatedly cut car imports from Japan or withheld exports of Chinese rare earths

to Japan in efforts to weaken Tokyo's resolve over territory and sovereignty in the East China Sea. In providing aid to Africa, China rewards those countries that vote with it at the United Nations. Russia uses its energy endowment to advance strategic objectives. In 2008, it shut off gas pipelines to parts of Europe in the middle of winter amid political disputes. The Kremlin offers huge financial support to annexed Crimea. In response to the Russian annexation of Crimea, US and others did not send troops to defend Ukrainian territory, but instead imposed sanctions on Russia. The US has also led international efforts to influence Iran's nuclear policies through sanctions. The preponderance of the dollar and US dominance of the international financial system mean that American sanctions have a lot of bite.

Conclusion

28. With an urgent need to modernise our forces and ever-increasing cost of their upkeep, it is imperative that we make the most efficient use of limited resources at our disposal. This is possible only through a proper understanding and application of modern financial management techniques and concepts.

29. As staff officers and advisors to CFAs, you will deal with these issues almost on a daily basis. It may be a capital procurement or expenditure under revenue head; for which you would need to draw upon knowledge of economics, finance and accounting. An effort will be made through the FM module to equip the participants with adequate knowledge to handle such assignments with competence.

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