FINANCIAL MANAGEMENT

UNIT 1: INTRODUCTION TO FINANCIAL MANAGEMENT

Financial Management

Financial management refers to the efficient and effective management of money in such a manner as to accomplish the objectives of the organization. It is the specialized function directly associated with the top management.

Business finance

It is a process of raising, providing and managing of funds or money used in the business. In short it is the process of acquisition of funds and the effective utilization.

Aims of Finance Function

1. Anticipation of funds Needed

The main aim of finance function is to assess the financial needs of an enterprise and then finding out suitable sources for raising them. The sources should be commensurate with the needs of the business

2. Allocation or utilization of funds

Efficient allocation of Investment avenues means investment of funds on profitable projects which means a project or an asset that provides return which is higher than the cost of funds. Though raising of funds is important but their effective utilization is more important. The funds should be used in such a way that maximum benefit is derived from them. The returns from their use should be more than their cost.

3. Increase profitability

Proper planning, managing and controlling of finance function aims at increasing profitability of the firms. Proper planning of anticipation of funds, selection of investment of avenues and allocation of funds helps to increase the profit. Hence financial functions need to match the cost and returns from the funds.

4. Maximizing Wealth of the firms

The prime objective of any finance function in any organization is to maximizing the firm's value by taking right decision.

Approaches to Finance Function

1. The Traditional Approach

2. The Modern Approach

Traditional Approach

The traditional approach to the finance function relates to the initial stages of its evolution during 1920s and 1930s when the term 'corporation finance' was used to describe what is known in the academic world today as the 'financial management'. According to this approach, the scope, of finance function was confined to only procurement of funds needed by a business on most suitable terms.

The Modern Approach

The modern approach views finance function in broader sense. It includes both rising of funds as well as their effective utilization under the purview of finance. The finance function does not stop only by finding out sources of raising enough funds; their proper utilization is also to be considered. The cost of raising funds and the returns from their use should be compared.

Objectives of Financial Management

1. Profit Maximization.
2. Wealth Maximization
3. Other objectives
    - Balanced asset structure
    - Judicious planning of funds
    - Efficiency
    - Financial discipline
    - Liquidity

Profit Maximization

According to this concept, actions that increase profit should be considered and actions that decrease profit should be ignored. Profit should be the main objective

of every business organization. Thus all the decisions whether financing, investment, dividend should focus on maximization of profit.

Advantages of Profit Maximization

1. It is a barometer through which the performance of a business unit can be measured.
2. It attracts he investors to invest their saving in securities.
3. It indicates that the fund is efficiently used for different requirements.
4. It increases the confidence of management in expansion and diversification programmers of a company.
5. It ensures maximum welfare to the share-holders, employees and prompt payment to creditors of a company.

Disadvantages of profit maximization

1. Profit is not a clear term. It is accounting profit? economic profit? profit before tax? after tax? net profit? gross profit or earning per share?
2. Profit maximization does not consider the Element of risks.
3. Huge profit attracts Government intervention.
4. Huge profit invites problems from workers. They demand high salary and fringe benefits.
5. Profit Maximization attracts Cut-throat competition.
6. Profit Maximization is a narrow concept
7. It does not consider the impact of time value of money.
8. It encourages corrupt practices to increase the profits.
9. Modern concept of marketing does not encourage profit maximization.
10. The true and fair picture of the organization is not reflected through profit maximization.

2. Wealth Maximization

It refers to gradual growth of the value of assets of the firms in terms of benefits it can produce. Any financial action can be judged in terms of the benefits it produces less cost of action. The wealth maximization attained by a company is reflected in the market value of share. In short term, it is the process of creating wealth of an organization. This will maximize the wealth of share-holders.

Symbolically, it is expressed as $W_o = N p_o$

W_o=Wealth of the firm,

N =Number of share owner and,

P_o =price per share in the market.

Advantages of wealth Maximization

1. Wealth Maximization is a clear term. Here, the present value of cash flows is taken in to consideration
2. It considered the concept of time value of money present cash inflow and cash out flows help the management to achieve the overall objective of company.
3. It is universally accepted concept
4. It guides the Management in formulating a consistent strong dividend policy to reach Maximum returns to equity share holders.
5. It considers the impact of risk factor.

Financial Decision

Financial decision refers to the decision concerning financial matters of a business concern. The functions of finance involves three important decision i.e.,
1. Investment decisions.
2. Financing decisions and
3. Dividend decisions.

All three decisions directly contribute to the corporate goals of wealth Maximizations.

1. Investment decisions

It refers to the activity of deciding the pattern of investment. It covers both short term investment decision and long term investment decisions. The long term investment decision is referred to as the capital budgeting and short term investment decision as working capital Management.

2. Financing decisions

It is another important decision where a business concern has to take maximum care in financing different proposals. The combination of debt to equity directly contributes to profitability of a business unit and reduces/financial risk. The instrument that is to be selected must aim of maximizing the returns to the investors and to protect the interest of creditors.

