UNIT 1 FINANCIAL MANAGEMENT: AN OVERVIEW

Structure

1.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning of financial management;
- describe the nature of finance function and evolution of financial management;
- explain the key activities of financial manager and organisation of finance functions;
- discuss the goals of financial management and risk return trade off; and
- discuss the challenges faced by financial manager.

1.1 INTRODUCTION

Financial Management means management of finance/funds. Financial decisions are important for the business firm as growth and development of a firm depend upon its financial policies. Any wrong decision may affect the solvency of the firm. This unit introduces you to the meaning of financial management, nature and organisation of finance function, evolution and goals of financial management and key activities and the challenges faced by the financial manager.

1.2 NATURE OF FINANCE FUNCTION

Meaning

It is said that the finance is the life blood of business. 'Money begets money' and 'money makes the mare go', are the famous proverbs that highlight that finance actually matters to everybody. Management is concerned with planning, organising, directing and control of any activity in a business. The successful business management is closely linked with efficient use of its finances. Financial management is concerned with planning, organising, directing and control of financial activities in a business. A firm has to decide the following:

1) From what sources tlie funds must be raised and how much from each source i.e., what should be tlie finance mix?

2) Where to invest those funds ? Wliat should be the composition of tlie assets of the firm?

3) I-Iow sliould the firm analyse, plan and control its affairs?

4) How large should a firm be so that it can grow fast?

Financial management, also called managerial finance or corporate finance, has been defined by different writers as follows :

"Financial management is concerned with efficient use of an important economic resource namely: capital funds. It is the study of the problems involved in the use and acquisition of funds". Ezra Solomon, The Theory of Financial Management: Columbia University Press (N.Y.) (1978).

"It can be broadly defined as the activity concerned with planning, raising, controlling and administering of funds used in the business." H. Guthman and H. Dougall : Corporate Financial Policy (Engleword Clifers) N. Y. Prentice Hall 1980.

Thus, financial management is concerned with managerial decision that results in procurement of funds and their effective utilization in the business. Financial management is nothing but managerial decision making on asset mix, capital mix and profit allocation.

Nature

According to Ezra Solomon, "the function of financial management is to review and control decision to commit and recommit funds to new and on going uses. In addition to raising funds, financial management is directly concerned with production, marketing and other functions within an enterprise whatever decisions are made about the acquisition or distribution of assets". From this statement, it is clear tliat the main function of financial management is not only to raise funds but includes the broader area of managing the finances for tlie firm more efficiently. Thus, the two main decisions involved in a firm are:

1) Investment Decision and 2) Financing decision including Dividend decision

1) Investment decision

The funds available may be invested in any project. The financial management provides a framework to make investment wisely. Investment decision relates to :

1) Management of working capital
2) Capital budgeting decision
3) Management of mergers, reorganisation and disinvestment
4) Buy or lease decisions
5) Securities analysis and portfolio management

The investment in fixed assets and management of current assets is major investment related problems in a company. Assets represent investment (or uses) of funds. Investment decision includes the decisions primarily relating to assets composition – fixed as will as current assets.

2) Financing Decision

The second function of financial management deals with financing pattern of tlie firm. The financing decision is mainly concerned with identification of sources of finance and determining financing mix and cultivating sources of funds and raising funds. The two main sources of funds are shareholders funds (owners' equity) and borrowed funds. The cost of funds, determination of debt equity mix, impact of tax, depreciation, consideration of control and financial strain, interest rate and inflation are some of the factors that affect the financing decision. A balance is to be maintained between owners' funds and outsiders' funds and long term and short term funds.

A firm usually maltes use of both internal and external funds. The employment of these sources in various combinations is called 'financial leverage'. Different types of analysis are required for this decision e.g., leverage analysis, EBIT – EPS analysis, which we will discuss later in this course.

Dividend Decision

This decision relates to disposition of distributable profit between dividends and retained earnings. Retained earnings being a source of funding, dividend decision is concerned as part of financing decision of the firm. The impact of levels of dividends and retention of earnings on market value of share and future earnings of the firm, funds required for future expansion, impact of legal and cash flow constraints and the future boom or recession are some factors that affect this decision. Retention of earnings depends upon reinvestment opportunities available and the opportunity to generate satisfactory rate of return for the shareholders. Dividends may be paid in cash or in the form of bonus shares. These and other aspects of dividend decision will be explained in detail later in this course.

1.3 EVOLUTION OF FINANCIAL MANAGEMENT

Finance management emerged as a separate field from accounting in 1900. The enterprises became big with complex decision to be made and requirement for huge funds growth in technological innovations and creation of new industries resulted in further need of funds hence promoting the study of finance to emphasise on investment, liquidity and financing of the firms.

