FINANCIAL MANAGEMENT : AN OVERVIEW

OBJECTIVES

After studying this lesson you should be able to :

- Explain the meaning and scope of finance function
- Explain the objectives of financial management
- Explain the role of finance manager in an enterprise
- Explain the conflict of goal between management and owners
- Understand how the finance function is organised
- Understand the relationship between financial management and other management areas.

STRUCTURE

1.1 Introduction

1.2 Meaning of finance function

1.2.1 Scope of finance function

1.3 Meaning of financial management

1.4 Objectives of financial management

1.5 Scope of financial management

1.6 Conflict of goal between management and owners

1.7 Organisation of finance function

1.8 Financial management and other related areas.

1.9 Summery

1.10 Key words

1.11 Self examination questions

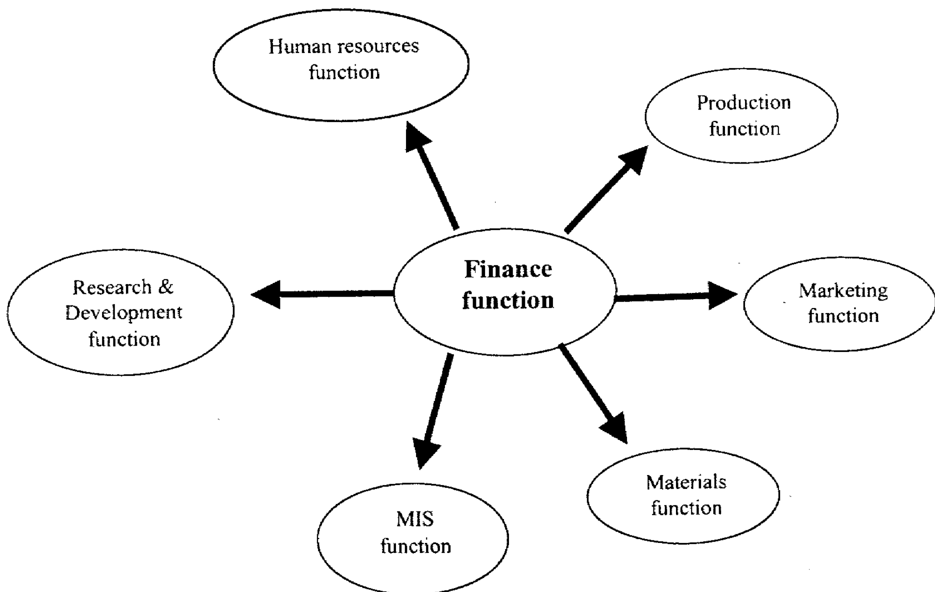
1.12 Books for further reading.

1.1 INTRODUCTION

Finance is regarded as the life blood of a business enterprise. It is the basic foundation of all kinds of economic activities. Finance is the master key which provides access to all the sources for being employed in manufacturing and merchandising activities. The success of an organisation largely depends on efficient management of its finances. In this lesson you will study the meaning, objectives and scope of financial management. Apart from the above this lesson also explains you the agency problem, organisation of finance function and the relationship between financial management and other related areas.

1.2 MEANING OF FINANCE FUNCTION

Finance is one of the functional areas in an organisation . It is one of the most important of all business functions. Finance department plays a vital role in the organisation. It may be described as heart in the human body. The basic function of heart in the human body is to pump the necessary blood to all parts of the body. Similarly, the finance department in the organisation has to supply the necessary finances to all the other departments (functions) to carryout their activities. It is the responsibility of the finance department to identify the financial requirements of various departments and supply the needed funds at the right time. The following picture presents the relationship between finance function and other functional areas in the organisation.



1.2.1 SCOPE OF FINANCE FUNCTION

The finance function is headed by finance manager in an organisation. As described above, inorder to provide necessary finances to other functional areas, the finance manager will have to concentrate on the following areas of finance function.

a) **Estimating financial requirements :** The first task of a finance manager is to estimate short term and long term financial requirement of his business. For this purpose, he will prepare a financial plan for present as well as for future. The estimation made through financial plans should be based on sound financial principles so that neither there are inadequate nor excess funds with the concern.

b) **Designing capital structure :** The capital structure refers to the proportion between debt and equity. After deciding about the quantum of funds required, it is the job of the finance manager to decide the securities through which funds can be raised.

c) **Selecting a investment pattern.** It is related to the use of funds. A decision will have to be made as to which assets to be acquired with the procured funds. While spending on various assets, the principles of safety, profitability and liquidity should be kept in mind. Apart from this, depending up on the nature of organisation a proper balance needs to be maintained between the proportion of investment in fixed assets and current assets.

d) **Implementing financial controls :** In order to understand whether the funds mobilied are used efficiently or not the finance manager use various financial tools. These are budgetary control, break- even analysis, ratio analysis, cost control and internal audit. The use of these control techniques will help him in evaluating the performance in various areas and take corrective measures wherever needed.

