INTRODUCTION TO FINANCIAL MANAGEMENT

(Dr.Rachanaa Datey)

Financial Management can be defined as:

THE MANAGEMENT OF THE FINANCES OF A BUSINESS / ORGANISATION IN ORDER TO ACHIEVE FINANCIAL OBJECTIVES

Taking a commercial business as the most common organisational structure, the key objectives of financial management would be to:

- Create wealth for the business

- Generate cash, and

- Provide an adequate return on investment bearing in mind the risks that the business is taking and the resources invested

There are three key elements to the process of financial management:

(1) Financial Planning

Management need to ensure that enough funding is available at the right time to meet the needs of the business. In the short term, funding may be needed to invest in equipment and stocks, pay employees and fund sales made on credit.

In the medium and long term, funding may be required for significant additions to the productive capacity of the business or to make acquisitions.

(2) Financial Control

Financial control is a critically important activity to help the business ensure that the business is meeting its objectives. Financial control addresses questions such as:

- Are assets being used efficiently?

- Are the businesses assets secure?

- Do management act in the best interest of shareholders and in accordance with business rules?

(3) Financial Decision-making

The key aspects of financial decision-making relate to investment, financing and dividends:

• Investments must be financed in some way – however there are always financing alternatives that can be considered. For example it is possible to raise finance from selling new shares, borrowing from banks or taking credit from suppliers

• A key financing decision is whether profits earned by the business should be retained rather than distributed to shareholders via dividends. If dividends are too high, the business may be starved of funding to reinvest in growing revenues and profits further.

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MEANING OF FINANCIAL MANAGEMENT

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

SCOPE/ELEMENTS

1. Investment decisions includes investment in fixed assets (called as capital budgeting). Investment in current assets are also a part of investment decisions called as working capital decisions.
2. Financial decisions - They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.
3. Dividend decision - The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two:
    a. Dividend for shareholders- Dividend and the rate of it has to be decided.
    b. Retained profits- Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

OBJECTIVES OF FINANCIAL MANAGEMENT

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

1. To ensure regular and adequate supply of funds to the concern.
2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
4. To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
5. To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

FUNCTIONS OF FINANCIAL MANAGEMENT

1. **Estimation of capital requirements:** A finance manager has to make estimation with regards to capital requirements of the company. This will depend upon expected costs and profits and future programmes and policies of a concern.

Estimations have to be made in an adequate manner which increases earning capacity of enterprise.

2. **Determination of capital composition:** Once the estimation have been made, the capital structure have to be decided. This involves short- term and long- term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.
3. **Choice of sources of funds:** For additional funds to be procured, a company has many choices like-
   a. Issue of shares and debentures
   b. Loans to be taken from banks and financial institutions
   c. Public deposits to be drawn like in form of bonds.

   Choice of factor will depend on relative merits and demerits of each source and period of financing.

4. **Investment of funds:** The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.
5. **Disposal of surplus:** The net profits decision have to be made by the finance manager. This can be done in two ways:
   a. Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
   b. Retained profits - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.
6. **Management of cash:** Finance manager has to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintainance of enough stock, purchase of raw materials, etc.
7. **Financial controls:** The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.

THE ROLE AND RESPONSIBILITIES OF FINANCIAL MANAGERS

Financial managers play a pivotal role in the success of companies. In this lesson, you'll learn about the duties and responsibilities of financial managers.

FINANCIAL MANAGEMENT

Meet Milton. He works in financial management. Milton's job is pretty important. In a nutshell, Milton's job in **financial management** involves allocating the financial resources of a company in a way that maximizes its wealth and profitability.

Let's expand upon this concept a bit. We can break down financial management activities into three broad categories: capital budgeting, financing and dividend policy.

Capital budgeting involves decisions about what investments a business will make with its resources. For example, Milton may help the president of his company figure out if a new business is worth the investment in financial terms.

Financing involves decisions about what external resources should be brought into the business to be used for investment in profitable enterprises. Examples of outside resources include funds acquired from investors from purchase of company stock and funds acquired from creditors through loans.

Dividend policy is the decisions about profits to be distributed to equity investors, such as shareholders. Milton may help determine if there is sufficient revenue to cover the company's expenses and anticipated investments and still provide for a dividend distribution.

