# Financial Management

## Learning Outcomes

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

- ✓ Understand the scope and functions of financial management
- ✓ Explain objectives of the business firm
- ✓ Describe the major decisions of the finance function
- ✓ Understand the structure and organisation of finance department.

# Financial Management

We have discussed financial accounting in the previous unit and now, we will move onto the concept of financial management.

Raising capital and utilising it to generate funds for business operations and for paying the suppliers of capital are the financial functions of a business organization. Financial management deals with planning and controlling the business's financial function and utilizing financial resources to get maximum returns on investments. It entails that a firm's funds be invested in healthy projects that yield the expected returns. Other organizational functions like production and marketing are closely linked with finance, because almost all business activities involve some kind of an acquisition or purchase and the use of funds.

The company's financial functions such as raising funds and using them do not hamper its general operations. The company prioritizes its production and marketing functions in the light of financial constraints. On the other hand, if a firm has ample funds, its management formulates flexible production and marketing strategies and it will formulate the financial policies to suit the company's production and marketing goals.

The finance function of an organization can be categorized as:

i. Managerial functions
ii. Routine functions

Managerial functions entail more planning, control and implementation of financial policies, whereas, routine functions require effective management to carry them out. Routine functions are more clerical in nature and depend on the effectiveness of managerial functions.

A few important routine functions are as follows:

(i) Supervising cash receipts and payments and ensuring that cash is in safe hands;

(ii) Safeguarding securities, insurance policies and other importantdocuments;

(iii) Making sure that financial procedures are being carried out properly; and

(iv) Preparing financial statements and maintaining records.

Employees, who have supervisory roles, are responsible for carrying out routine functions. The involvement of financial executives in managerial activities is a fairly recent phenomenon, as the scope of finance was limited to routine activities about four decades ago.

## Scope of Financial Management

Financial management can be divided into two categories:

a) Traditional approach

b) Modern approach

**Traditional Approach**

According to the traditional approach, the financial management was to be limited to raising funds to meet the organization's financial requirements. It took a very narrow perspective of financial management. This approach is based on the academic literature during the period that financial management was in the very initial stages of evolving into a separate discipline. Financial management was also known as ' corporate finance,' during the 1950s, as it was thought to be nothing more than simple procurement of funds and all the instruments or practices through which funds were raised. It was considered that the organization feels the need to raise funds only at the time of mergers, liquidation, and reorganisation etc., therefore, financial management had nothing to do with the allocation of funds.

The traditional approach was discarded due to the following limitations:

1. This approach focused only on the outside sources of funds such as investors, financial institutions, and investment banks, etc. and ignored the internal sources of raising funds;
2. It over emphasized on rare and infrequent events like mergers, takeovers, reorganisation, and liquidation, etc. Therefore, this narrow approach focused on securities and financial markets rather than the day-to-day financial requirements of the business; and
3. There was no mention of working capital management under this approach, as it emphasized entirely on long-term financial aspects. It lacked the ability to deal with routine managerial issues related to finance.

The first manifestation of the traditional approach was found in 1897 in Green's book, and later on, in Corporation Finance (1910) by Meades and in Corporate Promotion and Reorganization (1914) by Doing.

All these books over emphasized on the outside sources of finance, on long-term financial decisions etc., and completely ignored managerial problems related to finance and internal financial elements such as cost of capital, optimum capital structure, valuation of firm etc. the modern approach to financial management sought to overcome the narrow perspective taken by the traditional approach and its limitations.

**Modern Approach**

Various factors after the 1950s such as technological advancement, industrialization, government intervention, intense competition, population growth etc. indicated that there was a need to focus on efficient allocation of funds. The focus began shifting from infrequent financial decisions to day-to-day managerial problems and from raising funds to allocating them effectively. This approach took a broader view of financial management and determined that financial decisions taken on a routine basis could affect

the business activities as a whole. The modern approach was more analytical in nature as it addressed matters concerning technology, growth of the business, profitability, risk-taking, capital structure and the asset mix. The financial manager had to take rational decisions regarding investment, financing and dividends, and reach at an optimum allocation of funds. These decisions were called managerial finance functions and they required advanced decision-making techniques and extraordinary administrative and management skills.

