Introduction to Financial Management

Meaning and Definition of Financial Management:

- Financial management, is that branch of general management, which has grown to provide specialized and efficient financial services to the whole enterprise; involving, in particular, the timely supplies of requisite finances and ensuring their most effective utilization-contributing to the most effective and efficient attainment of the common objectives of the enterprise.

Some prominent definitions of Financial Management are cited below:

- "Financial management is an area of financial decision-making harmonizing individual motives and enterprise goals." —**Weston and Brigham**

- "Financial management is concerned with managerial decisions that result in acquisition and financing of long-term and short-term credits for the firm. As such, it deals with situations that require selection of specific assets and liabilities as well as problems of size and growth of an enterprise. Analysis of these decisions is based on expected inflows and outflow of funds and their effects on managerial objectives." —**Philppatus**

- **Howard and Upton** define financial management as "that administrative area or set of administrative functions in an organisation which have to do with the management of the flow of cash so that the organisation will have the means to carry out its objectives as satisfactorily as possible and at the same time meets its obligations as they become due.

- **Bonneville and Dewey** interpret that financing consists in the raising, providing and managing all the money, capital or funds of any kind to be used in connection with the business.

- **Osbon** defines financial management as the "process of acquiring and utilizing funds by a business".

The above definitions of financial management could be analyzed, in terms of the following points:

i. Financial management is a specialized branch of general management.

ii. The basic operational aim of financial management is to provide financial services to the whole enterprise.

iii. One most important financial service by financial management to the enterprise is to make available requisite (i.e. required) finances at the needed time. If requisite funds are not made available at the needed time; significance of finance is lost.

iv. Another equally important financial service by financial management to the enterprise is to ensure the most effective utilisation of finances; but for which finance would become a liability rather than being an asset.

v. Through providing financial services to the enterprise, financial management helps in the most effective and efficient attainment of the common objectives of the enterprise.

Nature or Features or Characteristics of Financial Management

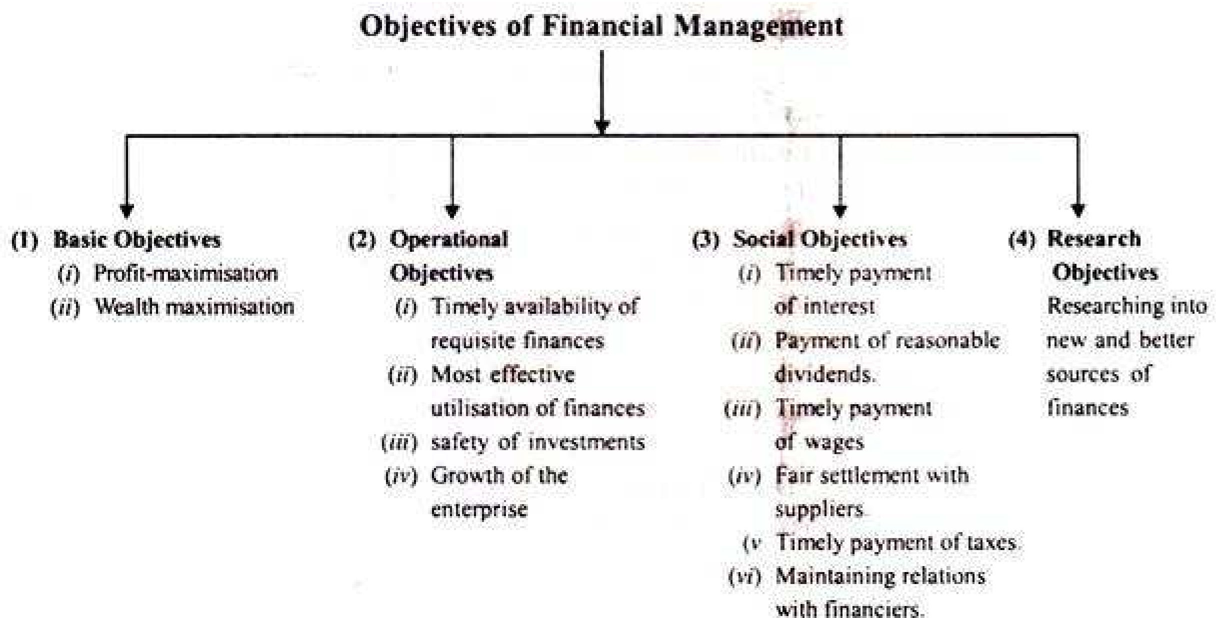
- Nature of financial management is concerned with its functions, its goals, trade-off with conflicting goals, its indispensability, its systems, its relation with other subsystems in the firm, its environment, its relationship with other disciplines, the procedural aspects and its equation with other divisions within the organisation.

