Chapter – I - Introduction to Financial Management

Meaning

Financial management refers to that part of management activity which is concerned with the planning and controlling of form's financial resources. It deals with the finding out various sources for raising funds for the firm.

Financial management is that managerial activity which is concerned with the planning and controlling of the firm's financial resources. It is an integrated decision making process concerned with acquiring, financing and managing assets to accomplish the overall goal of a business organization. It can also be stated as the process of planning decisions in order to maximize the shareholder's wealth. Financial managers have a major role in cash management, acquisition of funds and in all aspects of raising and allocating capital. As far as business organizations are concerned, the objective of financial management is to maximize the value of business.

Definition: "Financial management comprises the forecasting, planning, organizing, directing, co-coordinating and controlling of all activities relating to acquisition and application of the financial resources of an undertaking in keeping with its financial objective." This definition of financial management by Raymond Chambers aptly sums up the vital role played by it in any organization.

SCOPE OF FINANCIAL MANAGEMENT

As an integral part of the overall management, financial management is mainly concerned with acquisition and use of funds by an organization. Based on financial management guru Ezra Solomon's concept of financial management, following aspects are taken up in detail under the study of financial management:

- **a.** Determination of size of the enterprise and determination of rate of growth.
- **b.** Determining the composition of assets of the enterprise.
- **c.** Determining the mix of enterprise's financing i.e. consideration of level of debt to equity, etc.
- **d.** Analyze planning and control of financial affairs of the enterprise.

The scope of financial management has undergone changes over the years. Until the middle of this century, its scope was limited to procurement of funds under major events in the life of the enterprise such as promotion, expansion, merger, etc. In the modern times, the financial management includes besides procurement of funds, the three different kinds of decisions as well namely, investment, financing and dividend. All the three types of decisions would be dealt in detail during the course of this chapter.

The given figure depicts the overview of the scope and functions of financial management. It also gives the interrelation between the market value, financial decisions and risk return trade off. The financial manager, in a bid to maximize shareholders' wealth, should strive to maximize returns in relation to the given risk; he should seek courses of actions that avoid unnecessary risks. To ensure maximum return, funds flowing in and out of the firm should be constantly monitored to assure that they are safeguarded and properly utilized.

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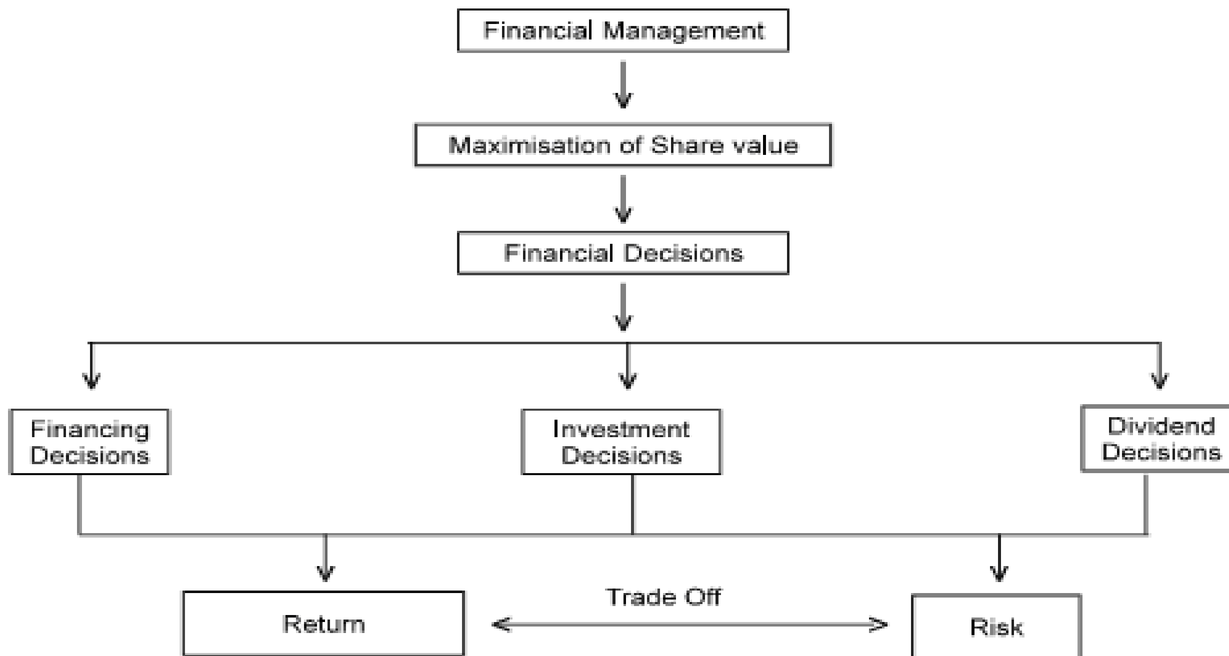

