Chapter - IV

FINANCIAL MANAGEMENT
- AN OVERVIEW
Introduction

Finance plays a significant role in the operations of any purposive organisation. Proper planning and control of business finance leads to the efficient utilization of recourses. Financial decisions also alter the size and variability of the earnings stream or profitability. The value of the firm is determined by financial policy decisions, such as risk and profitability. The task of financial management is to strike a balance between risk and profitability by contributing the highest long-term value to the securities of the firm. Financial management, therefore, performs a crucial role in the survival and success of business undertaking. The objectives of financial management cover the maximisation of profits, wealth and well being of shareholders. Towards this end the management has to be careful in making investment, dividend and financing decisions. Financial decisions, both past and present affect the viability and control of the firm. Financing is the critical management function which provides the means of remedying weaknesses in other areas. Financing thus is an integral part of managerial functions and responsibilities affecting an organisation’s performance. Further, the revolutionary changes also emphasise the importance of financial management. In olden days the marketing manager used to project sales; the engineering and production staff would determine the assets necessary to meet these demands; and the financial manager would simply raise the money necessary to purchase the plant, equipment and inventories. This mode of operation is no longer prevalent. Today, decisions are made in a much more co-ordinate manner, with financial manager directly responsible for the control process. The importance of financial management is, thus universally recognised in the business undertakings.

Concept

According to Guthmann and Dougall “business finance can be broadly defined as the activity concerned with the planning, raising, controlling, and administering the funds used in business. This definition is concerned with financial management of profit-seeking business organisations engaged in all types of activities.
To quote George A. Christy and Peyton Foster Roden, "Finance may be generally defined as the study of money, its nature, certain behaviour regulation and problems. It may deal with the way in which business men, investors, government, financial institutions and families handle their money. An understanding of what money is and does is the foundation of financial knowledge."

In the words of John J. Hapton "Finance can be defined as the management of the flow of money through an organisation, whether it be a corporation, school, bank, or government agency. Finance concerns itself with the actual flow of money, as well as any claims against money. Thus, financial management covers the finance functions, refer to its management, analysis of funds flow, procurement of funds and custody of funds etc. It also states that finance is a specialised functional field found under the general classification of business administration.

Solomon Ezra views financial management as "the blend of art and science through which firms make the important decisions of what to invest in, how to finance it, and to combine some appropriate objectives." Therefore, financial management must attend to three major decisions such as investment decision, financing decision and divided decisions, as these determine the value of the firm to its shareholders. Assuming the objective of maximizing the value of the firm, it should strive for an optimal combination of the three interrelated decisions.

Objectives of financial management

Financial Management determines how funds are procured and used. They relate to a firm's financing and investment policies. To make unavoidable and continuous financial decisions as rationale, the firm must have an objective. The properly defined and understood objectives are the key, to successfully moving from the firm's present position to a future desired position. Since business firms are profit making organizations, their objectives are frequently expressed in terms of money. Two primary objectives commonly encountered are maximisation of profits and maximisation of wealth. The latter is an operationally valid criterion to be adopted to maximize the welfare of owners.
Maximization of profits

Often, maximisation of profits is regarded as the proper objective of the firms. However, this concept is somewhat narrower than the goal of maximising the value of the firm. The term profit maximisation is deep rooted in the economic theory. In simple terms, the rationale behind profit maximisation objectives is that it guides financial decision making. Profit is a test of economic efficiency of the firm. It provides the tool by which economic performance can be judged. Moreover it leads to efficient allocation of resources as resources tend to be directed to uses which terms of profitability are the most desirable. It also encourages maximum social welfare. Financial management is concerned with the sufficient use of an important economy resource i.e., capital. It is therefore said that profitability should serve as the criterion for the financial management decisions.

The profit maximization criterion suffers from three basic weaknesses.

i) Vague

Profit in the short run is quite different from profits in the long run. If a firm continues to operate a piece of machinery without proper maintenance, it may be able to lower the operating expenditure in that year leading to increase in profits. But the firm will pay for the short-run saving, throwing the burden in future years, when the machine is no longer capable of operating because of prior neglect. In other words, maximising profits does not mean neglecting the long-term picture in favour of short-term considerations.

ii) Ignoring the timing of returns

Profit maximisation strategy ignores the differences in the time pattern of the benefits received from investment proposals or courses of action, because money received today has a higher value than money received next year. A profit sealing organisation, therefore, must, consider the timing of cash flows and profits. The reason for superiority of earlier benefits over future benefits lies in the fact that the former can be reinvested to earn a return. The profit maximisation criterion fails to consider the distinction between the returns received in different time periods and, thus, treats all benefits equally valuable. But it is true that, benefits in early years should be valued highly than benefits in later years.
lii) Ignores risk

Profit maximisation does not consider risk. The shareholders of the firm may expect to receive higher returns from investment of higher risk. This criterion fails to consider that shareholders may wish to receive a portion of the firm’s returns in the form of regular dividends.

