UNIT-5 MANAGING FINANCE

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Analyse the role of finance in modern business
- ✓ Evaluate the financial controls of an organisation
- ✓ Evaluate the various functions of financial management for an organisation

Unit 5

Managing Finance

Financial Management can be defined as a branch of management that deals with the effective use of financial resources in an organisation. The work of financial management is to plan, organise and control the use of the funds available for business, and to help the firm gain funds for its operations and utilise them effectively.

All actions taken by this branch of management have one goal: to promote the finances of the business. As such, it is crucial to every business, as one cannot work or progress without financial management.

This unit covers the scope, objectives and functions of financial management, but first it is important to note its basic responsibility and the requirement to plan funds in this form of management.

The Financial Management attributes of organisations are no longer the prerogative and sole responsibility of the higher ranks of management; nowadays, all managers have everyday accountability for them. Imagine a company without cash. It cannot afford to acquire essential assets such as people, materials or equipment necessary for a business to function and earn profits.

Financial management involves managing the firm's internal cash flows and its mix of debt and equity financing to maximise the value of the debt and equity claims on the firm to ensure that the company can pay its obligations when they become due.

Financial managers have the primary responsibility for acquiring the monetary resources needed by a firm and for utilising those monetary resources in projects that will maximise the value of the firm for its owners.

Financial Responsibility & Accountability

The financial management of any organisation is financially responsible for and accountable to that organisation. The Financial Management branch is accountable to the board of directors, or the head of the organisation, and it must report to them (whenever they require the information) the current budget of the organisation, the money that is being spent, the money that is being earned, when the management expects to earn and spend the money, and the company's assets and the liabilities. Its financial responsibilities include:

- Creating a reasonable budget for the business that will clearly express the goals of the business, the finances required to achieve these goals, and the various sources of funds.
- Generating the funds for the organisation through external or internal sources and ensuring that it has enough funds to pursue its objectives.
- Ensuring that the organisation does not become side-tracked or over-ambitious, in financial terms, i.e. ensuring that it does not accept obligations that will require funds that are not available.

- Paying the various bills and taxes and clearing the organisation's financial obligations on time, ensuring that sufficient funds are set aside for this purpose.
- Maintaining a proper and comprehensive record of the funds, financial activities and decisions of the business. For instance, it should divide funds acquired in a way that will satisfy the various shareholders; it should also retain enough funds for further operations, future projects, and to pay the various sources and elements of production.
- Reporting, to the various heads of the organisation, the avenues, current status and use of the finances.
- Ensuring that the money is being spent in proportion to the income and, if not, immediately rectifying the expenditures.

Investment Avenues

The financial manager recommends the best possible avenues for safe investments, enabling the company to earn profits on a regular basis.
A good financial management branch creates strong financial stability throughout the organisation and protects it from the uncertainties in the world of business emanating from the constant risks and threats to the economy, the prices of materials, and the growing interference from crime and politics.

Planning for Funds

Financial planning is the process of meeting the company's goals through the proper management of finance. The financial management of any organisation requires a good level of planning. Financial planning deals with the sources, investment and administration of capital.
Financial planning begins with a clear and researched estimation of the amount of money required to carry out the operations within a set period of time. It is then important to determine the sources of the funds and the competition.
It is important to plan the finances as this helps to control the funds effectively. This involves overseeing the funds' distribution by making short-term and long-term financial plans.
A financial planner devises a budget that will cover sudden price increases, thereby creating stability within the organisation in spite of the many uncertainties of the financial world. For example, buying a particular investment might help pay off a mortgage faster or delay retirement significantly.
Financial managers must plan ways to protect and increase the business's competitive advantage in its various target markets.

The planning of finances is undertaken with the following objectives in mind:

- To spend funds in a way that will eliminate wastage and gain maximum returns on the investment of these funds, irrespective of the organisation's funds being scarce or plentiful.
- To determine the capital or the funds required for both long-term and short-term projects. This means determining the expenses of the various factors of production for all

projects, such as the changes that may occur in the cost and the market of various units of production and the expenses required for the functions aside from production.

- To create a system or policy that deals with the efficient and planned distribution of profits, makes decisions on where, why and how many funds go to various parties, and controls the current funds.

Scope of Financial Management

Financial management can be broken down into three major areas: the investment decisions, the financial decisions, and asset management.

- ### Investment Decisions

  Investment decisions are the most important of the firm's three major decisions. They begin with the determination of the total amount of assets the firm needs to hold. Investment decisions are often supported by decision tools. The modern portfolio theory is often applied to help the investor achieve a satisfactory return compared to the opportunity costs.

  The modern portfolio theory aims at gaining the most from the expected portfolio returns despite the given amount of portfolio risk. On the other hand, the theory explains that it is possible to minimise risk for a given level of expected return. This is done by carefully choosing the proportions of various assets.