An Overview of Financial Management

Types of decisions

1. **Investment decisions:** These decisions determine how scarce resources in terms of funds available are committed to projects which can range from acquiring a piece of plant to the acquisition of another company. Funds procured from different sources have to be invested in various kinds of assets. Long term funds are used in a project for various fixed assets and also for current assets. The investment of funds in a project has to be made after careful assessment of the various projects through capital budgeting. A part of long term funds is also to be kept for financing the working capital requirements. Asset management policies are to be laid down regarding various items of current assets. The inventory policy would be determined by the production manager and the finance manager keeping in view the requirement of production and the future price estimates of raw materials and the availability of funds.
   - **Investment decisions**
   - Ascertainment of the total volume of funds, a firm can commit
   - Appraisal and selection of capital investment proposals
   - Measurement of risk and uncertainty in the investment proposal
   - Prioritization of investment decisions
   - Fund allocation and its rationing
   - Determination of fixed assets to be acquired
   - Determination of the level of investments and its management
   - Buy or lease decisions
   - Asset replacement decisions
   - Restructuring, reorganization, mergers and acquisitions
   - Securities analysts and portfolio management

2. **Financing decisions:** These decisions relate to acquiring the optimum finance to meet financial objectives and seeing that fixed and working capital are effectively managed. The financial

manager needs to possess a good knowledge of the sources of available funds and their respective costs, and needs to ensure that the company has a sound capital structure, i.e. a proper balance between equity capital and debt. Such managers also need to have a very clear understanding as to the difference between profit and cash flow, bearing in mind that profit is of little avail unless the organization is adequately supported by cash to pay for assets and sustain the working capital cycle. Financing decisions also call for a good knowledge of evaluation of risk, e.g. excessive debt carried high risk for an organization's equity because of the priority rights of the lenders. A major area for risk-related decisions is in overseas trading, where an organization is vulnerable to currency fluctuations, and the manager must be well aware of the various protective procedures such as hedging (it is a strategy designed to minimize, reduce or cancel out the risk in another investment) available to him. For example, someone who has a shop takes care of the risk of the goods being destroyed by fire by hedging it via a fire insurance contract.

- **Finance Decisions**
- Determination of the degree or level of gearing
- Determination of the pattern of LT, MT & ST funds
- Raising of funds through various instruments
- Arrangement of funds through various institutions
- Consideration of interest burden
- Consideration of debt level changes and firm's bankruptcy
- Taking advantage of interest and depreciation in reducing the tax liability of the firm
- Considering the various modes on improving the EPS and market value of the share.
- Consideration of cost of capital of individual component and weighted average cost of capital to the firm
- Optimization of finance mix to improve returns
- Portfolio management
- Consideration of the impact of under capitalization and over capitalization
- Consideration for foreign exchange risk exposure
- Balance between owner's capital and outside capital
- Evaluation of alternative use of funds
- Review of performance by analysis.

3. **Dividend decisions:** These decisions relate to the determination as to how much and how frequently cash can be paid out of the profits of an organization as income for its owners/shareholders. The owner of any profit-making organization looks for reward for his investment in two ways, the growth of the capital invested and the cash paid out as income; for a sole trader this income would be termed as drawings and for a limited liability company the term is dividends.

- Dividend decisions
- Determination of dividend and retention policies of the firm
- Consideration of the impact of the levels of dividend and retention of earnings on the market value of the share and the future earnings of the company
- Consideration of possible requirements of funds by the firm for expansion and diversification proposals for financing existing business requirements
- Reconsideration of distribution and retention policies in boom and recession period
- Considering the impact of legal and cash flow constraints on dividend decisions

GOALS / OBJECTIVES OF FINANCIAL MANAGEMENT

The basic objective centers on:

- Procurement of funds from various sources like, ESC, PSC, debentures, term loans and bonds
- Effective utilization of the funds to maximize the profitability of the firm and wealth of its owners.

Efficient financial management requires the existence of some objectives or goals because judgment as to whether or not a financial decision is efficient must be made in the light of some objective. Although various objectives are possible but we assume two objectives of financial management for elaborate discussion. These are:

1. Profit Maximization

It has traditionally been argued that the objective of a company is to earn profit, hence the objective of financial management is also profit maximization. This implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximized. Each alternative, therefore, is to be seen as to whether or not it gives maximum profit.

