Meaning of Financial Management

Financial Management is that specialised function of general management which is related to the procurement of finance and its effective utilization for the achievement of common goal of the organization**.**

It includes each and every aspect of financial activity in the business. Financial Management has been defined differently by different scholars. A few of the definitions are being reproduced below:-

"Financial Management is an area of financial decision making harmonizing individual motives and enterprise goals."- ***Weston and Brigam.***

"Financial Management is the application of the planning and control functions to the finance function."- ***Howard and Upton.***

"Financial Management is the operational activity of a business that is responsible for obtaining and effectively, utilizing the funds necessary for efficient operations."- ***Joseph and Massie.***

From the above definitions, it is clear that financial management is that specialised activity which is responsible for obtaining and affectively utilizing the funds for the efficient functioning of the business and, therefore, it includes financial planning, financial administration and financial control.

Importance of Financial Management

- The importance of corporation finance or financial management has arisen because of the fact that present day business activities are predominantly carried on company or corporate form of organisation. The advent of corporate enterprises has resulted in to:
- The increase in size and influence of the business enterprises.
- Wide distribution of corporate ownership
- Separation of ownership & Management.
- The knowledge of the discipline financial management is important not only to the practicing managers, but also to others who deal with a corporate enterprise, such as investors, lenders, bankers, creditors etc. as there is always a scope for the management to manipulate and "window dress" the financial statement.

Financial management is indispensable in any organisation as it help in:

- Financial planning and successful promotion of an enterprise.
- Acquisition of funds as and when required at the minimum possible cost.
- Proper use and allocation of funds.
- Taking sound financial of decisions.
- Improving profitability through financial controls.
- Increasing the wealth of the investors and the nation.
- Promoting and mobilizing individual and corporate savings.

Executive finance functions include all those financial decisions of importance which require specialized administrative skill.

Some of the executive functions are given below:-

(i) ***Financial Forecasting:*** the first and foremost function of financial management is to forecast the financial needs of the concern. In the initial stage, it is done by promoters but in a going concern, it is generally performed by the executive chief or by the officers of the finance-department in a large scale enterprise. In estimating the financial requirements of the concern, help of various budgets i.e., sales budget, production budget etc., profit and loss account and Balance Sheet is sought.

(ii) ***Establishing Asset-Management Policies*****:** In order to estimate and arrange for cash requirements of an enterprise, it is very necessary to decide how much cash will be invested in non-cash assets, i.e., fixed assets, and also the kind and coverage of insurance that a company will carry. Establishing a sound asset management policy is a pre-requisite to successful financial Management. No doubt the financial manager in deciding about the asset-management policies seeks cooperation of marketing executive in making decisions involving the carrying of inventories of finished goods and credit policy etc. and that of the production manager in making decision concerned with the carrying of inventories of raw materials and factory supplies, purchases etc.

(iii) ***Allocation of Net Profit*** **:** How to allocate the net profits of the concern is the another problem before the financial manager. After paying all taxes, the available net profits of the concern can be allocated for three purposes- (a) for paying dividends to the shareholders of the comp nay as a return upon this investment. (b) for distributing bonus to the employees and company's contribution tooth profit sharing plans, and (c) retention of profits for the expansion of business. As far as, the second alternative is concerned, the amount to be paid to employees is generally fixed by statutes or on contractual basis and therefore, there is no problem in allocating profits for that purpose. But a considerably attention is to be paid in so far as first and third alternatives are concerned namely the dividends to be distributed to the shareholders and the amount to be retained for future expansion plans.

(iv) ***Cash Flows and Requirements*****:** It is the prime responsibility of the financial manager to see that an adequate supply of cash is available at proper time for the smooth running of the business. A good financial executive should ensure that cash inflow and outflow must be continuous and uninterrupted. Inflow of cash originates in sales and cash outflows or cash requirements are closely related to volume of sales. Here the financial manger is to decided how much cash e must retain to meet the current obligations so that there would be no idle cash balance earning nothing for the company. But there is a dilemma because inflow of cash is not precisely predictable and seldom offset one another. Therefore, the financial manager must maintain a balance between inflow of cash and outflow of cash.