1. Financial Management is an integral part of overall management. Financial considerations are involved in all business decisions. So financial management is pervasive throughout the organisation.
2. The central focus of financial management is valuation of the firm. That is financial decisions are directed at increasing/maximization/ optimizing the value of the firm.
3. Financial management essentially involves risk-return trade-off Decisions on investment involve choosing of types of assets which generate returns accompanied by risks. Generally higher the risk, returns might be higher and vice versa. So, the financial manager has to decide the level of risk the firm can assume and satisfy with the accompanying return.

4. Financial management affects the survival, growth and vitality of the firm. Finance is said to be the life blood of business. It is to business, what blood is to us. The amount, type, sources, conditions and cost of finance squarely influence the functioning of the unit.
5. Finance functions, i.e., investment, rising of capital, distribution of profit, are performed in all firms - business or non-business, big or small, proprietary or corporate undertakings. Yes, financial management is a concern of every concern.
6. Financial management is a sub-system of the business system which has other subsystems like production, marketing, etc. In systems arrangement financial sub-system is to be well-coordinated with others and other sub-systems well matched with the financial subsystem.

Objectives of Financial Management:

The objectives of financial management might be classified into certain categories-as depicted in form of the following chart:



Following is a brief account of each one of the above objectives of financial management:

(I) <u>BASIC OBJECTIVES:</u>

1. <u>Profit-Maximisation:</u>

Since time immemorial, the primary objective of financial management has been held to be profit-maximisation. That is to say, that financial management ought to take financial decisions and implement them in a way so as to lead the enterprise along lines of profit maximasation. The

support for these objectives could be derived from the philosophy, that 'profit is a test of economic efficiency'.

Though, there could be little controversy over profit maximisation, as the basic objective of financial management – yet, in the modern times, several authorities on financial management criticise this objectives, on the following grounds:

(i) Profit is a vague concept, in that; it is not clear whether profit means – short-run or long-run profits. Or

– Profit before tax or profits after tax or

– Rate of profits or the amount of profits.

(ii) The profit maximisation objective ignores, what financial experts call the time value of money'. To illustrate, this concept, let us assume that two financial courses of action provide equal benefits (i.e. profits) over a certain period of time. However, one alternative gives more profits in earlier years; while the other one gives more profits in later years.

Based on profit maximization criterion, both alternatives are equally well. However, the first alternative i.e. the one which gives more profits in earlier years is better; as some part of the profits received earlier could be reinvested also.

Modern financial experts call this philosophy, 'the earlier the better principle'. The second alternative which gives more profits only in later years is inferior; as the time-value of profits is more in the case of the first alternative.

(iii) The profit maximization objective ignores the quality of benefits (i.e. profits). The factor implicit here, is the risk element associated with profits. Quality of benefits (profits) is the most when risk associated with their occurrence is the least. According to modern financial experts, less profit with less risk are superior to more profits with more risk.

(iv) Profit-maximisation objective is lop-sided. This objective considers or rather over-emphasizes only on the interests of owners. Interests of other parties like, workers, consumers, the Government and the society as a whole are ignored, under this concept of profit-maximisation.

2. Wealth-Maximisation:

Discarding the profit-maximisation objective; the real basic objective of financial management, now-a-days, is considered to be wealth maximisation. Wealth maximisation is also known as value-maximisation or the net present worth maximisation.

Since wealth of owners is reflected in the market-value of shares; wealth maximisation means the maximisation of the market price of shares. Accordingly, wealth maximisation is measured, by the market value of shares.

According to wealth maximisation objective, financial management must select those decisions, which create most wealth for the owners. If two or more financial courses of action are mutually exclusive (i.e. only one can be undertaken at a time); then that decision-which creates most wealth, must be selected.

The wealth arising from a financial course of action could be stated as follows:

Wealth = Gross present worth of a financial course of action minus amount of capital invested which is required to achieve the benefits i.e. cash flows.