In the absence of any preference for dividends, the firm can maximise profits from period to period by reinvesting all earnings, using them to acquire new assets that will boost future profits. But the non-payment of dividends usually leads to declaim in the market value of the firm’s share.

Wealth maximisation

This is also known as value maximisation or net present worth maximisation. The wealth maximisation criterion is based on the concept of cash flow generated by the decision rather than accounting for profit which is basis of the measurement of benefits. Another feature is that it considers both the quantity and quality dimensions of benefits. At the same time it also incorporates time value of money.

The wealth maximisation objective as described by Ezra, Solomon is “the gross present worth of a course of action is equal to the capitalised value of the flow of future expected benefit, discounted (or 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. The focus of financial management is, therefore to maximise wealth or net present worth.

The wealth maximisation objective is consistent with the objective of maximising the owner’s economic welfare. The wealth of the owners of a company – the shareholders – is reflected by the market value of the company’s shares.
Therefore, the wealth maximisation objective implies that the financial objective of a firm should be to maximise the market value of its shares. The value of the company’s share is represented by their market price, which in turn, is a reflection of the firm’s financial decisions. The market price serves as a performance index or report card of the firm’s progress; it indicates how well management is doing on behalf of its shareholders. Thus, the attention of financial management is on the value to the owners or suppliers of equity capital. The wealth of owners is reflected in the market value of shares. So, wealth maximization is a decision criterion.

Functions of financial management

The financial management function is not a standardized operation. The functions vary from firm to firm depending upon the size of the company, nature of industry and tradition. In small units the owner generally handles all matters involving the procurement and utilisation of funds while in the medium sized company financial officers may be concerned with the financial management. In a big enterprise primary importance is given to the financial managers to take decisions on various functions such as dividend policy, refinancing of maturing debt, introduction of a new product managing the firm’s working capital etc. Hence, the functions of financial management vary from firm to firm depending upon circumstances.

Traditionally, the study of business finance is centered on either the management of the firm’s current assets—cash, accounts receivable and inventories or the firm’s acquisition of funds. However, in the modern approach, finance function occupies a key position in the firm’s general management and plays a major role in planning and measuring the firm’s need for funds in raising the necessary funds, and then putting the funds acquired to effective use. Hence, measuring, acquiring and using of funds are the three basic functions of finance.

According to Ezra Solomon, “the function of financial management is to review and control decision, to commit or recommit funds to new or ongoing uses. Thus, in addition to raising funds, financial management is directly concerned with production, marketing and other functions within an enterprise wherever decisions are made about the acquisition or distribution of assets. However, financial
management involves the solution of the three decisions. They determine the value of the firm to its shareholders. Assuming that our objective is to maximise the value, the firm should strive for an optimal combination of the three interrelated decisions, solved jointly. The decision to invest in a new capital project for example, necessitates financing the investment. The financing decision, in turn, influences the dividend decision, for retained earnings used in internal financing represent dividends foregone by stockholders. Thus these three financial decisions are inseparable and therefore wherever a decision has to be taken, the financial manager should give due weightage to all of them as the situation demands.

i) Investment decision

Investment decision is the most important of all other financial decisions. Capital investment is the major aspect of the investment decision. Firstly, this decision relates to the allocation of funds to investment proposals whose benefits are to be realised in future. Secondly, it concerns the utilisation of short-term funds for investing current assets. Current assets can be known as the assets which in normal course of business are convertible into cash usually within a year. Investment on fixed assets is more crucial than the investment on current assets. To take an appropriate decision regarding investment in fixed and current assets, the investment decision viz., capital budgeting and working capital management have been developed.

Capital budgeting

Capital budgeting is a many sided activity that includes searching for new and more profitable investment proposal, investigation of engineering and marketing considerations to predict the consequences of accepting the investment, and making economic analysis to determine the profit potential of each investment proposal. The capital budgeting decision is more formal and analytical than that taken in planning for consumption of expenditures or routine business purchases of any other thing. The reasons for this are: firstly, the consequences of investment in fixed assets extend far into the future. Secondly, decisions to invest in fixed assets are often irreversible except at considerable cost to the firm, often both financial and operational. Thirdly, if a firm is to experience growth, its management must
recognise that the desired growth can take place only if it is willing to make a series of investment decisions involving fixed assets. Finally, the extent to which a particular capital investment opportunity will be profitable to a firm is influenced by many internal and external factors.

In making long term investment decisions the firm needs to (i) estimate project cash flows, (ii) estimate an appropriate discount rate or cost of capital for the project and (iii) formulate decision criteria that allow the firm to make investment choices, consistent with firm's goal of wealth maximisation. Therefore the investment proposal can be measured in terms of benefits or returns and risk associated with it. It is also related to the choice of the new asset out of the alternatives available or the reallocation of capital when an existing asset fails to justify the funds committed. Capital budgeting decisions thus have a major impact on the firm, and proper capital budgeting requires an estimate of the cost of capital. According to Robichek "there is broad, but not yet inversely agreement, that the correct standard to use for this purpose is the company's cost of capital.