1.3 MEANING OF FINANCIAL MANAGEMENT

Financial management is basically concerned with planning, organising and controlling of financial resources of an organisation. It is applicable to every type of organisation, irrespective of its size, kind and nature. It can be used in all orgnisations where there is a use of finance. Every management aims to utilise its funds in a best possible and profitable way. So this subject is acquiring a universal applicability. Financial management was a branch of economics till 1890 and thus as a separate descipline is of recent origin. It was earlier known as corporation finance and managerial finance.

1.4 OBJECTIVES OF FINANCIAL MANAGEMENT

It is generally agreed that the objective of financial management should be maximisation of economic welfare of shareholders. In order to achieve this and to make wise decisions, a clear understanding of the objectives which are sought to be achieved is

necessary. The objectives provide a frame work for optimum financial decision making. The following are the two widely discussed approaches in financial literature to achieve the above objective.

a) Profit maximisation

b) Wealth maximisation

We will discuss both the criteria and find out how wealth maximisation is a more suitable criterian than profit maximisation.

1.4.1 PROFIT MAXIMIZATION

It is an important concept in economic theory. It simply means that maximising the rupee income of the firm. According to this approach, actions that increase profits should be undertaken and those that decrease profits are to be avoided. The profit maximisation criterion implies that the investment, financing and dividend policy decisions of a firm should be oriented to the maximisaiton of profits.

This objective is justified on the following grounds.

1. The very survival of the organisation will be depending upon whether it is able to earn profits or not.
2. Profit is a test of economic efficiency.
3. It indicates the effective utilisation of resources.
4. It ensures maximum social welfare.

Profit maximisation suffers from the following limitations.

1. **Profit maximisation concept is vague or ambiguous.**

   The definition of profit itself is ambiguous. It has no precise connotation. It is amenable to different interpretations by different people. For example, profit may be short term profit or long- term, it may be total profit or rate of profit, it may be before tax or after tax, it may be return on capital employed or return on total assets. Hence, a loose expression like profit cannot form the basis of operational criterion for financial management.

2. **It ignores timing of benefits.**

   The second limitation to the objective of profit maximisation is that it ignores the differences in time pattern of the benefits received from investment proposals. The principle of 'the bigger the better' is adopted for decision making. Consider the following table.

Time pattern of benefits (Rs. in lakhs)

	Alternative A	Alternative B
Period 1	200	-
Period 2	100	100
Period 3	-	200
Total	300	300

It can be seen from the above table that profits associated with the two alternatives are identical. As per the profit maximisation criterion both the alternatives will be ranked equal. But if we look at the timing of return, alternative A provides higher returns in earlier years and the returns from alternative B are larger in later years. The early returns from A proposal can be reinvested. This will result in higher returns from alternative A.

3. It ignores quality of benefits

The profit maximisation concept ignores the consistency or the degree of certainty in getting returns from investment proposals. The following table reveals the above.

Quality of benefits Rs. in lakhs

Year	Alternative A	Alternative B
1	12	0
2	12	10
3	12	26
TOTAL	36	36

It is clear from the above table that the total returns of both the alternatives are identical. But if we see the certainty in getting returns, alternative A provides a stable returns. From the above it is clear that profit maximisation objective ignores risk.

In view of the above limitations, the profit maximisation criterion is considered as inappropriate and unsuitable operational criterion for financial decisions. It is not only vague and ambiguous but it also ignores risk and time value of money. As an alternative to the profit maximisation, the other criterian, that is, wealth maximisation is developed.

1.4.2 WEALTH MAXIMISATION

This is also known as value maximisation or net present worth maximisation. Net present value is the difference between the gross present value of benefits from an

investment proposal and the investment required to achieve these benefits. The gross present value of a course of action is found out by discounting or capitalising its benefits at a rate which reflects their timing or uncertainty. Any financial action with a positive net present worth should be undertaken otherwise it should be rejected.

