Lesson 1

Financial Management: Meaning, Objectives, Functions, Scope, and Significance

Objectives of the lesson

After studying this lesson, students will be able to:

- Understand the concept, nature and objectives of financial management,
- Describe scope of financial management,
- Understand nature of financial management with other subjects,
- Explain meaning of finance function and discuss functions of financial management, and
- Understand significanceof financial management.

1.0 Introduction

Finance is the kingpin of any economic activity. The very obejctive of profitability and wealth maximisation are fuelled by the word Finance. Business finance is that activity which is concerned with acquisition and conservation of capital funds in meeting financial needs. Finance function is concerned with with arranging the funds required by the enterprise in the most effective manner and further, investing or allocating these funds in the appropriate portfolio of the business. The effective blend of Finance with production, marketing, personnel, accounting and other business functions brings about the most effective utlisation of scarce resource to achieve the common enterprise goal of profitability to wealth maximisation. The art of managing finance to yield best possible results is financial management.

Finance is the art and science of managing money. Financial managers perform varied tasks such as financial forecasting, budgeting, cash management, credit administration, investment analysis, fund management and so on. Recently, the flexibility of the economy due to liberalisation has increased the role of financial manager. He needs to assimilate information, analyse it and make suitable strategies to attain the overall objective of the organisation i.e. wealth maximisation. This needs a thorough planning on his part and an effective implementation which can not possibly be done by an individual. This is a co-operative and coordinated effort with perfect communication system upward and downward. Thus, a proper financial plan implemented by a well devised organisational structure yields positive results for a progressive enterprise.

2.0 Meaning and Definitions of Financial Management

Financial management relates to the Art and Science of executing finance function. According to Howard and Upton 'Financial Management involves the application of general management principles to a particular financial operation.' To quote Joseph and Massie, 'Financial management is the operational activity of a business that is responsible for obtaining and effectively utilising the funds necessary for efficient operations.' It is that part of management which is concerned mainly with raising of finances in the most economic and suitable manner, using the funds as profitably as possible, planning future operations, controlling current performances and future developments through the use of different types of body of knowledge like Accounting, Budgeting and Management. Guthman and Dougal define Financial management as an 'activity concerned with planning, raising, controlling and administering of funds used in the business.'

Financial Management deals with financial aspects concerned with promotion, administration problems relating to growth and expansion, accounting problems relating to distinction between capital and revenue. Rehabilitation of sick units, providing financial assistance are other illustrative aspects of financial management that renders an infinite view of finance function. However, the broad execution of financial function remains to the core of arrangement of funds, allocation of funds to the utilisation of funds.

3.0 Nature of Financial Management

Nature of financial management can be described as:

- Financial management is a continuous process and an indispensable organ of management.
- It is an integral part/ focal point of business decision-making process.
- It is helpful to top management in projecting trends and taking effective decisions.
- It helps in performance measurement.
- It has a wide scope, i.e. concerned with diverse activities of business.

4.0 Objectives of Financial Management

An analysis of the definitions of financial management makes it clear that finance directs the flow of economic activity and facilitates the smooth operation. Finance provides the required stimulus for continued business operations of all categories. Finance is essential for expansion, diversification, modernization, establishment, of new projects and so on. The financial policy of any organization to a greater extent, determines not only its existence, and survival but also the performance and success of that organization. Finance is required for investment, purposes as well as to meet substantial capital expenditure projects. The financial management is generally concerned with procurement, allocation, and control of financial resources of a concern. The objectives of financial management can be:

- Optimal capitalization and sound capital structure: to achieve a flexible, produtive, effective mix of sources of funds that ensure increased profitability through maximum utilisation

- Effective utilisation of financial resources: to reapbenefits in return of their appropriate and time bound utlilisation. Financial management ensures that resources are not idle, blocked or being under utilised over time.
- Safety of investment: to ensure that funds invested are secured and returning expected value through utilisation.
- Maximization of profit and profitability: ensures that enterprise returns are increased with addition of investments including the profit earning capacity. Positive impact on shareholders' value and capitalisation will be the key drivers for this purpose.
- Maintenance of liquidity and solvancy: To ensure regular and adequate supply of funds to the concern. To ensure safety on investment, i.e., funds should be invested in safe ventures so that adequate rate of return can be achieved
- Maximization of return on equity: To ensure adequate returns to the shareholders. It depends on earning capacity, market price of the share and expectations of the shareholders.
- Maximization of wealth, value of firm, net worth, and NAV of equity: To maximizing the value of the firm. It is done through maximization of earning capacity and effective profit management.
- Financial discipline: ensurethatprocured funds are utilised in the efficient manner.