(v) ***Deciding upon Borrowing Policy:*** Every organisation plans for the expansion of the business for which he requires additional resources. Personal resources being limited the case must be arranged by borrowing money either from commercial bank, and other financial institutions or by floating new debentures or by issuing new shares. The financial manger, at this juncture, will take a decision about the time when the funds from outside sources are needed, the source from which they are to be received, how log they will be needed an from what source they will be repaid. Obviously, it is a very important function of financial manager.

(vi) ***Negotiations For New outside Financing:*** Finance function does not stop with the decision to undertake outside financing; it extends towards carrying on negotiations from the outside financing agencies to arrange for it. Finances are needed by an establishment to meet its short-term and long-term requirements. The financial manger must assess short and long term financial requirements of the organisation an start negotiations for raising these funds. It requires considerable planning because the sources are to be tackled in advance keeping in view the alternative sources and sounded in a manner that in case one fails, the other should be available. He must keep open the credit lines.

(vii) ***Checking upon Financial Performance*:** The Financial manager is under an obligation to check the financial performance of the funds invested in the business. It requires retrospective analysis of the operating period to evaluate the efficiency of financial planning. An unbiased assessment of financial performance shall be great value to the business in improving the standards, techniques, and procedures of financial control

EXECUTIVE FINANCE FUNCTION

EEF requires administrative skills in planning and execution. The basic EEF are:

- Establishing asset management policies,
- Estimating & controlling cash flow,
- Determining the allocation of net profit, deciding upon needs & sources of new outside financing,
- Carrying on negotiation for new outside financing, &
- Checking financial performance.

AS per the modern scholars the 3 major financial decisions are:

1. Investment Decision
2. Financing Decision
3. Dividend Decision

INVESTMENT DECISION

ID is vital function of finance since funds involves cost & are available in limited quantity. Its proper utilisation is necessary to achieve the ultimate goal of the company (i.e. Profit maximisation).

The ID relates to the selection of assets in which funds will be invested by a firm. Broadly speaking IDs are of 2 types:

- Long-term ID
- Short-term ID

LONG-TERM ID concerns with investment in LT assets which will yield a return over a period of time in future. It is known as '*Capital Budgeting*' which relates to selection of asset or investment proposal or course of action, whose benefits are likely to be available in future over the lifetime of project. Such decisions may take the form of internal or external decision.

In internal ID the finance manager has to decide what capital expenditure projects the company should take, what volume of funds should be committed, & how funds should be allocated as among different investment outlets. The measurement of the worth of investment

proposal is therefore major element in the capital budgeting. This implies the methods of appraising the investment proposal.

In the external ID the finance manager has to decide about issues concerning investment of funds outside the business, viz., merger, portfolio management, etc.

The second element of capital budgeting after appraising the investment proposal is the analysis of risk & uncertainty as the benefits from proposal are associated with future and it is uncertain.

The third element is the measurement of cost of capital.
In short elements of capital budgeting are :

- Total asset & their composition.
- Business risk complexion.
- Concept & measures of CoC.

SHORT-TERM ID deals with Working Capital Management, i.e., management of current assets- it decides allocation of cash, inventories and receivables.

The decision is influenced by trade off between liquidity and profitability. If the firm doesn't have adequate working capital, i.e., it doesn't invest sufficient funds in current assets, it may become illiquid and consequently may not have the ability to meet its current obligations and thus invites bankruptcy or insolvency. On the contrary if the current assets are too large it will adversely affect the profitability of the firm.

FINANCING DECISION

The ID is broadly concerned with assets mix or composition of assets of the firms while financing decision deals with financing mix or leverage or capitalisation.

The term capital structure deals with the proposal of debt and equity capital. The two aspects of financing decision are capital structure theory and capital structure decisions.