The net present worth can be defined in the following ways.

(i) $W = V - C$

Where W = Net present worth

V = gross present worth

C = Investment

(ii) alternatively W can be expressed as follows

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

where A_1, A_2 ———— A_n = expected cash flows

k = Cost of capital

C = investment

n = time

W = net present worth

The objective of wealth maximisation resolves two basic limitations of profit maximisation. 1) It considers time value of money 2) It takes care of uncertainty of expected benefits and the benefits are measured in terms of cash flows and not accounting profits.

The wealth maximisation objective is consitant with the objective of maximisation of economic welfare of shareholders. The wealth of shareholders is reflected by the market value of the company shares. Hence, wealth manximisation implies the maximisation of the market value of the companys shares, which is the fundamental objective of the firm.

For the above reasons, the wealth maximisation criterion is considered to be superior to the profit maximisation as an operational objective.

Implications of wealth maximisation.

Apart from maximising the economic welfare of shareholders it also serves the interests of other parties like suppliers of loaned capital, employees, management and society. Long term lenders are interested in long term solvency of the firm. Short term lenders are primarily interested in liquidity position so that they get payment in time. The employees may also try to acquire share of companies wealth through bargaining. The over all management objective is its survival in the long run. The social benefits will be

maximised if societies resources are optimally allocated. The optimum allocation of resources will lead to optimal capital formation and growth in the economy and consequently maximum economic welfare of the people in the society.

1.5 SCOPE OF FINANCIAL MANAGEMENT

Financial management as an academic discipline has undergone significant changes over years as regards to its scope and coverage. As such the role of finance manager has also undergone fundamental changes over the years. In order to have a better exposition to these changes, it will be appropriate to study both the traditional approach and modern approach to the financial management.

1.5.1 TRADITIONAL APPROACH

The traditional approach to financial management was popular in the intial stages of its evolution as a separate branch of academic study. Under this approach the role of finance manager was limited to raising and administering of funds needed by the corporate enterprises to meet their financial needs. It broadly covers the following three aspects.

(i) Arrangement of funds from financial institutions

(ii) Arrangement of funds through instruments, viz shares, bonds etc.

(iii) The legal and accounting relationships between a firm and its sources of funds.

The scope of traditional approach to financial management was mainly concerned with raising of funds externally. The finance manager had a limited role to perform. He was expected to keep accurate financial records, prepare reports on the corporation status, performance and manage funds in such a way that the firm will be in position to meet its maturing obligations. The term "Corporate Finance" was used in the place of the present term "Financial Management" under traditional approach.

The traditional approach to the scope of finance function evolved during 1920's and 1930's and dominated academic thinking during the fifties and through the early forties. It has now been discarded as it suffers from serious limitations.

The following are the limitations of traditional approach.

1. **Outsider looking approach :** The approach equated finance function with the raising and administering of funds. It, thus treated the subject of finance from the view point of suppliers of funds, i.e outsiders, bankers etc. It completely ignored the view point of those who had to take internal financing decisions.
2. **Ignored routine problems :** The approach gave emphasis to episodic or infrequent happening in the life of an enterprise like mergers, consolidation and reorganisation. As a result it did not give any importance to day to day financial problems of business undertakings.

3. **Ignored non- corporate enterprises :** The approach focussed attention only on the financial problems of corporate enterprises. Non-corporate undertakings remained outside its scope.

4. **Ignored working capital problems :** The approach laid emphasis on the problems of long term financing. The problems relating to financing short term or working capital were ignored.

5. **No emphasis on allocation of funds :** The approach confined financial management to issues involving procurement of funds. It did not emphasise on allocation of funds.

In the absence of the coverage of these critical aspects the traditional approach implied a very narrow scope for financial management. The modern approach provides a solution to these short comings.

1.5.2 MODERN APPROACH

The traditional approach outlived its utility due to changed business situations since mid 1950s. The modern approach views the term financial management in a broad sense and provides a conceptual and analytical frame work for financial decision making. According to it, the finance function covers both acquisition of funds as well as their allocations.

The new approach is an analytical way of viewing the financial problems of firm. The principal contents of the modern approach to financial management can be said to be. :

a) How large should an enterprise be, and how fast it should grow?

b) In what form should it hold assets?

c) What should be the composition of its liabilities

The questions posed above cover between them the major financial problems of a firm. In other words, financial management, according to the new approach is concerned with the solution of three major problems relating to the financial operations of a firm. They are A) The investment decision B) The financing decision C) The dividend policy decision .

A) Investment Decision

The first and perhaps the most important decision any firm has to make is to define the business or businesses that it wants to be in. This decision has a significant bearing on how capital is allocated in the firm .

The investment decision is basically concerned with the allocation of funds among both long term assets and short term assets. The investment in long term assets is popularly known in financial literature as capital budgeting. The aspect of financial decision making with reference to short term assets or current assets is popularly termed as working capital management.

(i) **Capital budgeting :** Capital Budgeting is probably the most crucial financial decision for a firm. It may be defined as the firms decision to invest its current funds most efficiently in the long term assets, in anticipation of an expected flow of benefits over a series of years. Whether an asset will be accepted or not will depend on the relative benefits and returns associated with it. Capital budgeting also considers the risk and uncertainty in getting future returns. The worth of long term asset is measured by discounting the future cash flows using cost of capital as the discount factor. Any project which leaves positive net present value will be accepted.

(ii) **Working capital management :** Working capital management is concerned with management of current assets. It is an important and integral part of financial management as short term survival is a prerequisite for long term success. In the process of taking this decision the finance manager has to trade off between profitability and risk (liquidity). There is a conflict between profitability and liquidity. If a firm does not maintain adequate current assets, it my become illiquid and may not be able to meet its maturing obligation and thus invite the risk of bankruptcy. If the current assets are too large, profitability is adversely affected.

(B) Financing Decision.

The second major decision involved in financial management is the financing decision. The investment decision is broadly concerned with the asset- mix or the composition of assets of a firm. Whereas, the financing decission is concerned with financing –mix or capital structure of the firm. The term capital structure refers to the proportion between debt and equity. The theory of capital structure shows the theoretical relationship between the employment of debt and the return to the shareholders. The use of debt implies higher return to shareholders as also the financial risk. A proper balance between debt and equity to ensure a trade off between risk and return to the shareholders is necessary. Financial manager has to determine the appropriate capital structure after considering various factors which will influence the capital structure decision of the firm. These factors will be discussed in the subsequent lessons.

C) Dividend Policy decision

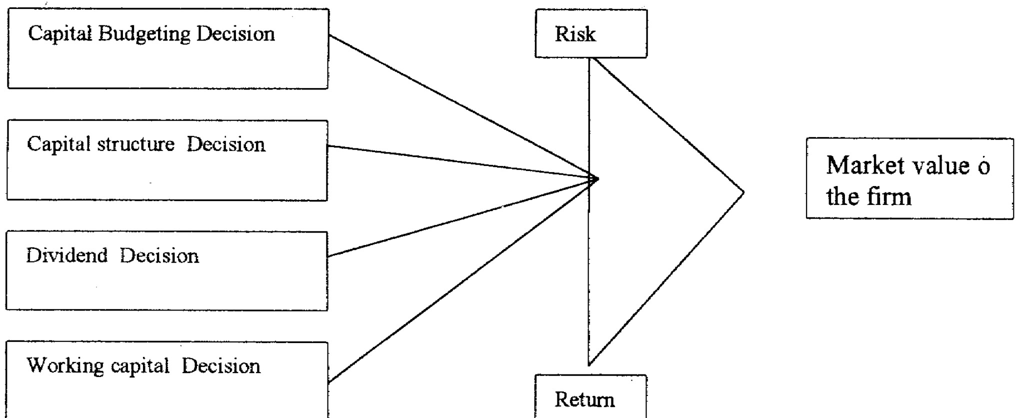
The third major decision of financial management is the decision relating to the dividend policy. The dividend decision involves the determination of the percentage

of profits earned by the firm to be paid to its shareholders. Whether to distribute all profits or retain them or combination of both be seen from the angle of its impact on the shareholders wealth. The optimum dividend policy is one which maximises the market value per share.

RISK – RETURN TRADE OFF

While taking financial decisions a proper balance should be maintained between the risk and return to maximise the value of the firm

RISK – RETURN TRADE OFF CHART



The financial manager, in the process of taking financial decisions should see the risk and return involved in each decision in order to maximise the value of he firm. He should ensure that the shareholders funds are safeguarded and properly utilised and avoided unnecessary risks.