## Finance Functions

Finance functions are divided into three major categories of decisions:

A. Investment decision;
B. Finance decision; and
C. Dividend decision.

An optimum combination of these three decisions maximizes the shareholder's wealth. These decisions are linked to each other and have a joint impact on the market price of the company's stock.

Each of these decisions is discussed below:

### A. Investment Decision

It is the most important decisions and deals with the assets that the firm has invested its funds in.

These assets are categorised as:

1. Long-term assets- yielding returns after the period of one year.
2. Short-term assets-also called current assets and can be converted into cash within one year.

The decision related to long-term assets is called **Capital Budgeting** and that related to short-term assets is called **Liquidity Decision**.

#### i. Capital Budgeting Decision

The effects and benefits of this decision will be realised in the future during the course of the investment project's life. The first step involved in capital budgeting I to select the asset to invest in from the alternatives. This decision involves evaluating relative returns and the measurement of the investment's worth. The second step is to assess the risk and uncertainty associated with the investment. There is an element of risk and uncertainty in long-term investments as their return in expected after the period of a year in the future. The return anticipated from investment should outweigh the risk. The last step is to assess the return from investment against a figure that is normally referred to as various terms such as the cut-off rate, required rate, hurdle rate, and the minimum rate of return, etc., the company's cost of capital is usually the standard that is used for this purpose and is a very important element of capital budgeting.

**ii. Liquidity Decision**

This decision is based on the premise that management is the trade-off between profitability and liquidity. In other words, profitability and liquidity are opposing concepts. If, for example, a company does not have sufficient working capital, then it is not liquid and cannot meet its immediate obligations, resulting in the risk of bankruptcy. If, on the other hand, a company has a large amount of current assets, it is not very profitable. Therefore, the main objective of the Liquidity Decision is to strike a balance between profitability and liquidity. The firm should invest funds in current assets in such a way that all of its funds are not locked up in one asset. It can be concluded that Liquidity Decision revolves around achieving two goals: the Working Capital Management and optimum allocation of funds in current assets.

**B. Financing Decision**

A firm has to make another major decision on its financing mix. When the determination of asset-mix has been made, decisions have to follow regarding raising the funds for firm's investment requirements. The important issue to address while making this decision is the evaluation of the proportion of equity and debt capital.

Debt capital influences the return of shareholders and their risk, which is why it is pertinent that financial managers should have the ideal capital structure in order to maximize the shareholder's return while minimising their risk. At that optimal combination of debt and equity the cost of capital is the lowest, while the market value of the share is highest.

In conclusion, the financial decisions are about following two aspects:

(i) Capital Structure Theory, and
(ii) Capital Structure Decision.

**C. Dividend Decision**

The financial manager makes the decisions regarding the amount of funds to be distributed as dividends. They can distribute all profits as dividends or retain some in the firm and give out the rest as dividends. The focus of dividend decision is to consider the shareholders' wealth along with trying to maximize the market value of shares. In other words, it is up to the financial manager to determine the dividend-payout ratio. There are various factors that affect an organisation's dividend policy.

In order to summarise our discussion above, we can say that according to the modern approach, it is essential for a firm to address the three decisions. The traditional approach lacked a conceptual and an analytical framework and was too narrow in its perspective. The modern approach has introduced financial management at a much broader scale and it has put emphasis on optimum decisions that achieve organizational goals.

## Objectives of the Firm

The modern approach to financial management has three basic questions at its core:

(i) Where to invest and how much to invest?

(ii) What amount of funds to be raised and how to generate them?

(iii) When to pay dividends and how much to distribute as dividends?

In order to answer these questions relating to investment, financing and dividend policies, the firm must have clear-cut objectives and priorities. It is generally understood that the primary financial goal of any firm is to maximize the owner's economic welfare.

There are two ways of achieving this objective:

A. Profit maximisation and

B. Wealth maximisation

**A. Profit Maximization**

According to the concept of profit maximisation, the firm must avoid all activities that reduce profits and focus on maximizing their gains. There are two ways of going about profit maximization; increasing the output from scarce inputs, or decreasing the cost of production. The economic concept of profit maximization considers profit to be a yardstick of economic efficiency in perfectly competitive markets. It argues that all firms strive to maximize their profits, and in doing so make efficient allocation of resources and increase social welfare. Profit maximization serves as an ultimate criterion for effective financial management decisions as it is based on allocating limited capital in the most optimum manner.