3. Dividend decisions

Dividend is a part of profits, which are available for distribution to equity share holders. Payment of dividends should be analyzed in relation to the financial decision of a firm.

The company can distribute profits as dividends to the ordinary shareholder's without retaining the profit or to retain all the profits or to keep a part of the profit in the business and distribute the remaining among the shareholders.

Financial planning

It is the process of estimating the total financial requirements of the firm and determining the sources of in its capital structure (D: E) is called financial planning

Characteristics / principles of sound financial plan

1) Simplicity
The financial plan should a simple financial structure so that, it can be easily understood even by a laymen [common man].

2) Foresight
Financial plan should be prepared only after taking into consideration of today and future needs for funds.

3) Long term view/needs
The financial plan should be formulated and conceived by the management keeping in view the long-terms needs of the company rather than the easiest way of obtaining the original capital.

4) Optimum use
The financial plan should provide for meeting the genuine needs of the company. A proper balance should be maintained between long-term and short-term funds since the surplus of one would not be able to offset the shortage of the other.

5) Contingencies
It should keep in view the requirements of funds for contingencies.

6) Flexibility
The financial plan should have a degree of flexibility also. It is helpful in making changes or revising the plan according to pressure of circumstances with minimum possible delay.

7) Liquidity
Liquidity is the ability of the enterprise to make available the ready cash whenever to make disbursement.

8) Economy
Economy means funds should be raised at minimum cost. Cost minimization depends on the selection of various sources of finance and optimum mix of debt-equity.

Functions of Finance Manager

1. Determining Financial Needs

One of the most important functions of the financial manager is to determine the financial needs of the business. This will enable to decide on the various sources of funds from where the funds can be raised.

2. Determining the Sources of Funds

The financial manager has to choose the various sources of funds. The funds can be raised by issue of equity shares, preference shares or by taking loan from bank.

3. Optimal Capital Structure

The financial manager has to establish an optimum capital structure and ensure the maximum rate of return on investment. The ratio between equity and other liabilities carrying fixed charges has to be defined. In the process, he has to consider the operating and financial leverages of his firm.

4. Ensure that there is no shortage of funds

A financial manager needs to manage the cash in such a way that there is neither shortage nor surplus and daily expenses can be met without any hassles. The funds must be utilized in such a way that the firm does not face shortage in near future.

5. The Funds are invested wisely

It is the task of the finance manager to ensure that the funds are invested wisely so as to ensure maximum ROI.

6. Ensuring Legal requirements

While acquiring funds, the financial manager needs to follow some basic steps such as legal formalities and documentation required. ¬ He might also need to negotiate with the financial institutions.

7. Ensure earnings rate is higher

For the determination of the capital structure, the financial manager must ensure that the earning rate is higher than the rate of interest on the borrowed amount.

Factors affecting financial planning

1) Nature of a Business

More Finance is required for capital intensive business and less finance is required for labour intensive business.

2) Flow of income of business

If there is regular flow of income in a business it can run with less capital.

3) Risk in a business

If the business involves high risk then it requires more owner capital because the available of debt capital is less.

4) Plans of expansion

Any plans for expansion will require more capital into the business.

5) Status and size of a business

If a business has good reputations it can easily obtain finance. In case if a firm does not have a good fame or size of a business of the firm then it is quite difficult to achieve finance for the business.

6) Government control

The financial plans should be prepared on the basis of Government policies, control and legal requirements.

7) Alternative sources of finance

Financial plan depends upon the availability of the alternative finance for the business that helps the firm to choose the profitable finance to the business.

8) Flexibility

The financial plan should be flexible enough to make changes incase re quired.

Steps in financial planning

1. Establishing Objectives- The financial objective is to employ the capital in whatever proportion necessary to increase the productivity of the remaining factors of production in the long run.

2. Policy formulation-

Financial policies are guides to all actions which deal with procuring, administration and disbursing the funds of business.

3. Forecasting-
Financial management has to forecast the future variability of factors.

4. Formulation of Procedure-
Financial policies are broad guides which have to be executed in step by step way.

Functions of Financial Management

1. Estimation of capital requirements

Estimations have to be made in an adequate manner which increases earning capacity of enterprise.

2. Determination of capital composition:

Once the estimation has been made, the capital structure has to be decided.

3. Choice of sources of funds: a company has many choices like-

Issue of shares and debentures

Loans to be taken from banks and financial institutions

Public deposits to be drawn like in form of bonds.

4. Investment of funds

The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.

5. Disposal of surplus

The net profits decision has to be made by the finance manager. This can be done in two ways:

Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.

Retained profits - The volume has to be decided which will depend upon expansion, innovational, diversification plans of the company.

6. Management of cash

Finance manager has to make decisions with regards to cash management.

7. Financial controls

The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances.