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Financial Management Introduction Part: 1

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1. Introduction

The management of finance and various financial activities concerning the planning, utilizing and controlling of financial resources is known as financial management. Without finance no organization can run efficiently. For the successful implementation of plans, finance is required. Financial management deals with procurement and utilization of funds. Though there are various functions like production, marketing, human resource but finance function assumes an important place. Finance function deals with three important activities of raising funds, investing funds in different kinds of assets and disbursing the returns in the form of dividends that is, the financing decision, investment decision and dividend decision.

According to Solomon (1978),

Financial management is "concerned with the management decision that results in the acquisition and financing of long term and short term credits of a firm. As such it deals with the situations that require selection of specific assets as well as the problem of size and growth of an enterprise. The analysis of these decisions is based on the expected inflows and outflows of funds and their effects upon managerial objectives"

According to James C. Van Horne (1972) financial management is"concerned with the acquisition, financing and management of assets with some overall goal in mind".

Objectives of Financial management

No activity can be undertaken without some objectives. Objectives provide the direction. The most important objectives of financial management are Profit maximization and Wealth maximization. Profit is essential for any economic activity. It is a yardstick for economic efficiency. Profit maximization means that either the firm should produce maximum output with the given input or uses a minimum input for the given output. When we talk about profit maximization in financial management, the profit maximization objective implies that the investment, financing and dividend decision should be taken in such a way that it maximizes profits.

The objective of profit maximization suffers from certain limitations such as it is an ambiguous concept as there is different connotation for the word profit. Some view it as return on investment, return on assets or profit before tax or profit after tax. There is no clarity as to which profit is to be considered. The other limitation with which this objective suffers is that it ignores time value of money that is it does not take into consideration the returns received in different periods. It treats all the returns at par irrespective of when they are received for example, return received of Rs five thousand in the first year is treated at par with the Rs five thousand received after two years.

This objective ignores the basic principle of financial management the earlier the better as benefits received sooner are more valuable than benefits received later. The profit maximization criterion does not consider the distinction between

returns received in different time periods and treat all benefits irrespective of the timing as equally valuable.
The one more important drawback of this objective is that it ignores quality of benefits. Quality refers to the degree of certainty with which cash flows are expected. It does not give weight age to uncertainty of returns. The riskiness associated with the cash flows is not considered. If there is too much fluctuation in cash flows, it does not have certainty and should be considered as more risky.

Another alternative objective in financial management is to maximize the wealth of shareholders. It means maximizing the net present value of a course of action. Net present value is the difference between the present value of its benefits and the present value of its costs.

This objective is also known as value maximization or net present worth maximization.
An alternative which has positive NPV would add to the wealth of shareholders where as the alternative having negative NPV would have a negative impact on the wealth of shareholders and hence not desirable. In case of Mutually Exclusive projects, the alternative, which has maximum NPV, should be adopted. NPVs of different alternatives are additive in nature.

That is NPV (A)+ NPV(B)= NPV (A+B)

This is referred to as the principle of value additivity[2].

The objective of wealth maximization is based on the concept of cash flows and not on accounting profits and hence offers an unambiguous measure and considered to be superior in making investment and financing decision.[3]

Cash flows recognize revenues and expenses only with respect to actual inflows and outflows of cash.

The wealth created by the firm is reflected in the market price of shares. Market price is the operational justification for the wealth maximization. This objective considers the time value of money and the quality of benefits. It guides the management in framing policies, which maximize returns to shareholders. Solomon advocated that the proper goal of financial management is wealth maximization and hence provides the basic guideline for evaluating the financial decisions.

The two important issues associated with value or share price maximization, namely economic value added and focus on stakeholders.

Economic value added:

EVA determines if the proposed investment positively contributes to the shareholder's wealth. It is the difference of after tax operating profits of the firm and cost of funds used to finance investments. A positive EVA would enhance the wealth of shareholders. Financial management concern is not just limited to enhancing of shareholder's wealth but It takes due consideration of other stakeholders. The stakeholders include groups such as employees, customers, suppliers, creditors, owners and others who are directly associated with the company.

The other objectives of financial management are providing reasonable return to shareholders of a business concern, to ensure ploughing back of profits for growth and expansion, to enforce financial discipline, to have the optimum capital structure and so on.

2. Scope of Financial management

Finance function is one of the most important functions of an organization. No matter how good you are in designing and crafting strategies, marketing and production plans and schedules, if the company does not have adequate funds, plans would remain as plans only and would never be implemented because of unavailability and inadequacy of funds and hence the management of finance assumes a lot of importance. Though financial management has immense scope but for easy understanding it can be divided into two approaches

- **The traditional approach**
- **Modern approach**

According to the traditional view, the financial management is concerned with the raising of funds. Funds are raised at special occasions like at the time of mergers, reorganization, restructuring, liquidation and so on, which is known as episodic financing. The role of finance function was very limited and narrow as per the traditional approach. The areas which are covered are procurement of short and long term funds, identification of sources through which these funds would be raised, legal and accounting relationships with the sources who have provided the funds and redistribution of income and assets among these resources. This approach ignored the day-to-day management of finance and just concentrated on the suppliers of funds making it an outsider looking in approach. It completely ignored the working capital financing which is required for the day to day running of business. Since the focus is on procurement, it did not cover the allocation of funds. Traditional approach failed and was criticized, as it could not answer the various questions in different facets as rightly described by Solomon.

The criticism of traditional approach gave rise to the modern approach, which was definitely broader and wider. It was not only concerned with the raising or procurement of funds but also its proper management and administration. Modern approach is mainly concerned with the three important decisions like investment decisions, financing decisions and dividend policy decisions. Modern approach was started during mid 1950s. It covers conceptual and analytical framework for financial decision-making. The main issue dealt in modern approach is its matching of funds to their uses.

The questions which are dealt with, in this approach are:

How much funds an enterprise should commit?

What assets should an enterprise acquire?

How the financing of funds take place?

These three questions are related to the three major finance decisions namely investment decisions, financing decisions and dividend decisions.

Finance functions: There are three important finance decisions namely financing decision, investment decision, and dividend decision. A firm should attempt to balance cash inflows and outflows while performing these functions. The decisions should also try to balance the two major aspects of profitability and liquidity. The decisions should be taken in such a way that the shareholder's wealth is maximized.

Investment Decision: The investment decisions would determine what specific assets should the firm acquire? Investment decision would also mean deciding the right mixes of assets that is mix of current assets and fixed assets.

Fixed assets are those assets, which have the capacity to generate income and yields return over a long period of time. These assets involve huge investments and investment in such assets is known as capital budgeting decisions. Examples of fixed assets are Plant and Machinery, Land and buildings, fixtures etc. Management of fixed assets is known as capital budgeting. Capital budgeting relates to the selection of asset or investment proposal or course of action whose benefit is going to be available in future over a long period of time. The evaluation of these proposals is based on a standard known as cut off rate, hurdle rate, required rate, discount rate or minimum rate of return. This is the rate which reflects the time and risk preferences of the owners or suppliers of capital. A higher rate would reflect more risk in the investment proposal.

Current assets are those assets that are required to support the functioning of fixed assets and which can be converted into cash within a short duration of time that is one year or less than one year without much diminution in value. Investment in such assets is popularly known as Working capital management.

If the company invests in too much of current assets then it is emphasizing on liquidity and if the company is investing too much in fixed assets, it is focusing more on profitability. A right balance needs to be stricken in investment policy as liquidity and profitability, both are important.

Financing decision:

The financing decision relates to when and how to acquire funds and deciding the proper mix of debt and equity and determining the firm's capital structure. A firm's capital structure is the mix of securities through which funds are raised to meet the financial requirements of the company. The company should try to achieve optimum capital structure. By optimum capital structure we mean the value of the firm is maximized and the cost of capital is minimized. Degree of leverage would affect the capital structure of a firm. Right degree of leverage is important decision as too much employment of debt, will increase the risk and too much of equity will not allow the firm to have the advantage of cheaper source of financing.

Leverage is the employment of an asset or source of finance for which firm pays fixed cost or a fixed return. The degree of debt in the capital affects the risk perception of the shareholders. It is important for the company to know from where, how much and when it should acquire the funds. The decision should result in optimal capital structure, which means it maximizes the value of the firm and minimizes the cost of capital.

Dividend decision: The third major decision of financial management is the dividend decision, which should be analyzed in relation to the financing decision and investment decision.

The dividend decision would deal with the distribution of income and deciding the portion of EPS to be declared as dividends. The proportion of profits distributed as dividends is known as dividend payout ratio and the retained proportion is known as the retention ratio. A firm should try to have an optimum dividend policy, which maximizes the wealth of the shareholders.

3. Summary

To conclude the traditional approach had a very narrow perception and did not have an analytical and conceptual framework but the modern approach is broad and involves the three major decisions concerning financial management i.e investment decision, financing decision and dividend decision.