INTRODUCTION

The term financial management has undergone a rapid change in its objective and scope viewing in a narrower sense of raising of funds, to procurement and utilisation and other related institutional aspects of funds. The objective of financial management today covers the optimum financial decision for maximisation of profits, wealth and well being of shareholders. The task of financial management involves the striking of a balance between risk and profitability by contributing the highest long-term value to the securities of a firm. Unlike in the past, the financial decisions are made in a much co-ordinated manner, by the financial manager who is directly responsible for the control process.¹ The financial management therefore, performs a crucial function for the survival and success of business undertaking by bringing a balance between the demand for and supply of funds. The financial management thus, in the modern term, can be conveniently divided into three major decisions - the functions of finance. They are

(i) The investment decision, (ii) The financing decision and (iii) The dividend decision.

THE CONCEPT

In the words of John J. Hampton, "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 flows of money, as well as any claims against money". Solomon, Ezra views financial management as "the (that) blend of art and science through which firms make the important decisions of what to invest in, how to finance it, and how to combine some appropriate objectives".

Financial management covers the finance functions, refer to its management, role, the means of its payment, 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. Therefore, financial management must attend to three major decisions such as investment decision, financing decision and dividend decision, as these determine the value of the firm to its shareholders. Assuming the objective of maximising 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 mobilised and utilised. 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. Since business firms are profit-seeking organisations' 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 maximise the welfare of owners.

Maximisation of Profits

Often, maximisation of profits is regarded as the proper objective of the firm. However, this concept is somewhat narrower than the goal of maximising the value of the firm. The rationale behind profit maximisation objective is that it guides financial decision making. Profit is a test of economic efficiency of the firm as it provides the tool through which economic performance can be judged. Moreover, it leads to efficient allocation of resources. It also ensures maximum social welfare. Financial management, thus is concerned with the efficient use of capital which

is an efficient economic resource. It is therefore said that 
profitability maximisation should serve as the basic criterion for the financial management decisions.

The profit maximisation objective, however, suffers 
from three basic weaknesses, viz., 
i) Vagueness, 
ii) Ignoring the timing of returns, and 
iii) Ignoring the risk.

Maximisation of Wealth

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

The wealth maximisation objective as described by 
Ezra, Solomon is "the gross present worth of a course of

6. Solomon, Ezra and John J. Pringle, An Introduction to 
Financial Management, California: Good Year 

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 and it is 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. 8.

The wealth maximisation objective is consistent with the objective of maximising the owners' 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 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 9.

Thus the attention of financial management is on the value to the suppliers of equity capital which is reflected in the market value of shares.

FUNCTIONS OF FINANCIAL MANAGEMENT

The study of business finance, traditionally, has centered around 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, measuring, acquiring and using of funds are the three basic functions of finance.10

The financial management function is not a standardized operation.11 The functions vary very widely from firm to firm, time to time, the nature, traditions and size of the firms. 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.

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 whenever decisions are made about the acquisition or distribution of assets.\textsuperscript{12}

The solution of the three decisions of financial management determines the value of the firm to its shareholders. Assuming that the objective is to maximise the value, the firm should strive for an optimal combination of the three interrelated decisions, solved jointly. The 'investment decision' in a new capital project, for example, necessitates financing the investment. The 'financing decision', in turn, influences, and is influenced by the 'dividend decision', for retained earnings used in internal financing represents dividends foregone by stockholders.\textsuperscript{13}

Thus, three financial decisions are inseparable and therefore whenever a decision has to be taken, the financial manager should give due weightage to all of them as the situation demands.

INVESTMENT DECISION

Capital investment decision is the most important of all other financial decisions. 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 in fixed assets is more crucial than the investment in current assets. To take an appropriate decision regarding investment in fixed and current assets, the investment decisions viz., capital budgeting and working capital management have been evolved.

Capital Budgeting

"Budget is a 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". 14 Thus, budget acts as a guide to the departmental heads and also helps in planning and controlling.

Capital budgeting is a many sided activity that includes searching for new and more profitable investment proposals, 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\textsuperscript{15}. The capital budgeting decision is both more formal and analytical than that taken in planning for consumption expenditures or routine business purchases of any other thing.

The extent to which a particular capital investment opportunity will be profitable to a firm is influenced by many internal and external factors.\textsuperscript{16} 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 criterion that allow the firm to make investment choices, consistent with firm's goal of shareholders wealth maximisation.\textsuperscript{17} Therefore, the investment proposal can be measured in terms of benefits or returns and risk associated with it. It also relates 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.\textsuperscript{18}


budgeting decisions thus have a major impact on the firm, and proper capital budgeting requires an estimate of the cost of capital.\textsuperscript{19} According to Robicheck, "there is broad, but not yet universal agreement, that the correct standard to use for this purpose is the company's cost of capital".\textsuperscript{20}

Working Capital Management

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. It is usually referred to 'net working capital'. The net working capital indicates the solvency of an enterprise. The items mentioned under current assets are known as circulating capital or current capital, since these assets change from one form to another during the course of the business operations.\textsuperscript{21}

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.

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 could be maximised. Once the firm has committed itself to new investment, it must select the best means of financing its commitments. Since firms regularly make new investments the need for financing and hence the necessity of 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 prices for the firm"\textsuperscript{25}. 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.\textsuperscript{26}

DIVIDEND DECISION

Another important financial decision of the firm is its dividend decision. The establishment of an effective dividend policy is, therefore, of key importance to the firm's overall objective of owners wealth maximisation.\textsuperscript{27} 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 pay out 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 less 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. The dividend policy of the company affects its capacity for auto-financing, because the more dividend 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. 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 are vital aspects of a firm's long-run survival. It is one of the major responsibilities of a 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. However, profit forecasting and planning relate to the need to generate income for long run survival and the maximisation of the value of the enterprise. Moreover, coordination between man and materials can be achieved through profit planning and control.

To conclude, in the words of Welsch profit planning and control is "a systematic and formalised approach for accomplishing the planning, co-ordination and control responsibilities of management."  