The depression of the 30's meant firms had to concentrate on defensive aspect of survival, preservation of liquidity and reconstruction. Business lacked funding, those institutions which were willing to lend required exorbitant interest rates. During those times finance manager had the responsibility of ensuring that the enterprise was having optimal usage of funds, avoiding unnecessary expansion programmes and maintaining the loyalty of existing customers'. Use of computer brought better and fruitful analysis of financial performance. Introduction of various financial instruments in 1990s replacing hard cash as a transfer of funds and financial management emerged as a distinct management discipline and is linked to changes in business and socio-economic scenario, brought about by the advancements in information technology, multi division corporation and increasing global competition. The 21st century has brought globalisation through merger of firm, increased competition, access to international markets and need for quality products.

Financial management is important in all types of business as well as not for profit organisations like hospitals and schools. Sound financial management is necessary for the survival and growth of an enterprise.

Check Your Progress A

1) What is financial management?

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2) List the functions of financial nianagement.

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3) Differentiate between financing decision and investment decision.

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1.4 KEY ACTIVITIES OF FINANCIAL MANAGER

In a business firm the financial manager occupies a very important position. He is one of the dynamic members of corporate managerial team. His role, day-by-day, is becoming more and more significant.

The financial manager's task is not that of an accountant whose job is primarily to record the business transactions, prepare financial statements which show tlie working results of the organisation for a given period and its financial condition at a given point of time. The accountant is not concerned with tlie management of funds which is a syecialised task and he is seldom involved in tlie decision making process. In the modern day business, the role of financial manager has changed. Financial manager is expected to manage the funds in such a manner as to ensure their optimum utilisation and their procurement in a manner that the risk, cost and control considerations are properly balanced in a given situation.

Financial manager is responsible for effective utilisation of funds. He is to point out situations where tlie funds are being kept idle or where proper use of funds is not being made.

Important activities of the financial manager are : 1) estimating the requirement of funds; 2) decision regarding the capital structure; **3)** investment decision; **4)** dividend decision; 5) supply of funds to all part of the organisation or cash management; 6) evaluating financial performance witli respect to return on investment; 7) financial negotiations witli banks, financial institutions and public depositors; 8) keeping touch witli stock exchanges; and 9) maximising both the return on ordinary shares and the total wealth of the company.

In tlie present context the financial manager provides leadership in the cost effective use of an organisation's financial resources.

The responsibilities and duties of financial manager are indeed the organisation-wide, He interacts with production manager for a new plant, for forecasting and planning with marketing manager, for inventory level with purchase manager and sales manager for receivables pol icy.

1.5 GOALS OF FINANCIAL MANAGEMENT

A good goal must be clear, timely measureable and consistent. So must be the goal of financial management. A firm may have different goals e.g., production goals, sales goal, and financial management goal.

But what is the main goal of financial management ? The main goal of financial management should be such that is directed to achieve tlie ultimate goal of a firm.

The ultimate goal, as a good consensus, of a firm is to maximise the shareholders' wealth.

This in operational terms means:

a) Maximisation of profit

b) Maximisation of Return on capital employed

c) Growth in earning per share or market value of a share or dividends

d) Optimum level of leverage

e) Minimisation of costs of capital.

Let us examine in detail maximisation of shareholders wealth as an ultimate goal of financial management.

Maximisation of Shareholders' Wealth

The separation of ownership from management and the increase in intensity of competition has lead to the redefinition of profit maximisation objective of a firm. Financial theory, in general rests upon the promise that the objective of the firm should be maximisation of the value of the firm to the equity shareholders. It means maximising the market value of its equity shares. The justification of this objective is that it provides a rational guide for business decision making and helps in efficient allocation of resources. A second reason in favour of this objective is that equity shareholders provide risk (venture) capital for starting a company. They appoint the board of management. So this objective brings a responsibility on management to promote the welfare of equity shareholders.

The shareholders wealth can be maximised by maximising value of shares of a firm. The economic value of the shareholders' wealth is the market price of the share which is the present value of all future dividends and benefits expected from the firm. The underlying assumption in this approach is that shares are traded in efficient capital market where tlie effect of a decision is reflected in marlcet price of a share. With this objective in view the management will allocate the available economic resources in the best possible way keeping in view the risk involved. This objective timely guides three functions of financial management (investment, financing and dividend decision). The main problem of this objective is that an efficient capital market must exist which can really discover and reflect time marlcet price. Thus, wealth maximisation of shareholders is the main objective, though profit maximisation can be considered as a part of wealth maximisation objective.