- ### Financing Decisions

  The financial manager is concerned with the makeup of the right-hand side of the balance sheet. In addition, dividend policy must be viewed as an integral part of the firm's financing decision. The dividend pay-out ratio determines the amount of earnings that can be retained in the firm. Retaining a greater amount of current earnings in the firm means that little money will be available for current dividend payments. The value of the dividends paid to stockholders must therefore be balanced against the opportunity cost of retained earnings lost as a means of equity financing.

- ### Asset Management

  Once assets have been acquired and appropriate financing provided, these assets must still be managed efficiently. The financial manager is charged with varying degrees of operating responsibility over existing assets.

  These responsibilities require that the financial manager be more concerned with the management of current assets than with that of fixed assets.

Objectives of Financial Management

The main objective of financial management is to gather, manage and spend the company's money effectively, enabling it to gain profits and prosper. Here are the objectives of this branch of management:

- ✓ Preserve assets.
- ✓ Proper Credit Management.
- ✓ Increase shareholder value over time.
- ✓ Exercise good risk management in investing.
- ✓ Control costs.
- ✓ Create a plan of work that is balanced in its expenditure and income.
- ✓ Profit maximisation through minimum expenditure of acquired funds in such a way that there is no unnecessary cost and the returns derived from the business's investments are maximised.
- ✓ Increase wealth by making investments in projects or organisations that provide a maximum return, and to ensure that the investment is safe.
- ✓ Provide adequate insurance protection against personal risk of death, disability, income loss, medical care, property and liability, and unemployment.

Functions of Financial Management

• Financial Forecasting

Typically, financial forecasting reflects on what will happen to a company's cash flow and capital in the short, medium or long term. Therefore, it is a foundation which influences the firm in decision- and policy-making and prepares it for the coming years.
It makes decisions on the investment of the organisation's funds. An investment means putting efforts, interests or resources into a particular proceeding in the hope of gaining a profit.
The forecasting methods provide the means for a business to express its goals and focus areas and to ensure that they are aligned with the company's vision and mission. They also help the business determine the asset requirements and the need for external finances.
In general, financial forecasting is a reliable tool for determining whether the business will succeed or fail, or make gains or incur losses.

• Capital Budgeting

Capital budgeting or investment appraisal is the process of planning expenditures on assets in which cash flows are expected to operate for longer than one year.
Through this, a business decides whether projects such as building a new plant or investing in a long-term venture are worth pursuing. Often, a feasible project's lifetime cash inflows and outflows are assessed in order to determine whether the returns generated will meet a satisfactory target benchmark. This aspect also involves making decisions relating to the various sources of finance, the

time required to acquire the funds, the type of source of finance, the duration for which it would finance the organisation, the amount that it would contribute, and the means of returning the funds to the source.

The commonly used methods of capital budgeting include net present value (NPV), internal rate of return (IRR), discounted cash flow (DCF), and payback period.

- **Capital Management**

Capital management involves strategies that strive to maintain sufficient and equal levels of working capital, current assets, and current liabilities.

This helps a company to meet its total expense obligations while also managing and tracking cash flows that are related to short-term financial decisions.

The following are the goals of capital management:

- **Risk Management**

Risk management is the process of identifying, analysing and minimising the uncertainties in investment decision-making.

Essentially, risk management commences whenever an investor or fund manager analyses and quantifies the potential gains and losses in an investment and executes the appropriate actions and omissions based on their investment objectives and risk tolerance.

Inadequate risk management can result in severe consequences for companies and their individual workers. For instance, the recession that began in 2008 was largely caused by the failure of the credit risk management of directly involved financial firms.

- **Accounting**

Accounting in financial management includes the creation of financial statements, cash flow reports, capital statements, etc. Such reports are used to provide information about the business's performance not only within the company but also to third parties such as investors, creditors and government to ensure the business's profitability and solvency. They also serve as a real and concrete basis for the next stage of financial decision-making. They must distribute the finances in such a way that there is enough left over for profits after paying the workers' wages, factory and office bills, returns to the sources and shareholders, any debt payments, production costs, etc. A financial manager must control the expenditures of the organisation as well as managing and procuring funds.

- **Credit Management**

  Credit management is concerned with decision-making on credit limits, acceptable levels of risk, and terms of payment for customers. Simply put, it is the process of controlling and collecting payments from customers.

An effective credit management system helps reduce the amount of capital against the debtors and protects the company's good credit standing and good credit management practices from bad debts.

Further Reading:

- ✓ *Introduction to Finance: Markets, Investments, and Financial Management.* John Wiley & Sons, 15 Jun 2011. By Ronald W. Melicher