Explanation:

The gross present worth of a financial course of action is equal to the capitalized value of the flow of expected future benefits (i.e. cash flows); which are discounted at a rate – reflecting both- time value of money and their quality (i.e. the risk associated with benefits).

Mathematically, the wealth arising from a financial course of action could be calculated as follows:

$$W = \frac{A_1}{(1+k)} + \frac{A_2}{(1+K)^2} + \ldots\ldots\ldots \frac{A_n}{(1+K)^n} - C$$

Where,

W = Wealth, arising from a financial course of action.

A_1, A_2, A_n = Stream of cash flows expected to come from the financial course of action,

K = Appropriate discount rate, reflecting time value of money and quality of benefits, associated with the financial course of action.

C = initial capital outlay to pursue that financial course of action.

The wealth maximisation objective is held to be superior to the profit maximisation objective, because of the following reasons:

(i) It is based on the concept of cash flows; which is more definite than the concept of profits. Moreover, management is more interested in immediate cash flows than the profits a large part of which might be hidden in credit sales- still to be realized.

(ii) Through discounting the cash flows arising from a financial course of action over a period of time at an appropriate discount rate; the wealth maximisation approach considers both- the time value of money and the quality of benefits.

(iii) Wealth maximisation objective is consistent with the long term profitability of the company.

(II) <u>OPERATIONAL OBJECTIVES:</u>

(i) <u>Timely Availability of Requisite Finances:</u>

A very important operational objective of financial management is to ensure that requisite funds are made available to all the departments, sections or units of the enterprise at the needed time; so that the operational life of the enterprise goes smoothly.

(ii) <u>Most Effective Utilization of Finances:</u>

Throughout the enterprise, the finances must be utilized most effectively. This is yet, another important operational objective of the financial, management.

To ensure the attainment of this objective, the financial management must:

– Formulate plans for the most effective utilisation of funds, among channels of investment, which create most wealth for the company.

– Exercise and enforce ‘financial discipline’ to prevent wasteful expenditure, by any department, or branch or section of the enterprise.

(iii) Safety of Investment:

The financial management must primarily look to the safety of investment i.e. the channels of investment might bring in less returns; but investment must be safe. Loss of investment, in any one line, might lead to capital depletion; and ultimately tell upon the financial health of the enterprise.

(iv) Growth of the Enterprise:

The financial management must plan for the long-term stability and growth of the enterprise. The limited finances of the enterprise must be so utilized that not only short run benefits are available; but the enterprise grows slow and steady, in the long run also.

(3) SOCIAL OBJECTIVES:

(i) Timely Payment of Interest:

The financial management must see to it that interest on bonds, debentures or other loans of the company is paid in time. This will not only keep the creditors satisfied with the company adding to its goodwill; but also prevent any untoward consequences of the non-payment of interest, in time.

(ii) Payment of Reasonable Dividends:

An important social objective of financial management is that shareholders i.e. the equity members of the company must get at least some regular dividends.

This objective is important for two reasons: –

– It helps the company maintain its competitive image, in the market.

– The members on whose funds the company is running profitable operations must be duly compensated, as a matter of natural justice.

(iii) Timely Payment of Wages:

The financial management must make a provision for a timely payment of wages to workers. This is necessary to keep the labor force satisfied and motivated. Further, if wages are paid on time; the legal consequences of non-payment of wages, under the ‘ Payment of Wages Act’, need not frighten management.

(iv) Fair-Settlement with Suppliers:

The financial management must make it a point to settle accounts with suppliers and fellow-businessmen in time, in a fair way; otherwise the commercial reputation of the enterprise will get a setback.

(v) Timely Payment of Taxes:

An important objective of financial management would be to make timely payment of taxes to the Government – so as to avoid legal consequences; and also fulfill its social obligations towards the State.

(vi) Maintaining Relations with Financiers:

The financial management must develop and maintain friendly relations with financiers i.e. banks, financial institutions and various segments of the money market and capital market. When good relations are maintained with financiers; they might come to the rescue of the enterprise, in situations of financial crisis.

(4) RESEARCH OBJECTIVES:

The successful attainment of various objectives by the financial management requires it to follow a research approach. It must research into new and better sources of finances; and also into new and better channels for the investment of finances.