FINANCIAL MANAGERS - ROLE & DUTIES

Some small businesses may not have a full-time financial manager. The company's owner or president may fulfill this role. On the other hand, very large corporations will have a team of financial managers that fulfill specialized roles. Let's look at some of these roles.

If Milton is responsible for his company's accounting activities, such as reporting and analysis of the company's earnings, expenses and overall financial position, he is serving as **controller**. Controllers also play an important role in regulatory reporting.

The people at the top of the financial management food chain are typically the **treasurer** and **finance officers** of the company. These folks are involved in overseeing and directing the budgets and investments of the company. They are also involved in strategy formulation.

Financial management also involves managing risk. **Risk managers** fill this role. For example, if Milton is serving as a risk manager, his job is to reduce and mitigate the financial risks the company is exposed to due to its business, such as ensuring the company is adequately insured.

Many businesses extend credit to their customers. **Credit managers** are responsible for overseeing a company's issuance of credit to customers, determining who gets credit, the credit limits and collection of unpaid debt.

UNIT 1

Financial Management: it's Definition, Meaning and Objectives

(Dr.Rachanaa Datey)

Definition:

One needs money to make money. Finance is the life-blood of business and there must be a continuous flow of funds in and out of a business enterprise. Money makes the wheels of business run smoothly. Sound plans, efficient production system and excellent marketing network are all hampered in the absence of an adequate and timely supply of funds.

Sound financial management is as important in business as production and marketing. A business firm requires finance to commence its operations, to continue operations and for expansion or growth. Finance is, therefore, an important operative function of business.

A large business firm has to raise funds from several sources and has to utilise those funds in alternative investment opportunities. In order to ensure the most judicious utilisation of funds and to provide a reasonable rate of return on the investment, sound financial policies and programmes are required. Unwise financing can drive a business into bankruptcy just as easily as a poor product, inept marketing or high production costs.

On the other hand, adequate and economical financing can provide the firm a differential advantage in the market place. The success of a business enterprise is largely determined by the way its capital funds are raised, utilised and disbursed. In the modern money-using economy, the importance of finance has increased further due to increasing scale of operations and capital intensive techniques of production and distribution.

In fact, finance is the bright thread running through all business activity. It influences and limits the activities of marketing, production, purchasing and personnel management. The success of a business is measured largely in financial terms. The efficient organisation and administration of the finance function is thus vital to the successful functioning of every business enterprise.

Meaning of Financial Management:

Financial management may be defined as planning, organising, directing and controlling the financial activities of an organisation. According to Guthman and Dougal, financial management means, "the activity concerned with the planning, raising, controlling and administering of funds used in the business." It is concerned with the procurement and utilisation of funds in the proper manner.

Financial activities deal with not only the procurement and utilisation of funds but also with the assessing of needs for funds, raising required finance, capital budgeting, distribution of surplus, financial controls, etc.

Ezra Solomon has described the nature of financial management as follows: "Financial management is properly viewed as an integral part of overall management rather than as a staff specially concerned with funds raising operations.

In this broader view, the central issue of financial policy is the wise use of funds and the central process involved is a rational matching of the advantage of potential uses against the cost of alternative potential sources so as to achieve the broad financial goals which an enterprise sets for itself.

In addition to raising funds, financial management is directly concerned with production, marketing and other functions within an enterprise whenever decisions are made about the acquisition or distribution of funds."

Objectives of Financial Management:

Financial management is one of the functional areas of business. Therefore, its objectives must be consistent with the overall objectives of business. The overall objective of financial management is to provide maximum return to the owners on their investment in the long- term.

This is known as wealth maximisation. Maximisation of owners' wealth is possible when the capital invested initially increases over a period of time. Wealth maximisation means maximising the market value of investment in shares of the company.

Wealth of shareholders = Number of shares held ×Market price per share.

In order to maximise wealth, financial management must achieve the following specific objectives:

(a) To ensure availability of sufficient funds at reasonable cost (liquidity).

(b) To ensure effective utilisation of funds (financial control).

(c) To ensure safety of funds by creating reserves, re-investing profits, etc. (minimisation of risk).

