M.COM-Ist Year (Ist Sem) , PAPER- FINANCIAL MANAGEMENT

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TOPIC: MEANING, OBJECTIVE, FUNCTION AND SCOPE OF FINANCIAL MANAGEMENT

1.1 INTRODUCTION

Finance is regarded as the life blood of a business enterprise. This is because in the modern money-oriented economy, finance is one of the basic foundations of all kinds of economic activities. Long considered a part of economics, corporation finance emerged as a separate field of study in the early part of 20th century. At first it dealt with only the instruments, institutions, and procedural aspects of capital markets. Accounting data and financial records were not the kind we use today, nor were regulations making it necessary to disclose financial data. But interest in financial innovations, promotions, consolidations, and mergers has always been increasing.

In a modern company's development, the financial manager plays a dynamic role. Besides records, reports, the firm's cash position, and obtaining funds, the financial manager is concerned with

(1) investing funds in short-term as well as in long-term assets and

(2) obtaining the best mix of financing and dividends in relation to the overall solution of the firm. All of this demands a broad outlook and an alert creativity that will influence almost all facts of the enterprise and its external environment.

1.2 MEANING AND NATURE OF FINANCIAL MANAGEMENT

Finance is the lifeblood of a business firm. The health of every business concern mainly depends on the efficient handling of finance functions. In simple term, Financial Management may be defined as the management of the finance or funds of a business unit in order to realize the objective of the firm in an efficient manner. It is broadly concerned with the mobilization and use of funds by a business firm. Financial management is that managerial activity which is concerned with the planning and controlling of the firm's financial resources. In other words, it is concerned with acquiring, financing and managing assets to accomplish the overall goal of a business enterprise (mainly to maximise the shareholder's wealth).

"Financial management is concerned with the efficient use of an important economic resource, namely capital funds". Solomon Ezra & J. John Pringle.

"Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient business operations" J.L. Massie.
"Financial Management is concerned with managerial decisions that result in the acquisition and financing of long-term and short-term credits of the firm. As such it deals with the situations that require selection of specific assets (or combination of assets), the selection of specific liability (or combination of liabilities) 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". Phillippatus.

The term 'nature' as applied to financial management refers to its relationship with closely related fields of economics and accounting, its scope, functions and objectives. Traditionally, 'finance' was not considered a separate input until finance theory became well developed. Finance function as an area of management is of recent origin. Financial management has gained considerable importance over the years. It is concerned with overall managerial decision making, in general, and with the management of economic resources in particular. The term financial management can be defined as the management of flow of funds in a firm and therefore it deals with the financial decision making of the firm. Since rising of funds and their best utilization is the key to success of any business organizations', the financial management as a functional area has got a place of prime relevance. All business activities have financial implications and hence financial management is inevitably related to almost every sphere of business operations.

1.3 RELATION OF FINANCE FUNCTION WITH OTHER DISCIPLINES

Finance function is not a totally independent area of Business. Being an integral part of the over-all management, it draws heavily on related disciplines and fields of study, namely, economics, accounting, marketing, production and operations research. These areas are both inter-related and different as well. Now, we discuss the relationship among finance function and the various related disciplines.

Finance and Economics: Traditionally, finance was not considered a separate input. In the traditional theory, finance was supposed to take the form of either circulating capital or fixed capital, and the concept of finance as distinct from capital was not well conceived and developed. In modern theory finance is different from capital. The field of finance is closely allied to the field of economics. Finance management is a form of applied economics, which draws heavily on economic theory. Economics deals with supply and demand, costs and profits, production, consumption and so on. Finance is closely related to economics, for it is seriously concerned with supply and demand in the financial markets, including the stock exchange, the money market, foreign exchange market, etc. It is equally concerned with the policies of the Reserve Bank of India as they are reflected in commercial banks and financial institutions in general. When money-market is tight, financial environment is hard-hit. In a period of economic depression, business activity recedes and the financial market is adversely affected. The importance of economics in the development of finance function and economic theory is more evident in two areas of economics-macroeconomics and micro-economics.

Macro economics is concerned with the structure of banking system, financial intermediaries, the public finance system and economic policies of the Government. Since the business firm has to operate in the macroeconomic environment, the finance manager has to be aware of the institutional framework it contains. He must be alert to the consequences of the varying levels of economic activities and changes in economic policies. In the absence of an understanding of the broad economic environment, the finance manager will not be able to achieve financial success.

Micro economics is concerned with the determination of optimal operating strategies for firms as individuals, with the efficient operations and with defining an action that will make it possible for a firm to achieve financial success. The concepts involved in supply and demand relationships and profit maximizing strategies are drawn for the micro economic theory. The theories related to the management of utility preference, risk and determination of value are rooted in micro economic theory. The rationale of depreciating assets is taken from this area of economics. Although the finance manager does not directly apply the theories of micro economics, he must act in conformity with the general principles established by these theories. Thus, knowledge of both micro and macroeconomics is necessary for a finance manager so as to understand the financial environment. Stated simply, economics is closely intertwined with finance.

Finance and Accounting: Much of modern business management has only been possible by accounting information. Management is a process of converting information into action; and accounting is a source of most of the information that is used for this purpose. Accounting has been described by Richard M. Lynch and Robert W. Williamson as "the measurement and communication of financial and economic data". It is a discipline which provides information essential to the efficient conduct and evaluation of the activities of any organization. The end-product of accounting is financial statements such as the balance sheet, the income statement and the statement of changes in financial position (sources and uses of funds statement). The information contained in these statements and reports assists the financial managers in assessing the past performance and future directions of the firm and in meeting certain legal obligations, such as payment of taxes and so on. Thus, accounting and finance are functionally closely related. However, there are key differences in viewpoint between finance and accounting. The first difference relates to the treatment of funds while the second relates to decision-making.

As far as the viewpoint of accounting relating to the treatment of funds is concerned, the measurement of funds in it is based on the accrual system. For example, revenue is recognized at the point of sale and not when collected. Similarly, expenses are recognized when they are incurred rather than when actually paid. The accounting data based on accrual system do not reflect fully the financial circumstances of the firm. On the other, the viewpoint of finance relating to the treatment of funds is based on cash flows. The revenues are recognized only when actually received in cash and expenses are recognized on actual payment (i.e. cash outflow). This is on account of the fact that the finance manager is concerned with maintain solvency of the firm by providing the cash flows necessary to satisfy its obligations and acquiring and financing the assets needed to achieve the goals of the firm.

Regarding the difference in accounting and finance with respect to their purpose, it needs to be noted that the purpose of accounting is collection and presentation of financial data. The financial manager uses these data for financial decision-making. But, from this one should not conclude that accountants never make decisions or financial managers never collect data. The fact is that the primary focus of the functions of accountants is on collection and presentation of data while the finance manager's major responsibility is concerned to financial planning, controlling and decision- making.

Finance and other concerned Disciplines

There exists an inseparable relationship between the finance functions on the one hand and production, marketing and other functions on the other. Almost all kinds of business activities, directly or indirectly, involve the acquisition and use of money. For instance, recruitment and promotion of employees in production is clearly a responsibility of the production department. But it requires payment of wages and salaries and other benefits, and thus, involves finance.

Similarly, buying a machine or replacing an old machine for the purpose of increasing productive capacity affects the flow of funds. Sales promotion policies require outlays of cash, and therefore, affect financial resources. How, then, we can separate production and marketing functions and the finance function of making money available to meet the costs of production and marketing operations ? We can't give precise answer to this question. In fact, finance policies are devised to fit production marketing and personnel decisions of a firm in practice.

1.4 SCOPE OF FINANCIAL MANAGEMENT

Financial management, as an academic discipline, has undergone significant changes over years as regards 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, let us study both the traditional approach and the modern approach to the finance function.

Traditional Approach

Initially the finance manager was concerned and called upon at the advent of an event requiring funds. The finance manager was formally given a target amount of funds to be raised and was given the responsibility of procuring these funds. So, his function was limited to raising funds as and when the need arise. Once the funds were raised, his function was over. Thus, the traditional concept of financial management included within its scope the whole gamut of raising the funds externally. The finance manager's role was limited to keeping accurate financial records, prepare reports on the corporations' status and performance and manage cash in a way that the corporation is in a position to pay its bills in time. The term 'Corporation Finance' was used in place of the present term 'Financial Management'.

The traditional approach dominated the scope of financial management and limited the role of the finical manager simply to 'raising of funds'. And it was during the major events, such as promotion, reorganization, expansion or diversification in the life of the firm that the financial manager was called upon to raise funds. Because of its restricted role, the finance text books, for example, in the USA, till the mid-1950s covered discussion of the instruments, institutions and practices through which funds are obtained. Further, as the problem of raising funds was more intensely felt in the case of an 'episodic event', these books also contained detailed descriptions of the major events like mergers, consolidations, reorganizations and recapitalizations. The notable feature of the traditional view of financial management was the assumption that the financial manager had no concern with the decisions of allocating the firm's funds. These decisions were assumed to be given to him.

The traditional approach did not go unchallenged even during the period of its dominance. It has been criticized because it failed to consider the day-to-day managerial problems relating to finance of the firm. It concentrated itself to looking into the problems from management's the insider's point of view (see Solomon, Ezra, The Theory of Financial Management, Columbia University Press, 1969, p.3). The second ground for criticism of the traditional treatment was that the focus was on financing problems of corporate enterprises. To that extent the scope of financial management was confined only to a segment of the industrial enterprises, as non-corporate organizations lay outside its scope. Finally, this approach was having lacuna with regards to its focus only on long- term financing. The issues involved in working capital management were not in the preview of finance function.

Modern Approach

The modern or new approach is an analytical way of looking into the financial problems of the firm. Financial management is considered a vital and an integral part of overall management. To quote Ezra Soloman: "The central issue of financial policy is the wise use of funds, and the central process involved is a rational matching of advantages of potential uses against the cost of alternative potential sources so as to achieve the broad financial goals which an enterprise sets for itself".

Thus, in a modern enterprise, the basic function is to decide about the expenditure decisions and to determine the demand for capital for these expenditures. In other words, the finance manager, in his new role, is concerned with the 'efficient allocation of funds'. This problem was not considered important in achieving the firm's long run objectives. The main contents of modern approach to financial management according to Soloman Ezra are: What is the total volume of funds an enterprise should commit? What specific assets should an enterprise acquire? How should the funds required to finance? These three questions 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 problems namely, investment, financing and dividend decisions. We may refer to these decisions as managerial finance functions since they require special care and extraordinary administrative ability.

1.5 FUNCTIONS OF FINANCE

Depending upon the nature and size of the firm, the finance manager is required to perform all or some of the following functions. These functions outline the scope of financial management.

Investment Decision

Investment decision is the 'oldest' area of the recent thinking in finance. The investment decision relates to the selection of assets in which funds will be invested by a firm. The assets which can be acquired fall into two broad groups: (i) long term assets which yield a return over a period of time in future, (ii) short-term or current assets defined as those assets which in normal course of business are convertible into cash usually within a year. The decisions related to the former aspect are called 'capital budgeting' decisions while the latter type of decisions are termed as working capital decisions. Because of the uncertain future, capital budgeting decision involves risk. Other major aspect of capital budgeting theory relates to the selection of a standard or hurdle rate against which the expected return of new investment can be assayed. This standard is broadly expressed in terms of the cost of capital. The measurement of the cost of capital is, thus, another major aspect of the capital budgeting decision. For details of these decisions, please see lesson Working Capital Management, on the other hand, deals with the management of current assets of the firm. Though the current assets do not contribute directly to the earnings, yet their existence is necessitated for the proper, efficient and optimum utilization of fixed assets. There are dangers of both the excessive as well as the shortage of working capital. A finance manager has to ensure sufficient and adequate working capital to the firm. A trade-off between liquidity and profitability is required.

Financing Decision

Provision of funds required at the proper time is one of the primary tasks of the finance manager. Every business activity requires funds and hence every financial manager is confronted with this problem. The investment decision is broadly concerned with the asset-mix or the composition of the assets of a firm. The concern of the financing decision is with the financing mix or capital structure or leverage. The term capital structure refers to the proportion of debt and equity capital. The financing decision of a firm relates to the choice of the proportion of these sources to finance the investment requirements. There are two aspects of the financing decision - (i) the theory of capital structure which shows the theoretical relationship between the employment of debt and the return to the shareholders. The use of debt implies a higher return to the shareholders as also the financial risk. A judicious mix of debt and equity to ensure a trade-off between risk and return to the shareholders is necessary. A finance manager has to evaluate different combinations of debt and equity and adopt one which is optimum for the firm. Leverage analysis, EBIT-EPS analysis, capital structure models etc. are some of the tools available to a finance manager for this purpose.

Dividend Decision

Another major area of decision making by a finance manager is known as the Dividend decisions which deal with the appropriations of after tax profits. The finance manager must decide whether the firm should distribute all profits, or retain them, or distribute a portion and retain the balance. Like the debt policy, the dividend should be determined in terms of its impact on the shareholder's value. The optimum dividend policy is one which maximises the market value of the firm's shares. Thus, if shareholders are not indifferent to the firm's dividend policy, the financial manager must determine the optimum dividend pay-out ratio. The dividend pay-out ratio is equal to the percentage of dividends distributed to earnings available to shareholders. The financial manager should also consider the questions of dividend stability, bonus shares and cash dividends.

1.6 OBJECTIVES OF FINANCIAL MANAGEMENT

The Process of decision making by a finance manager must be goal oriented one. He must have a specific goal in mind as he plans future course of action. It is generally agreed in theory that the financial goal of the firm should be the maximisation of owners' economic welfare. Owners' economic welfare could be maximised by maximising the shareholders' wealth as reflected in the market value of shares. In this section, we shall discuss that the shareholder's wealth maximisation is theoretically logical and operationally feasible normative goal for guiding the financial decision making. This part also throws some light on 'profit maximisation goal'.

Profit Maximisation Goal

A business firm is profit-seeking organisation. Hence, profit maximisation is well considered to be an important means for achieving the objective of maximising the owners' economic welfare. According to financial experts too, one approach to determine the decision criterion for financial management is the profit maximisation goal. Under this approach, actions that increase profits should be undertaken and those that decrease profits are to be avoided. In specific operational terms, as applicable to financial management, the profit maximisation criterion implies that the investment, financing and dividend policy decisions of a firm should be oriented to the maximisation of profits.

Firms in market economy are expected to produce goods and services desired by society as efficiently as possible. Price system is the most important organ of a market economy indicating what goods and services society wants. Goods and services in great demand can be sold at higher prices. This results in higher profits for firms. Thus price system provides signals to managers to direct their efforts towards areas of high profit potential. The buyer’s behaviour and extent of competition determine the prices, and thus, affect the allocation of resources for producing various kinds of goods and services.

The economists are of the opinion that under the conditions of free competition, businessmen pursuing their own self-interests also serve the interest of society. It is also assumed that when individual firms pursue the interest of maximising profits, society’s resources are efficiently utilized. Thus, profit is a test of economic efficiency. It provides the yardstick by which economic performance can be judged. Moreover, it leads to efficient allocation of resources as resources tend to be directed to uses which in terms of profitability are the most desirable. Also, it ensures maximum social welfare.

The profit maximisation objective has, however, been criticised in recent years. It is argued that profit maximisation is a consequence of perfect competition, and in the face of imperfect modern markets, it cannot be a legitimate objective of the firm. It is also argued that profit maximisation, as a business objective, was developed in the early of 19th century, when the characteristic features of the business structure were self-financing, private property and single entrepreneurship. The only aim of sole proprietor then was to enhance his individual wealth and personal power, which could easily be satisfied by the profit maximisation objective. The modern business environment has the features of limited liability and a divorce between management and ownership. In this changed business structure, the owner manager of the 19th century has been replaced by professional manager who has to reconcile the conflicting objectives of all the parties connected with the business firm. So, now-a-days profit maximisation is regarded as unrealistic, difficult, unfair and immoral.

Besides the aforesaid objections, profit maximisation fails to serve as an operational criterion for maximising the owners' economic welfare. It suffers from the following limitations:

(i) It is vague: It does not clarify what exactly it means. For example, which profits are to be maximised, short-term or long-run, rate of profit or the amount of profit?

(ii) It ignores timings: The concept of profit maximisation does not help in making a choice between projects giving different benefits spread over a period of time. The fact that a rupee received today is more valuable than a rupee received later is ignored.

(iii) It ignores risk: The streams of benefits may possess different degree of certainty. Two firms may have same total expected earnings, but if the earnings of one firm fluctuate considerably as compared to other, it will be more risky. Possibly owners of the firm would prefer smaller but certain profits to a potentially large but less certain stream of benefits.

Wealth Maximisation

On account of the reasons cited above, these days profit maximisation is not considered to be an ideal criterion for making investment and financing decisions. Ezra Soloman has suggested the adoption of wealth maximisation as the best criterion for the financial decision making. This objective is generally expressed in terms of maximisation of the value of a share of a firm.

Wealth maximisation means maximising the 'net present value' (or wealth) of a course of action. The net present value of a course of action is the difference between the present value of its benefits and the present value of its costs. A financial action which has a positive net present value creates wealth and, and therefore, is desirable. On the other hand, a financial action resulting in negative net present value should be rejected. Between a numbers of desirable mutually exclusive projects the one with the highest net present value should be adopted. The wealth of the firm will be maximised if this criteria is followed in making financial decisions (Soloman, Ezra, 1969).

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 case of the profit maximisation criterion. Measuring benefits in terms of cash flows avoids the ambiguity associated with accounting profits. This is the first operational feature of the net present wealth maximisation criterion. Another important feature of the wealth maximisation criterion 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 quality of benefits has reference to the certainty with which benefits are expected to be received in future. The more certain the expected returns (cash inflows), the better the quality of benefits and the higher the value. Similarly, money has time value. For the above reasons, the Net Present Value maximisation is superior to the profit maximisation as an operational objective.

1.7 ORGANISATION OF FINANCE FUNCTION

Because of the vital importance of the financial decisions to a firm, it is essential to set up a sound and efficient organisation for finance function. The ultimate responsibility of carrying out the finance functions lies with the top management. Thus, a department to organize financial activities may be created under the direct control of the board of directors. Figure 1.1 depicts the organisation of the financial management function in a large typical firm.

It should be remembered that the job of the chief financial executive does not cover only routine aspects of finance and accounting. As a member of top management he is closely associated with the formulation of policies as well as decision making. Under him controllers and treasures, although they may be known by different designations in different firms. The tasks of financial management and allied areas like accounting are distributed between these two key financial officers. The functions of the treasurer include obtaining finance, banking relationship, investor relationship, cash management, working capital finance, insurance and credit management. The typical functions performed by the controller are: (a) financial accounting, (b) internal audit, (c) taxation, (d) budgeting, planning and control, (e) economic appraisal, (f) management accounting and control.

1.8 SUMMARY

Financial Management is broadly concerned with the acquisition and use of funds by a business firm. Investment decisions are essentially made after evaluating the different project proposals with reference to growth and profitability projections of the company. Financing decisions are concerned with the determination of how much funds to procure from amongst the various avenues available i.e. the financing mix or capital structure. Dividend decision is to decide whether the firm should distribute all profits or retain them or distribute a portion and retain the balance. It has been traditionally argued that the objective of a company is to earn profit. This means that the finance manager has to make decision in a manner that the profit is maximized. The alternative to profit maximization is wealth maximization. This is also known as Value maximization or Net Present Worth maximization.

Financing Decision: It is related to the financing mix or capital structure or leverage and the determination of the proportion of debt and equity.

Investment Decision: Investment decision is related with the selection of assets, that a firm will invert.

Wealth Maximization: It is maximizing the present value of a course of action.

1.10 SELF ASSESSMENT QUESTIONS

1. Define the scope of financial management. What role should the financial manager play in the modern enterprises?

2. What are the basic financial decisions? Explain.

3. "The profit maximisation is not an operationally feasible criterion". Do you agree? Illustrate your views.

4. "The wealth maximisation objective provides an operationally appropriate decision-criterion". Comment.

5. How should the finance function of an enterprise be organised? What functions are performed by the financial officers?

1.11 SUGGESTED READINGS

1. M Y Khan & P K Jain: Basic Financial Management; McGraw Hill Education (India) Pvt Ltd., New Delhi.

2. R. P. Rustagi: Financial Management–Theory, Concepts and Problems; Taxmann Publications (P) Ltd., New Delhi.

3. Prasanna Chandra: Investment Analysis and Portfolio Management; McGraw Hill Education (India) Pvt. Ltd., New Delhi.

4. Eugene F Brigham & Michael C Ehrhardt: Financial Management– Theory and Practice; Cengage Learning (India) Pvt. Ltd., New Delhi.

5. J Van Horne & John M. Wachowicz: Fundamentals of Financial Management; Pearson Education Ltd. New Delhi.

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