Working Capital Management

Managing working capital essentially means providing the necessary resources to enable the company to finance the production and sales cycle. Thus, requirement of working capital starts with the purchase and use of raw materials and completes with the production of finished goods and sales. The business fluctuations also affect the working capital requirements, particularly the temporary working capital requirements of the firm.

Working capital management is concerned with the management of the current assets. The efficiency of the business enterprise to earn profits depends largely on its ability to manage working capital. Technically, working capital may be defined as the excess of current assets over current liabilities and provisions and it also usually refers to net working capital. The net working capital indicates the solvency of an enterprise. The items mentioned under current assets are known as gross working capital, since these assets change from one firm to another during the course of the business operations.
ii) Financing decision

The financing decision is the second major decision of financial management. The financial manager is concerned with determining the best financing mix or capital structure. If a company can change its total valuation by varying its capital structure, an optimal financing mix would exist; in which market price per share should be maximised. Once the firm has committed itself to new investment, it must select the best means of financing these commitments. Since firms regularly make new investments, the need for financing and hence, the need for making the financing decisions are on going. The financial manager should decide, when, where and how to acquire funds to meet the firm's investment needs. To quote Bolten, "the judicious use of long term debt and common equity (financial leverage) can, if properly handled, lead to a lower cost of capital and higher profits and share price for the firm". Thus, there are two aspects of the financing decision. First, the theory of capital structure which shows the theoretical relationship between the employment of debt and the return to the shareholders. The second, aspect is the determination of an appropriate capital structure. To conclude, the financing decision is not only concerned with how best to finance new assets but is also concerned with the best overall mix of financing for the firm.

iii) Dividend Decision

Another important financial decision of the firm is its dividend policy. The establishment of an effective dividend policy is therefore of key importance to the firm's overall objective of owners wealth maximisation. The implementation of sound dividend policy is not easy because these decisions are closely related to the firm's financing activities.

Therefore, the dividend policy involves the decision to payout earnings or to retain them for reinvestment in the firm. The increase in cash dividends means that less money is available for reinvestment. The ploughing back of fewer earnings into the business will lower the expected growth rate and depress the price of the stock. Thus, dividend policy has two opposing effects and the optimal policy is the one that
strikes a balance between current dividends and future growth and thereby maximizes the price of the firm’s stock\textsuperscript{30}. The dividend policy of the company affects its capacity for auto-financing; because the more dividends it pays, the less it has for reinvestment in the business. Dividend payments are taken to mean the distribution or paying out of a company’s profits to the shareholders which will result in a reduction in the value of the business. The issue of bonus shares, out of profit or reserves, does not constitute a payment of dividend in the sense that the net assets of the company remain intact. Dividends are usually paid in the form of cash, but may be paid in kind, such as, the firm’s own products or the shares of other companies held by the firm\textsuperscript{31}. The payment of dividends is entirely at the discretion of the directors, though there are certain legal rules which must be observed. It is also restricted by the desire to use retained earnings as a source of finance to take up the investment opportunities available to the firm.

**Profit planning and control**

Profit planning and control are vital aspects of a firm’s long run survival. It is one of the major responsibilities of financial manager of an enterprise. A firm’s financial condition changes with the passage of time and it is preferable to take appropriate action to meet impending events than forced to make crisis decisions when the event occurs\textsuperscript{32}. However, profit forecasting and planning need to generate income for long-run survival and the maximisation of the value of the enterprise. Moreover, co-ordination between man and materials can be achieved under profit planning through budgeting. “Budget is quantitative expression of a plan of action and an aid to co-ordination and implementation. Budgets may be formulated for the organisation as a whole or for any sub-unit. The master budget summarises the objectives of all sub-units of an organisation – sales, production, distribution, and finance\textsuperscript{33}. Thus, budget acts as a guide to the departmental heads and also helps in planning and controlling. To conclude, in the words of Welsch, profit planning control is a systematic and formalized approach for accomplishing the planning co-ordination and control responsibilities of management\textsuperscript{34}.
Summary

Financial management is one of the important functional areas of business management. It is an appendage to the finance function. In a business undertaking, financial management is concerned mainly with raising funds in the most economic and suitable manner, and using them as effectively as possible. It is concerned with managerial decisions like (i) the financing decision (ii) the investment decision, and (iii) the dividend decision. These decisions are to be taken by analysing and visualising their effects on the objectives of a business undertaking. Any decision taken by the financial manager, ultimately aims at achieving the fundamental objective of maximizing shareholder's worth in a business undertaking. Any decision taken by the financial manager, ultimately aims at achieving the fundamental objective of maximizing shareholder's worth in a business undertaking.
REFERENCES