1.6 RISK AND RETURN TRADE OFF AS A GUIDING FACTOR IN DECISION MAKING

From the financial point of view in any investment or financing proposal there is always the element of risk and return embeded. It is said that the greater the risk, greater the gain. So risk and return go together. Higher return entails higher risk; and lower return entails lower risk. Risk is defined as the 'variability of expected returns from an investment. If you invest in fixed deposit, there is no variability as income is fixed. But if you buy a share, dividend is not fixed. Less the variability, less is the risk and *vice versa*.

Return is defined as the "gain (or loss) expected over a given period of time by the decision makes". A financial manager cannot avoid risk, but wants greater returns at the same time. So he has to 'trade off between risk and return".

To explain the point further, let us assume: (a) that expected earnings are equal to expected cash flows, (b) that there are no taxes. Suppose you have Rs. 10,000 of which you have borrowed Rs. 2,000 @ 5% and you want to open a small photocopy shop. The total cost of operating in one year is Rs. 10,000 and sales are Rs. 11,000. The position is as follows :-

Debt Rs. 2,000 – Interest Rs. 100

i) Financing — Risk and return

Own funds Rs. 8,000 – Income Rs. 900

Operating costs Rs. 10,000

ii) Operating – Risk and Return

Cash sales Rs. 11,000

At the end of the year you have Rs. 11,000, of which you reinvest in the business Rs. 10,000. Of remaining Rs. 1000 you pay interest of Rs. 100 and keep with you Rs. 900. This return is product of two factors: (1) you earn Rs. 1,000, (2) Rs. 1,000 were divided between a creditor and you, the owner, which affected the owner's return. Based on the return on total assets you earned 10% (1000/10000), but earned a rate of return of 11.25% for the owner 900/8000 x 100, which is the result of operating and financing activities.

The rate of return from operations is determined by margin and turnover which are affected by sales, net operating income and net operating assets. The margin can be increased by either raising sales more than operating expenses or by reducing operating expenses more than sales. A turnover can be increased by increasing sales relatively more then operating assets or reducing operating assets relatively more than sales.

Financing **Risk and Return**

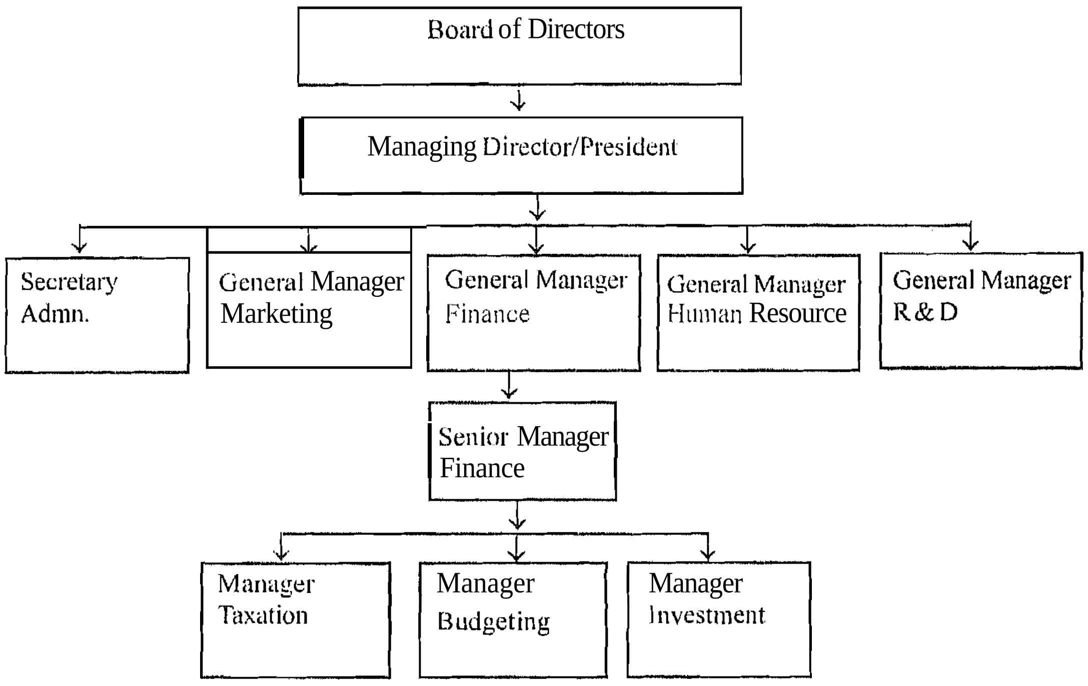
The next step towards maximisation of present value of owner's investment is to arrange source of funds so that the owner obtains as high a return as possible out of the earnings of the business without assuming undue risk. The difference between earning power of 10% and return on owner's equity of 11.25% is due to financial leverage". This is because you have used funds for which you are paying a fixed return. The leverage are : (1) the ratio of residual owner's equity to total funds supplied, and (2) the proportion of operating income used to pay interest payments.