However, profit maximization cannot be the sole objective of a company. It is at best a limited objective. If profit is given undue importance, a number of problems can arise. Some of these have been discussed below:

- The term profit is vague. It does not clarify what exactly it means. It conveys a different meaning to different people. For example, profit may be in short term or long term period; it may be total profit or rate of profit etc.
- Profit maximization has to be attempted with a realization of risks involved. There is a direct relationship between risk and profit. Many risky propositions yield high profit. Higher the risk, higher is the possibility of profits. If profit maximization is the only goal, then risk factor is altogether ignored. This implies that finance manager will accept highly risky proposals also, if they give high profits. In practice, however, risk is very important consideration and has to be balanced with the profit objective.
- Profit maximization as an objective does not take into account the time pattern of returns. Proposal A may give a higher amount of profits as compared to proposal B, yet if the returns begin to flow say 10 years later, proposal B may be preferred which may have lower overall profit but the returns flow is more early and quick.
- Profit maximization as an objective is too narrow. It fails to take into account the social considerations as also the obligations to various interests of workers, consumers, society, as well as ethical trade practices. If these factors are ignored, a company cannot survive for long. Profit maximization at the cost of social and moral obligations is a short sighted policy.

Arguments in favour of profit Maximization

1. It is a barometer to measure the efficiency and economic prosperity
2. A firm will be able to survive the adverse business conditions only if it has earnings to face the situation.
3. It facilitates growth
4. It helps to achieve social goals
5. It motivates investment
6. Credibility of the firm increases
7. Stock prices will go up in the market

Arguments against profit maximization

- The concept profit is very vague
- It ignores risk factor and timing of returns
- It may allow decision to be taken at the cost of Long-run stability and profitability of the concern
- It emphasizes more on the short run profitability and short run projects
- It fails to consider the social responsibility

2. Wealth Maximization

It means maximizing the Net Present Value (or wealth) of a course of action. The NPV of a course of Action is the difference between the present value of its benefits and the present value of its cost.
The maximization of wealth is possible by making decisions of the firm to get benefits that exceed cost. It takes into consideration the time and the risk of effected benefits. The wealth maximization is not only for the shareholders but also for the stake holders

The WM goals advocated on the following grounds:

- It takes into consideration the long-run survival and growth of the firm
- It is consistent with the object of owners economic welfare
- It suggests the consistent dividend payments to the shareholders
- The financial decisions result in the capital appreciation
- It considers risk and time value of money
- It considers all future cash flows, dividends and EPS
- The maximization of firm's value is reflected in the market price of share.
- Profit Maximization partly enables the firm in wealth maximization
- Shareholders prefer WM to PM

Criticisms

- The society's resources are used to the advantage of a particular firm, hence, society welfare is criticized
- It is a prescriptive idea than a descriptive one

Why Wealth Maximization Works?

Of course, there are other goals too like:

- Achieving a higher growth rate
- Attaining a larger market share
- Gaining leadership in the market in terms of products and technology
- Promoting employee welfare
- Increasing customer satisfaction

3. Value Maximization

The primary objective of FM is to maximize the value of the firm. It facilitates in maximizing the value of equity share which serves as an index of the performance of the company.
It takes into consideration the present and the future earnings, risk dividend, retention policies, level of gearing.
The Share holder wealth is maximized only if market share increases, hence WM is redefined as value maximization

Other maximization of objectives

- Sales Maximization
- Growth Maximization
- Return on investment maximization
- Social objectives
- Group of objectives (Production, inventory, sales, market share, profit)

Financial objectives of a firm:

- Return on Capital employed or ROI
- Value addition and profitability
- Growth in EPS and PE ratio
- Growth in MV of Share
- Growth in Dividends
- Optimum level of leverage
- Survival and growth of the firm
- Minimization of finance charges
- Effective utilization of Short, medium and long term objectives

FINANCE FUNCTION:

It is one of the main functions of a business organization, which, aims at procuring and judiciously utilizing the financial resources with a view to maximizing the value of the firm thereby the value of the owners i.e., equity shareholders in a company is maximized.

Approaches to Finance Function

- Providing of funds needed by a business on most suitable terms (This approach confines only to raising of funds)
- Second Approach relates finance function to cash. This approach implies that finance function is related to every activity in the business
- Third approach to this function envisages the raising of funds and their effective utilization.

To conclude, finance function covers financial planning, rising of funds, allocation of funds, financial control.

Aims of Finance Function

- Acquiring sufficient funds
- Proper utilization of funds
- Increasing profitability
- Maximizing concern's value

Scope or Content of Finance function

- Estimating financial requirements
- Deciding the capital structure
- Selecting a Source of finance
- Selecting a pattern of investment
- Proper cash management
- Implementing financial controls
- Proper use of surpluses.

Organization chart of finance function