5.0 Scope of Financial Management

Financial Management entails the process of planning, organizing, monitoring, and also controlling the financial resources of an organization. The idea for doing such is to be able to achieve the vision or goals of the company at the stipulated time frame. Thus, Financial Management is concerned with (i) Anticipating financial needs, (ii) Acquiring financial resources, (iii) Allocating funds in business, (iv) Assessing risk in business, and (v) Effective utilization of resources.

- Anticipating Financial Needs: Core responsibility underlying the financial management is to identify the future financial needs of the enterprise which can be split into short-term and long-term needs. Short term needs stipulate the financial resources to dispense revenue nature needs like routine incomes and expenses viz, sales and purchases. Long term needs are emphasised on investing in capital nature resources like fixed assets to business expansion portfolio. These needs can be ascertained after reviewing the empirical data associated with enterprise, competitors, national and global market trends etc.
- Acquiring Financial Resources: Once the financial needs are identified, it is extremely important to review the current financial profile. Financial profile provides a landscape view of resources available within the enterprise to feed the financial needs. Obviously, financial management underscores the importance of arrangement of funds to secure the financial needs. The financial management approach is multi-faceted to secure the

financial needs initiating from Revenue generated from sales, gains from sale of securities and investments through to dividends from shareholding and interests from lending etc. However, the real test of finance function is to raise new funds from different sources striking a perfect blend of types of funds raised and current dynamics of funds internally available. Verification and comparative analysis of different sources of funds becomes critical. Recent announcements of Reliance/ Jio to make itself debt free is an excellent example where in enterprise has re-structured its face of capital through attracting investments into its ventures from Saudi Aramco, Google, Facebook and so on.

- Allocating Funds in Business: For the survival and growth of any enterprise, allocation is one critical indicator of financial health. Finance function, particularly resources responsible for the execution, needs to review the flow of money into portfolios from time to time to determine if the allocation has been done effectively. To reach this objective, financial management has to identify "areas of investment for funds" from which it has planned to earn revenue and ultimately profit, to achieve the business goals.
- Assessing Risk in Business: Risk Management has become indispensable to Finance function over time. It has also become a niche area for professionals associated with Assessment of Financial Risk in business. It is imperative for enterprise to face inherent and invited risks to exploit the weaknesses within the financial system controlled by financial management. There is always an emergency risk that can severely impact the enterprise in many forms. Pandemic is one such example of emergency risks getting converted into inherent risks. Financial management is not only responsible to identify and assess the risks enterprise is exposed to, but also for mitigation of risks through the application of different methods. We must consider rapidly changing local and global business environment including the significant changes in state economic policy.
- Effective Utilization of Resources: A well-oiled finance function would always be wary of how funds have been utilised. The monitoring and assessment of funds invested in different areas or portfolios are the real output for finance function to administer the corrective action path, if required. This kind of an assessment would reveal challenges in utilisation, over and under-utilisation etc. This also provides the view of effectively utilised funds spreading the best practices for such allocation and utilisation. It is important to mention that both right areas to invest and right time to invest are crucial for effective utilisation of funds.

6.0 Relationship of Financial Management with other Subjects

The success of a business – small or big depends on efficient financial management as finance is both cause and effect of diligent planning and management. The objectives and scope of financial management should tune with objectives of the organisation in general and specific schemes. Financial management aims at wealth maximisation of the shareholders and stake holders by optimum utilisation of scarce resources in a planned direction.

Financial management provides a conceptual and analytical framework for financial decision making. This covers not only acquisition of funds but also judicious allocation towards various functions thus forming an integral part of the overall management. Financial Management is a sub-system in an organization which must coordinate with other subsystems such as production, marketing etc.

- Financial Management and Economics: Economic concepts of micro and macroeconomics are of great relevance in financial management. Micro economic concepts like demand and supply, cost theory, production theory etc. are extremely useful for any financial manager. For example, cost theory has an implication to cost of capital while demand and supply functions in microeconomics lay base for availability, procurement, and utilisation of finance. In the same way, Macroeconomics concepts of inflation, per capita income, aggregate-demand, aggregate supply etc. are also useful for finance manager. These concepts are important in the application and investment of funds in productive areas through analysis and assessment of profits.
- Financial Management and Accounting: A finance manager must make decisions about future. Forecasting is a powerful tool for the same and historic accounting information and cost data are key inputs to Forecasting.
- Financial Management and Mathematics: Finance functions make use of statistical, mathematical and econometrics tools and techniques. These may include time value of money, correlation, regression analysis and financial modelling techniques.
- Financial Management and Marketing: Various marketing decisions, such as product, pricing, promotion, product mix, market segmenting, targeting, and positioning, choice of distributional channels etc are taken in consultation with finance department.
- Financial Management and Human Resource: HR decisions about requirement, recruitment, selection, training & development of manpower are based on allocated funds.
- Financial Management and Production Management: Product planning and engagement of factors of productions is based on cost benefit analysis carried out by finance department.
- Therefore, scope of financial management is not limited to finance functions or the principles of management, but it is closely associated with many other subjects and areas which crossroads with the Finance on a daily basis.

7.0 Finance Function

A proper blend of production, marketing, personnel, accounting and other business functions can help control the wastage of funds. Charles Gutenberg visualizes the importance of scientific arrangement of records with the help of which inflow and outflow of funds can be effectively managed, stocks and bonds effectively marketed, and the efficiency of the organization greatly improved. The operational functions of finance include financial planning, cash management, credit management, securities floatation, and custody of funds and documents.

The ultimate of finance function lies in maximization of the value of the firm. Thus, it is not confined to procurement of funds but of utilizing the scarce resources in an optimum manner. The task of procuring and utilizing funds should be in consonance with proper timing, at proper cost, the sale of stock, the types and duration of obligations, the condition of money market etc. One predominant feature which differentiates finance from other managerial functions is the 'time'. Finance function comprises the following functions:

- Money Management: This includes efficient management of monetary resources i.e. resource mobilization, working capital management and investment decisions.
- Record Keeping and Reporting: This includes financial accounting, cost accounting and management accounting.
- Control Functions: This includes budgeting, cost control and internal audit.
- Auditory Functions: This includes pricing, acquisitions, expansion, diversification, dividend policy, etc.

8.0 Functions of Financial Management

According to Weston and Brigham, 'financial management is an area of financial decision making, harmonizing individual motives and enterprise goals.' In the words of Phillippatus, 'financial management is concerned with the managerial decisions that result in the acquisition and financing of long-term and short-term credits for the firm.' As such it deals with the situations that require selection of specific assets/ combination of assets, the selection of specific liability/ combination of liabilities as well as the problem of size and growth of an enterprise. The scope of financial management include:

- Financial planning and estimation: To estimate short-term and long-term financial requirements of his business a sound financial plan is prepared for present as well as for future reference. The estimation of financial needs is done by using (i) cost approach, and (ii) earning yield approach.
- Deciding the sources of funds: It refers to the kind and proportion of different sources of funds. After deciding about the quantum of funds required, it should be decided which type of securities (equity or debt) are to be raised. It may be wise to finance fixed assets through long-term debts.
- Optimal capital structure: Various sources, from which finance may be raised, include long term loans from financial institutions and banks, issue of debentures and bonds, share capital, public deposits etc. If finances are needed for short periods then banks, public deposits and financial institutions may be appropriate; on the other hand, if long-term finances are required then share capital and debentures may be useful.
- Formulation of financial policies and systems: For having appropriate control over utilization of funds, it is important to formulate financial policies and systems. The

financial policies may include investment policy, dividend policy, credit policy etc. These policies enable firm and its various sections to work in right direction. The financial systems also help the organization to have effective control on wastage and leakage of funds.

- Profit planning and assessment: Profit planning is one of the prime functions of financial management. It is done through sales assessment and forecasting, effective cost-volume-profit (CVP) analysis, add or drop decisions, make or buy decisions, leverage analysis and the ratio analysis.
- Capital budgeting and investment decisions: It refers to planning and execution of investment in long-term and short-term assets. It is done through effective cost-benefit analysis and the risk-return analysis.
- Management of assets: The selection of an investment pattern is related to the use of funds, i.e., what proportion of funds is to be allocated for long term investment in assets and for working capital. The investment decisions are also concerned with the assets to be purchased. The decision-making techniques such as capital budgeting, opportunity cost analysis, etc. may be applied in making decisions about capital expenditures.
- Management of working capital and liquidity: While spending on various assets, principles of safety, profitability and liquidity should not be ignored. The investment made in long term assets and short-term assets, such as inventory, receivables and cash are required to be monitored so that maximum advantage of investment can be taken. The actions required for this purpose include proper valuation of assets, replacement of depreciated assets, optimization of investment in working capital i.e., inventory, receivables, and cash.
- Management of profit and dividend decisions: The profit allocation decisions are taken in two ways, by dividend declaration and profit retention. The dividend decisions are taken by identifying the rate of dividends and other benefits to shareholders, such as interim dividend and bonus shares. The volume of retained earnings is decided according to expansion, diversification or innovation needs, profitability of further investment and other purposes specified by the firm.
- Financial analysis and control: The finance manager not only plans, procures, and utilizes the funds; he also exercises controls over finances. This can be done through many techniques like ratio analysis, Cost Volume Profit analysis, financial forecasting, cost control etc.
- Acquisitions and Mergers: Mergers refers to integration of two entities into one big organization. Acquisition consists of purchase of smaller firms by a bigger organisation with minimum cash outlay. This requires a proper valuation of firm's securities to arrive at the exchange rate.