Capital structure theories show the relationship between or trade off between risk and return. The employment of debt ensures higher return to SHs and also higher risk, so an optimal capital structure should be selected by finance manager.

Capital structure decision deals with determination of an appropriate capital structure. The finance manger while making debt-equity mix decision is to see how it will maximise EPS and also market value of shares.

DIVIDEND DECISION

DD relates to allocation of business earnings between payments to SHs and retain earnings, i.e., dividend decision or retention decision.

Retained earnings constitutes one of the potent source of funds for financing corporate growth but dividend constitute the CFs that accrue to equity investors, although growth and dividend are desirable, this two goals are conflicting, as a higher dividend rate means less retained earnings and consequently a slower rate of growth in earnings and stock prices.

INCIDENTAL FINANCE FUNCTIONS are those functions of clerical or routine nature which are necessary for the execution of decisions taken by the executives. Some of the important incidental finance functions are:-

(a) supervision of cash receipts an disbursements an safeguarding of cash balance.
(b) Proper custody and safeguarding of the important and valuable papers, securities and insurance policies.
(c) Taking care of all mechanical details of financing.
(d) Record-keeping and reporting.
(e) Cash planning an credit management.
The above incidental functions are self-explanatory and require no explanation,

ROUTINE FINANCE FUNCTION

RFFs are also known as incidental FFs, which are performed by executives and subordinate staff, viz., accountant, audit assistant, etc.

- *Supervision over cash receipt*: Main source of cash receipt is sales, therefore finance department should collect debt of credit sales in time.

- *Cash disbursement*: CD should be made in time. Finance manager has to make payment to creditors.

- *Keep records of cash*: records of cash receipts and payments are to be made so as to control cash flows.

- *Tally cash and bank balances*: Finance department looks after both cash and bank balances so as to see that bank transactions are carried out properly and it also makes bank reconciliation statement.

- *Safeguarding valuable assets*: Important papers are to be safeguarded, for e.g., if the company has invested in shares, debt or loan papers.

- *Insurance policy*: Finance department is responsible for insuring various assets and preserving policy and presenting claims and get money.

- *Record keeping*: Finance department should file all papers of financial decision, correspondence, etc.

- *Prepare reports*: Finance department has to make reports. (B/S, P/L A/c., etc.)

PROFIT MAXIMISATION

Profit maximization as a business objective was developed in early 19th century when the characteristics features of the business structure were self-financing, private property & single entrepreneurship. The only aim of the single owner was to enhance individual wealth & personal power, which could be done by PM.

PM objective in terms of RoI, EPS or profit to sales ratio focus attention on minimization of cost & maximization of earnings. According to this approach, actions that increase the profit should be undertaken & those decreases profit are to be avoided. In simple words the investment, financing & dividend policy decisions of a firm should be oriented towards maximization of profit.

The term profit can be used in two senses:

- As an ***owner oriented approach*** it refers to the amount of income which is paid to the owners of business, i.e., shareholders.
- As an ***operational concept*** it is used for profitability which refers to a situation where output exceeds input, i.e., value created by the use of resources is more than the total of input resources, thus it implies that a firm should be guided in financial decision making by one test: select assets, projects & decisions which are profitable & reject those which are not.

The reasons behind profitability maximization are simple:

- Profit is the ultimate test of economic efficiency.
- It provides yardstick by which economic performance can be judged.
- It leads to efficient allocation of resources.
- It ensures maximum social welfare.

POINTS IN FAVOUR OF PROFIT MAXIMISATION

- Profit is a barometer through which the performance of a business unit can be measured.
- Profits ensure maximum welfare to the SHs, employees and prompt payment to creditors of a company.
- PM increases the confidence of management in expansion and diversification programmes of a company.
- PM attracts the investors to invest their savings in securities at a time.
- Profit indicates the efficient use of funds for different requirements.