(d) To ensure adequate return on investment (profitability).

(e) To generate and build-up surplus for expansion and growth (growth).

(f) To minimise cost of capital by developing a sound and economical combination of corporate securities (economy).

(g) To coordinate the activities of the finance department with the activities of other departments of the firm (cooperation).

Profit Maximisation:

Very often maximisation of profits is considered to be the main objective of financial management. Profitability is an operational concept that signifies economic efficiency. Some writers on finance believe that it leads to efficient allocation of resources and optimum use of capital.

It is said that profit maximisation is a simple and straightforward objective. It also ensures the survival and growth of a business firm. But modern authors on financial management have criticised the goal of profit maximisation.

The following objections against the profit maximisation objective:

Objections against the Profit Maximisation Objectives:
(i) The concept is ambiguous or vague. It is amenable to different interpretations, e.g., long run profits, short run profits, volume of profits, rate of profit, etc.

(ii) It ignores the timing of returns. It is based on the assumption of bigger the better and does not take into account the time value of money. The value of benefits received today and those received a year later are not the same.

(iii) It ignores the quality of the expected benefits or the risk involved in prospective earnings stream. The streams of benefits may have varying degrees of uncertainty. Two projects may have same total expected earnings but if the earnings of one fluctuate less widely than those of the other it will be less risky and more preferable. More uncertain or fluctuating the expected earnings, lower is their quality.

(iv) It does not consider the effect of dividend policy on the market price of the share. The goal of profit maximisation implies maximising earnings per share which is not necessarily the same as maximising market-price share. According to Solomon, “to the extent payment of dividends can affect the market price of “the stock (or share), the maximisation of earnings per share will not be a satisfactory objective by itself.”

(v) Profit maximisation objective does not take into consideration the social responsibilities of business. It ignores the interests of workers, consumers, government and the public in general. The exclusive attention on profit maximisation may misguide managers to the point where they may endanger the survival of the firm by ignoring research, executive development and other intangible investments.

Wealth Maximisation:
Some scholars have advocated wealth maximisation as the goal of financial decision-making. Wealth maximisation or net present worth maximisation is defined as follows: "The gross present worth of a course of action is equal to the capitalised value of the flow of future expected benefits, discounted (or as capitalised) at a rate which reflects their certainty or uncertainty.

Wealth or net present worth is the difference between gross present worth and the amount of capital investment required to achieve the benefits being discussed. Any financial action which creates wealth or which has a net present worth above zero is a desirable one and should be undertaken.

Any financial action which does not meet this test should be rejected. If two or more desirable courses of action are mutually exclusive (i.e., if only one can be undertaken), then the decision should be to do that which creates most wealth or shows the greatest amount of net present worth. In short, the operating objective for financial management is to maximise wealth or net present worth."

Wealth maximisation is more operationally viable and valid criterion because of the following reasons:

(a) It is a precise and unambiguous concept. The wealth maximisation means maximising the market value of shares.

(b) It takes into account both the quantity and quality of the expected steam of future benefits. Adjustments are made for risk (uncertainty of expected returns) and timing (time value of money) by discounting the cash flows,

(c) As a decision criterion, wealth maximisation involves a comparison of value of cost. It is a long-term strategy emphasising the use of resources to yield economic values higher than joint values of inputs.

(d) Wealth maximisation is not in conflict with the other motives like maximisation of sales or market share. It rather helps in the achievement of these other objectives. In fact, achievement of wealth maximisation also maximises the achievement of the other objectives. Therefore, maximisation of wealth is the operating objective by which financial decisions should be guided.

The above description reveals that wealth maximisation is more useful if objective than profit maximisation. It views profits from the long-term perspective. The true index of the value of a firm is the market price of its shares as it reflects the influence of all such factors as earnings per share, timing of earnings, risk involved, etc.

Thus, the wealth maximisation objective implies that the objective of financial management should be to maximise the market price of the company's shares in the long-term. It is a true indicator of the company's progress and the shareholder's wealth.

However, “profit maximisation can be part of a wealth maximisation strategy. Quite often the two objectives can be pursued simultaneously but the maximisation of profits should never be permitted to overshadow the broader objectives of wealth maximisation.