- Corporate Taxation: Corporation as a separate entity is subject to income tax structure which is distinct from personal taxation. A proper planning is necessary for finance manager in this area.

Financial Management means planning, organizing, directing, and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise. Broadly, financial management includes investment decisions, financing decisions and dividend decisions.

- Investment decisions: These are concerned with planning and estimation of investment in total asset (both long term and short term). Planning for long-term assets, popularly referred to as 'capital budgeting' is defined as the firm's decision to invest its current funds most efficiently in fixed assets with an expected flow of benefits over a series of years. The investment in short-term asset, popularly termed as 'working capital' is estimated by considering cash conversion that takes place within a year. This is vital as liquidity of today determines tomorrow's long-term success.
- Financing decision: After planning investment, the next issue is how to finance the same. This speaks about weighing the proportion between debt and equity i.e. the finance mix or leverage. The finance mix should be optimum to balance risk and return and pay the investors maximum.
- Dividend decision: The dividend policy of the organisation is one crucial area as the two basic issues – dividend and retained earnings are to be balanced. Dividend is today's return on investment and retained earnings strengthen the capital base. Both they have impact on the market value of the share and thereby of the firm. An optimal dividend policy gives an assured and reasonable return to investors today and protects tomorrow.

In nutshell, financial decisions broadly cover:

- Decisions related with long-term funds and long-term assets: These are concerned with capital budgeting, leverage analysis, and risk Analysis. The key decision areas are sources of long-term finance, capital structure, cost of capital, financial leverage, anddividend.
- Decisions related with short-term funds and short-term assets: These are concerned with working capital management, receivables management, inventory management, cash management. The key decision areas are sources of short-term finance, receivables, inventory, cash and cash equivalants, short-term liabilities such as creditors, bank overdraft etc.
- Decisions related with liquidity and solvency: These are concerned with firm's ability to meet long and short-term obligations. The key decision areas are efficient operating, financing and investment activities and also the decisions concerned with dividend, and retailed earnings. The firm should adopt balanced approach of liquidity, and financial stability of organisation.

Financial decision making involves decisions in three key areas – Investment decisions (which speak about asset management-both fixed and working capital), financing decision to give various means to fund the assets to be aquired, and dividend decision (which is related with financial planning for present and future commitment to shareholders). Financial management aquires importance from the point of view of successful promotion, smooth functioning, diverse decision making, performance evaluation and suggesting ways and means to come out of financial crisis.

9.0 Significance or Importance of Financial Management

The importance or significance of financial management can be expressed as:

- Financial management helps organisations in financial planning and Administration.
- It is focal point of decision making; it coordinates various functional activities of the organization.
- Financial management makes funds available from right source, right price and at the right time.
- It ensures that procurement of funds does not affect right of management as well as control over affairs of the company.
- Helps in purposeful allocation of financial resource.
- It ensures profitability, liquidity and solvency of the business.
- Helps in maximizing return on investment and the value of firm.
- Ensures growth, expansion, diversification, and long run survival of business.
- Helps in critical financial decisions and trend projection.

Summary

The two basic objectives of financial management are profit maximisation and wealth maximisation. The former neglects time value of money, quality of profits. Shareholders' wealth maximisation means maximising the net present value of a course of action to shareholders. Several thinkers defined financial management different ways; but the essence of all is to raise funds at optimum cost and channelise them into optimum possible use to maximise wealth primarily to shareholders and subsequently to all the stakeholders. Thus, it includes three 'A's, i.e., Anticipating financial needs, Acquiring financial resources and Allocating funds in business.

To chalk out, implement, monitor, co-ordinate and control the financial plan, an effective organisational structure is vital. With the changing political, economic policies, the financefunctionsare gaining importance in the Indian panorama. The finance manager should keep himself abreast with all the financial information globally related to his business so that he can work towards the target of wealth maximisation for his investors. The twin aspects, viz., procurement and effective utilization of funds are the crucial tasks which the finance manager faces. The financial manager is required to look into the financial implications of any decision in the firm. Thus all decisions involving management of funds comes under the preview of the finance manager. A large number of decisions involve substantial or material changes in the value of funds procured or employed. In performing finance functions the financial manager should aim at increasing the value of the shareholder's stake in the firm.

Self Check Questions

1. What do you mean by financial management? Discuss its nature and scope.
2. What is financial management? State the objectives of financial management.
3. Write short notes on (a) Investment Decisions (b) Financial Decisions (c) Dividend Decisions.
4. What is the finance function? Explain clearly various finance functions in a business organization.
5. It is often said that financial activities hinge on the money management. Do you agree with this point of view?
6. "Finance is the life blood of business". Elucidate this statement with suitable illustrations.