PM approach has the benefit of being a simple & straight forward statement of objective; there are some serious drawbacks to accept it as a primary objective of the enterprise. Certain objections have been raised against PM as a goal of business enterprise. The PM criteria has been questioned & criticised on several grounds. The main technical flaws of the criteria are:

1. Ambiguity
2. Timings of benefits
3. Quality of benefits
4. Dividend

AMBIGUITY: The first drawback is that PM is a vague & ambiguous concept as it doesn't discriminate between short-term & long-term profits. It may convey a different meaning to different people. For eg., it may be a short-term or long-term; total profit or a rate of profit; before tax or after tax; or return to total capital employed or return on total assets or return on SHs equity & so on.

Thus a question arises, if PM is taken to be the objective, which of this variants of profit should a firm try to maximise?

TIMINGS OF BENEFITS: The objective of PM doesn't take into consideration the time value of money. A profit seeking organisation must consider the timings of cash flow &

State of economy	Alternative A (Rs.)	Alternative B (Rs.)
Recession	900	0

profits because money received today has a higher value than money received after a year. The PM criterion doesn't consider the distinction between return received in different time periods & that all benefits irrespective of timing have equal value. This is not true because benefit in early year should be valued more than equivalent benefits in later years. The earlier benefits can be reinvested in business to earn profit.

It ignores the differences in the time pattern of the benefits received from in vestment proposals or courses of action. While working out profitability, the bigger the better principle is adopted as the decision is based on the total benefits received over the working life of the asset, irrespective of when they were received.

Period	Alternative A (Rs.)	Alternative B (Rs.)
I	5,000	-
II	10,000	10,000
III	5,000	10,000
TOTAL	20,000	20,000

QUALITY OF BENEFIT (RISK): The PM criteria ignore the quality aspect of benefits associated with a financial course of action. The term quality refers to degree of certainty with which benefits can be expected. As a rule, the more certain the expected return, the higher the quality of the benefits. On the contrary, the more uncertain or fluctuating expected returns the lower the quality of benefits. Thus the quality resembles the risk factor associated with return to investors.

In short, potential earnings of different projects are related with risk of varying degrees. In view of this different projects may have different value even though earning capacity is the same.
The problem of uncertainty renders PM unsuitable as an operational criterion for financial management as it considers only the size of benefits.

Normal	1,000	1,000
Boom	1,100	2,000
Total	3,000	3,000

DIVIDEND : PM objective doesn't allow for the effect of dividend & the market price of the stock. If the firm sets maximisation of EPS as its principal objectives, management would be refrained from paying dividend so as to retain earning & invest them in marketable securities, but market value of shares of the firm is likely to be decreased resulting in loss to the owners. Hence, PM objective can't be considered as a satisfactory objective.

POINTS AGAINST PROFIT MAXIMIZATION

- Profit is not a clear term. Is it accounting profit? Economic profit? Profit before tax? After tax? Net profit? Gross profit? Or EPS?
- It encourages corrupt practices to increase profits.
- PM does not consider the impact value of money.
- The true and fair picture of the organisation is not reflected through PM.
- PM attracts cut-through competition.
- Huge amount of profit attracts Government intervention.
- Some of the industries would like to attain 'industry leadership'. They do not bother about the increase in cost and getting a low profit with huge market share.
- A huge profit invites problems from workers. They demand high salary & fringe benefits.
- Pm is narrow concept; it affects the long-term liquidity of a company.
- Estimating the exact amount of profit of a company under the changing world is difficult and impracticable task.

WEALTH MAIXMIZATION

The WM approach is also known as Value Maximization approach or Net Present worth Maximization approach is the difference between gross present worth & the amount of capital investment required to achieve the benefits. Where, gross amount represents present value of expected cash benefits discounted at a rate which reflects their certainty or uncertainty.

Thus, the WM goal as a decision criteria suggests that any financial action which creates wealth or which has a NPV above zero is desirable & should be accepted, while which doesn't satisfy this test should be rejected. VM criteria is universally accepted for financial decision-making as it satisfies all the 3 requirements of a suitable operational objectives of financial course of action, viz., exactness, quality of benefits & time value of money.
The WM criterion is based on the concept of CFs generated by decisions rather than accounting profit (as used in PM approach). It also considers both the quantity & quality dimensions of the benefits & also incorporates the time value of money.