This research objective of financial management requires it to:

– Collect financial data about the progress of its competitive counterparts.

– Make a study of money market and capital market operations, through a study of latest financial magazines and other literature on financial management.

Finance Functions (Scope of Financial Management)

- The finance function encompasses the activities of raising funds, investing them in assets and distributing returns earned from assets to shareholders. While doing these activities, a firm attempts to balance cash inflow and outflow.
- It is evident that the finance function involves the four decisions viz., financing decision, investment decision, dividend decision and liquidity decision.

Thus the finance function includes:

1. Investment decision

2. Financing decision

3. Dividend decision

4. Liquidity decision

1. Investment Decision:

- The investment decision, also known as capital budgeting, is concerned with the selection of an investment proposal/ proposals and the investment of funds in the selected proposal.
- A capital budgeting decision involves the decision of allocation of funds to long-term assets that would yield cash flows in the future. Two important aspects of investment decisions are:

i. The evaluation of the prospective profitability of new investments, and

ii. The measurement of a cut-off rate against that the prospective return of new investments could be compared.

- Investment proposals should, therefore, be evaluated in terms of both expected return and risk.
- The computation of the risk-adjusted return and the required rate of return, selection of the project on these bases, forms the subject-matter of the investment decision.
- Long-term investment decisions may be both internal and external.

2. **Financing Decision:**

- Financing decision is the second important function to be performed by the financial manager. Broadly, he or she must decide when, from where and how to acquire funds to meet the firm's investment needs.
- The central issue is to determine the appropriate proportion of equity and debt. The mix of debt and equity is known as the firm's capital structure.
- The financial manager must strive to obtain the best financing mix or the optimum capital structure for firm. The firm's capital structure is considered optimum when the market value of shares is maximized.

3. **Dividend Decision:**

- Dividend decision is the third major financial decision. The financial manager must decide whether the firm should distribute all profits, or retain them, or distribute a portion and return the balance.
- The proportion of profits distributed as dividends is called the dividend-payout ratio and the retained portion of profits is known as the retention ratio. Like the debt policy, the dividend policy should be determined in terms of its impact on the shareholders' value.
- The optimum dividend policy is one that maximizes the market value of the firm's shares. Thus, if shareholders are not indifferent to the firm's dividend policy, the financial manager must determine the optimum dividend-payout ratio.
- Dividends are generally paid in cash. But a firm may issue bonus shares. Bonus shares are shares issued to the existing shareholders without any charge. The financial manager should consider the questions of dividend stability, bonus shares and cash dividends in practice.

4. **Liquidity Decision:**

- Investment in current assets affects the firm's profitability and liquidity. Current assets should be managed efficiently for safeguarding the firm against the risk of illiquidity. Lack of liquidity in extreme situations can lead to the firm's insolvency.
- A conflict exists between profitability and liquidity while managing current assets. If the firm does not invest sufficient funds in current assets, it may become illiquid and therefore, risky.

But if the firm invests heavily in the current assets, then it would loose interest as idle current assets would not earn anything.

- Thus, a proper trade-off must be achieved between profitability and liquidity. The profitability-liquidity trade-off requires that the financial manager should develop sound techniques of managing current assets and make sure that funds would be made available when needed.

Functions of Financial Management / Manager:

1. Estimation of Capital Requirement:

Estimation depends upon expected costs, profits, future programs and policies of a firm. Estimation must be adequate, as it can increase the earning capacity of the firm.

2. Determination of Capital Composition:

It is based on long term-short term debt equity analysis. This will depend upon the proportion of equity capital a company is processing and additional funds which have to be raised from outside parties.

3. Choice of Sources of Funds:

Choice of funds depend upon the relative merits and demerits of each resource. Various sources of funds are:

- Issue of shares and debentures
- Loans to be taken from banks and financial institutions
- Public deposits to be drawn, like in the form of bonds

4. Investment of Funds:

Financial Manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns are possible.

5. **Disposal of Surplus:**

It refers to the decisions on the net profits made about the dividend declaration and retained earnings.

6. **Management of Cash:**

The Financial manager has to make decisions with regards to cash management. It is required for many purposes like payment of wages and salaries, bills, creditors, maintenance of stock, raw materials, etc.

7. **Financial Control:**

Financial Manager not only has to plan, procure and utilize 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.

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