1.6 CONFLICT OF GOAL BETWEEN MANAGEMENT AND OWNERS : Agency Problem

The basic feature of a corporate undertaking is the separation of the ownership and management. The Shareholder in a corporate undertaking are scattered and hardly exercise any control on management which may be inclined to act in its own interest rather than those of owners. However, sharesholders as owners of the enterprise have

the right to change the management. Due to the threat of being dislodged / dismissed for poor performance, the management would have natural inclination to achieve an acceptable level of performance to satisfy the shareholders goals , while focussing primarily on their own personal goals . The management would aim at satisfying instead of maximizing shareholders wealth .

However, the conflicting goals of management objective of survival and maximizing owners wealth can be harmonized. The shareholders delegate the decision making authority to professional management on the promise that the later will work for the best interest of the former, that is management is an agent of the owners. In order to ensure that management would take optimal decisions compatible with the shareholders interest of value maximization and minimize agency problem in terms of conflict of interests , two remedial measures are suggested.

a) **Incentives to agents :** Allotment of stock options, preference shares, performance linked cash, bonus and attractive perquisite's to the management.

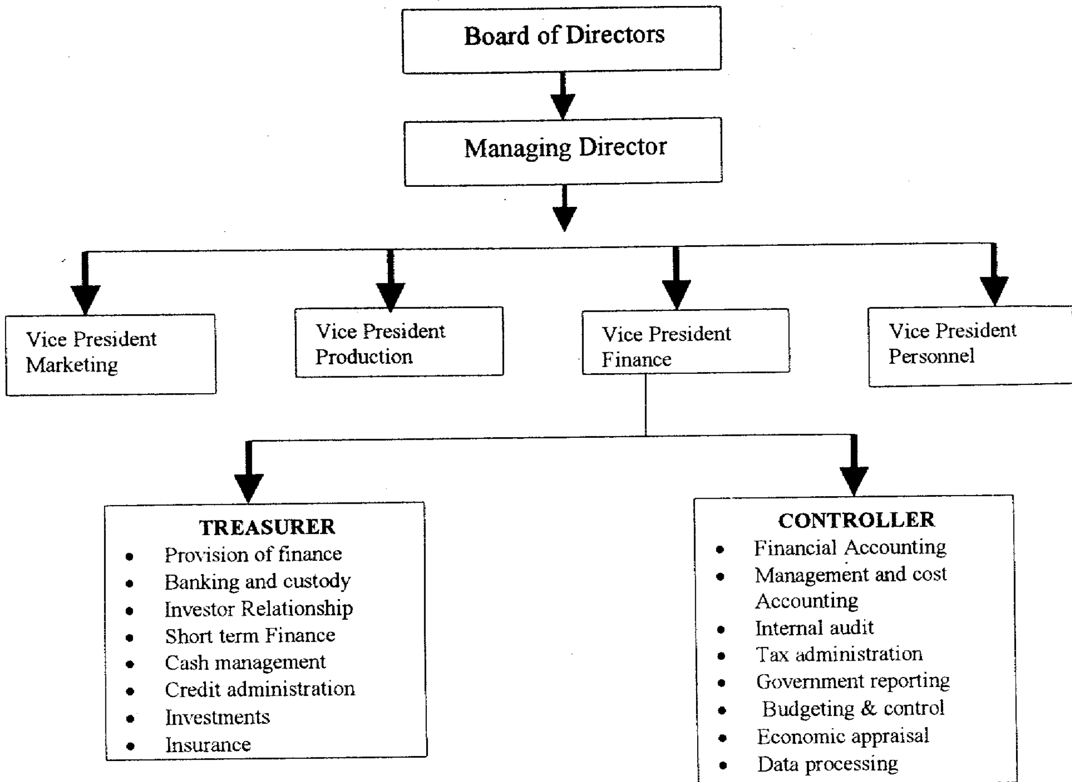
b) **Monitoring of Agents :** Monitoring can be done by bonding the agent, auditing financial statements and limiting decision making by the management.

The foregoing policies to mitigate the agency problems involve cost. However this is the price that the owners have to pay to harmonize the conflicting goals between them and the management of the enterprise.

1.7 ORGANISATION OF FINANCE FUNCTION

The finance function is very vital for every type of organization. There is a need to set up a sound and sufficient organization to achieve its goals . However organization of finance function is not a standardized one . It varies from firm to firm , depending upon its nature , size and other requirements . The titles used to designate the key finance officials are also different viz, Vice President (Finance), Chief Executive (Finance) , General Manager (Finance) etc. However in most companies the Vice – President (Finance) has under him two officers carrying out the important functions – the accounting function and finance function. The former is designated as controller and the later as a Treasurer.

The organization of finance function may be diagramatically presented as below:



1.8 RELATIONSHIP BETWEEN FINANCIAL MANAGEMENT AND OTHER AREAS OF MANAGEMENT

Financial management , as an integral part of overall management , is not totally independent area. It draws heavily on related areas such as economics, accounting, marketing , production and quantitative techniques . Although these desciplines are interrelated , there are key differences between them. The relationship between financial management and other areas of management is explained below.

Finance and Economics :

There are two important linkages between economics and finance . The macro-economic environment determines the sphere or frame work within which a firm operates and the micro- economic theory provides the conceptual under pinning for the tools of financial decision making.

Thus, the knowledge of economics is necessary for a financial manager to understand financial environment and the decision theories which undertake contemporary financial management . He should be familiar with these two areas of economics.Macro

economics provides the financial manager with an insight into policies by which economic activity is controlled. Operating within that institutional framework, the financial manager draws on micro economic theories of the operations of firms and profit maximization.

Finance and Accounting

Finance and accounting functions are closely related and almost invariably fall within the domain of the finance manager. But there are key differences between the finance and accounting. They are:

i) The accounting is concerned with recording, classifying and summarizing of financial transactions . Whereas financial management is concerned with decision making and value maximization.

ii) The Accountant prepares the accounting report based on accrual method which recognizes revenues when sale occurs and matches expenses to sales . The focus of finance manager is on cash flows. He is concerned about the magnitude , timing and risk of cash flows as these are fundamental determinants of values.

iii) Accounting deals primarily with the past. It records what has happened . Hence it is relatively more objective and certain. Finance is concerned mainly with the future . It involves decision making in the face of imperfect information and uncertainty . Hence it is characterized with high degree of subjectivity.

Finance and other related disciplines

Apart from economics and accounting , finance also draws for its day to day decisions on supportive disciplines such as marketing, production and quantitative methods. For example , finance manager should consider the impact of a new product development and production plans made in the marketing area since their plans will require capital outlays and have an impact on the projected cash flow.

Similarly changes in production process may necessitate capital expenditure which the financial manager must evaluate and finance. Finally the tools and the techniques developed in the quantitative methods area are helpful in analyzing complex financial management problems.

The marketing , production and quantitative methods are indirectly related to day -to- day decision making by finance managers and are supportive in nature while economics and accounting are the primary desciplines on which the financial manager draws substantially.

1.9 SUMMARY

Financial management is mainly concerned with planning, organizing and controlling of financial resources. The objective of financial management is to maximize

economic welfare of shareholders . The role of finance manager was confined to procurement of funds under traditional approach. The modern approach views the term financial management in a broad sense and provides a conceptual and analytical framework for financial decision making.

1.10 KEY WORDS

Capital Structure	:	The proportion between debt and equity
Liquidity	:	Firms ability to meet its maturing obligations
Investment decision	:	Allocation of funds among long term and short term assets.
Dividend	:	Distribution of profits among shareholders
Risk	:	Variability in getting future returns

1.11 SELF EXAMINATION QUESTIONS

(A) Short answer questions

1. What is finance function?
2. Explain the scope of finance function.
3. What is profit maximization?
4. What is agency theory?
5. What is financing decision ?
6. Distinguish between finance and accounting

(B) Long answer questions

1. What are the major types of financial decisions that business firms take ? How do you trade off risk and return?
2. The wealth maximization objective provides an "operationally appropriate decision criterion" comment.
3. Explain the concepts of profit maximization and wealth maximization . Which of these you think is a better operational guide for a finance manager?.
4. Explain the relationship between the financial management and other areas of management.
5. How is the finance function organised ? What are the functions that finance officers perform in a large firm.

6. Explain the role of finance manager in an organisation?

10.12 BOOKS FOR FURTHER READING

1. Prasanna Chandra , Financial Management , Tata Mc-Graw Hill Co. Ltd, New Delhi. 5th Ed. 2002.

2. I.M. Pandey, Financial Management, Vikas Publishing House, New Delhi, 8th ed. 2001.

3. M. Y. Khan & Jain P. K., Financial Management Tata Mc- Graw Hill Co. Ltd, New Delhi, 3rd Ed. 2001.

4. Van Horne , Financial Management and Policy, Prentice Hall of India , New Delhi, 2001.