The lower the ratio of residual owner's equity to total funds supplied, the higher the leverage factor (or vice versa) and the lower the proportion of operating income used for interest payment. the higher the leverage factor (or vice versa).

But net operating income is to be taxed. If tax is paid it will be deducted from net operating income left after charging interest expense. In that case rate of return or equity and earning per share shall be lower than the situation when tax is not paid on income. Financial leverage magnifies the fluctuations in earnings available for residual owners. When net operating income rises, the earnings of residual owners increase at a faster rate and if it falls, the earnings of residual owners decline more rapidly. The use of financial leverage widens the dispersion of possible earnings per share, thereby increasing the risk for equity owners. Thus, a balance is to be maintained between the chance of making greater profits for the owners against variability of returns and chances of firm going bankrupt.

1.7 ORGANISATION OF FINANCE FUNCTIONS

An organisation differs from company to company. An organisation can be vertical, horizontal or a circular. It can be on the basis of functions or divisions e.g. products or territories. However, a common type of organisation on functional basis is as given below :



Under above type of organisation each major function is organised as a separate department. Its emphasis is on specialisation. I-Iencc finance manager occupies a job of an expert. I-Ie not only supervises finance department but also coordinates activities with other departments. Thus, he plans, organises, controls and administers funds used in the business.

1.8 CHALLENGES FOR FINANCIAL MANAGER

While mobilisation of funds and investment of funds have been the prime respon bility of financial manager/CFO. Owing to momentous changes in the business environment particularly economic and financial, the nature of.challenges faced by financial manager have undergone immense shifts. The first and the foremost challenge is shareholders value creation. The shareholders, even the minority, have become demanding and vocal. They are no more satisfied with increasing sales, or decreasing costs; they want growing total shareholders return. **As** a consequence, the financial manager has to concentrate not only on earning per share but also on market capitalization.

The next important challenge comes from investors, both individual and institutional. Indeed the rise of the mutual funds signifies tlie major departure in tlie financial environment of business. In addition to tlie traditional skills of financial manager, a good understanding of tlie psychology of investors has emerged as tlie prime skill for them.

The third major challenge faced by financial manager is dealing with continually increasing risks in the market. With tlie onset of liberalisation, privatisation and globalisation of business, tlie business risks have multiplied. The generation of risk adjusted return lias emerged as a newer measures of performance of financial manager. A reading into a financial magazine brought out altogether a new challenge being faced by the financial managers. That magazine had mentioned that a research into tlie expectations of CEOs from financial managers had shown that the greatest expectation of tlie CEOs from financial managers is to make them look smart. Looking smart essentially means to be able to base your arguments on facts and figures. He should have sound interpersonal and communication skills, and overall organisational knowledge. Financial manager is expected to continually generate appropriate measures of performance for managerial performance evaluation within the company and reporting to tlie external shareholders etc. Therefore, rapid technological advancement, complied with large scale investment made by MNCs, merger movements and wide-spread diverification of products have made his job demanding. But rewards, financial or otherwise can be great for those who enjoy the challenges. All in all financial manager is in tlie new world of business and finance.

Check Your Progress B

1) List the key activities of a financial manager?

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2) What is risk'?

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3) Define return.

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1.9 LET US SUM UP

Financial management is also called corporate finance or managerial finance. It's mainly concerned with acquisition of funds and use of funds by a business firm. The goal of financial management is maximisaion of shareholders wealth, though profit maximisation can be a part of wealth maximisation objective. There are two basic dimensions of financial analysis: risk and return, higher the risk higher the return, and higher the market value; and lower the risk, lower the return and lower the market value. Financial manager is concerned witli planning and allocation of resources etc. There are many key activities of financial manager. In the era of globlisation, privatisation and libralisation financial manager has to face many challanges.

I . KEYWORDS

Earnings per share	:	Earnings after taxes divided by the number of common shares outstanding.
Financial Management	:	The acquisition, financing and management of assets.
Profit Maximisation	:	Maximising a firm's earnings after taxes.
Return	:	Gain or loss expected over a given period of time.
Risk	:	Variability of expected return over an investment.

1.11 TERMINAL QUESTIONS/EXERCISES

I) Critically evaluate the goals of financial management.

2) Explain basic finance functions. How do they evolve risk-return trade off'?

3) Discuss the challanges faced by the financial managers in India.