Using Ezra Solomon's symbols & method, the NPV can be calculated as shown below:

a) $W = V - C$

Where, W = Net Present Value / Worth
V = Gross Present Value / Worth
C = Investment

b) $V = E/K$

Where, E = Size of future benefits available to suppliers of input capital
K = Capitalization / Discount rate & timings of benefits

c) $C = G - (M+I+T)$

Where, G = Average flow of Gross annual earnings
M = Maintenance ex penses
T = Taxes
I = Interest or Preference dividend

In short, NPV can be expressed symbolically as:

$$W = A_1/(1+K) + A_2/(1+K)^2 + \text{------} + A_n/(1+K)^n - C$$

Where, A1, A2, --- = CFS expected to occur from a course of action
K = Appropriate discount rate
C = Investment

FINANCIAL MANAGER'S ROLE

Manager is a person who is responsible, in a significant way, to carry out the finance functions. It is noted that, in a modern enterprise, the financial manager occupies a key position. He or she is the one of the member of the top management team. The finance manager is now responsible for shaping the fortunes of the enterprise and is involved in the most vital decision of the allocation of the capital. He or she must ensure that the funds of the enterprise are utilized in the most efficient manner.

The role of the financial manager is central in the flow of the money from investors into the firm and then back to those some investors. There are two major decisions for the financial manager to make that greatly affect this process.

In fact, they are central to the success or failure of the company as a whole. The capital budgeting decision asks how much money the company should invest and into what assets should this investment be made. The financing decision determines how the cash for the investment will be raised

The financial manager is an important position within the structure of any firm. Almost every firm of any size has a person whose role is "to create value from the firm's capital budgeting, financing and net working–capital activities".
What are the main functions of a financial manager?

Funds Raising: The traditional approach dominated the scope of financial management and limited the role of the financial manager simply to funds raising. It was during the major events, such as promotion, reorganization, expansion or diversification in the firm that the

financial manager was called upon to raise funds. In his or her day-to-day activities, his or her only significant duty was to see that the firm had enough cash to meet its obligations. The traditional approach has been criticized because it failed to consider the day-to-day managerial problems relating to finance of the firm.
It concentrated itself to looking into the problems from management's-the insider's point of view. Thus the traditional approach of looking at the role of the financial manager lacked a conceptual framework for making financial decisions and neglected the real issues relating to the allocation and management of funds.

Funds Allocation: In a modern enterprise, the basic finance function is to decide about the expenditure decisions and to determine the demand for capital for these expenditures. In the other words, the financial manager,in his or her new role,is concerned with the efficient allocation of funds.The allocation of funds is not a new problem,however it was not considered important enough in achieving the firm's long run objectives.
In his or her new role of using funds wisely, the financial manager must find a rationable for answering the following three question

a. How large should an enterprise be, and how fast should it grow?
b. In what form should it hold its assets?
c. How should the funds required be raised?

Profit Planning : The functions of the financial manager may be broadened to include profit-planning function. Profit planning refers to the operating decisions in the areas of pricing, costs, volume of output and the firm's selection of the product lines. The profit planning helps to anticipate the relationships between volume, costs and profits and develop action plans to face unexpected surprises.

Understand Capital Markets: Capital markets bring investors (lenders) and firms (borrowers) together. Hence the financial manager has to deal with the capital markets. He or she should fully understand the operations of capital markets and the way in which the capital markets value securities. He or she should also know how risk is measured and how to cope with it in investment and financing decisions.
For example: - if a firm uses excessive debt to finance its growth, investors may perceive it as risky. The value of the firm's share may, therefore, decline. Similarly, investors may not like the decision of a highly profitable, growing firm to distribute dividend. They may like the firm to reinvest profits in attractive opportunities that would enhance their prospects for making high capital gains in the future. Investment also involves risk and return. It is through their operations in capital markets that investors continuously evaluate the action of financial manager.