This concept in not without its limitations which are listed as follows:

i. It is considered to be vague and ambiguous;

ii. It does not consider the timing of earning profits; and

iii. It ignores the risk and uncertainty factor.

The first limitation relates to the fact that this concept does not address the clarity of the term "profit." It is not clear whether it deals with the maximization of profit before tax or after tax, total profit or the rate of return etc. This lack of clarity forms a very weak base for financial management to build up on.

Another limitation of the profit maximization concept is that it does not take into account the timing of cash inflows from investment. It does not consider the value of returns that an investment yields at different periods of time. In the real world, benefits received in the earlier years are valued more than those received in the future.

Profit maximisation disregards the risk and uncertainty factor, which is associated with returns on investment. Basically, it focuses purely on the size of benefits that an investment yields rather than taking the quality of returns in consideration as well. As per the general rule, the more certain the expected return, the higher the quality of the gain on investment. Similarly, the more uncertain the expected return, the lower the quality of benefits. Investors seek to minimise risk and uncertainty; therefore, the profit

maximisation concept is not suitable to their objectives, as it does not provide an effective framework for financial management.

A financial management system that gives due consideration to all three decisions i.e. investment, finance and dividends decisions, should entail the following:

1. It must clear and precise;
2. It must focus on both quantity and quality aspects of return on investment; and
3. It must recognize the time value of money.

An approach that addresses the factors mentioned above is wealth maximisation.

### B. Wealth Maximisation

This concept states that the firm's management should function to maximize the present value of the firm's expected returns. It is based on the most widely acknowledged objective of a firm i.e. to maximize its value and the wealth of its owners. The firm's **discount rate**, also known as the cost of capital, which reflects time and risk, is used to calculate the present value of expected returns. Therefore, the discount rate of a firm reflects the time and risk preferences on the suppliers of capital.

Another merit of the wealth maximisation concept is that it takes both quantity and quality of returns into consideration. It states that, other things being constant, a certain return/income is more valuable than an uncertain return/income. Similarly, returns received in an earlier period should be valued more than those received later. Therefore, this concept addresses the quantity and quality aspect unlike the profit maximization criterion.

Given its merits, the wealth maximization objective is more effective than the profit maximization objective.

It compares the present value of expected returns to the cash outflow associated with an investment. If it results in a positive **net present value**, then, the investment is advisable. In simpler words, if the present value of future cash flows in higher than the present value of cash outflows (both time and risk considered), then, the investment is considered profitable.

On the other hand, if the present value of future returns in outweighed by the cost of undertaking the investment, then, it the project is to be rejected. When a firm is considering many alternative investments, then, the one with the highest net present value is chosen.

The following derivations ascertain the net present wealth according to Ezra Solomon's methods:

i. $W = V - C$ where $W$ = Net Present Wealth
$V$ = Gross Present Wealth
$C$ = Investment / Capital Outflow

ii. $V = E / K$

Where E = Size of future stream of benefits

K = Capitalisation rate / discount factor, reflecting both risk and timing of benefits attached to E.

iii. E=G- (M+I+T)

Where G = average expected future cash inflows (earnings before interest, taxes and dividends);

M = average annual re-investment required to maintain G at the projected level expected flows of annual payments on account of interest, dividend and charges

T = expected annual outflows on account of taxes

The wealth maximisation objective can be illustrated using the symbols defined above:

$$W = \frac{A_1}{1+k} + \frac{A_2}{(1+k)^2} + \dots\dots + \frac{A_n}{(1+k)^n} - C_o$$

$$= \sum_{t=1}^{n} \frac{At}{(1+k)^t} - C_o$$

When, $A_1$, $A_2$, .... $A_n$ = the stream of benefits (cash inflows) expected to occur on the investment project;

$C_o$ = cost of the project

k = the discount factor / capitalisation rate to calculate the present value of expected cash flows; and,

W = the net wealth of the firm (the difference between the present value of stream of expected benefits and the present value of cash outflow).

Our discussion above establishes that wealth maximisation considers two very important factors i.e. the time value of money and risk, by determining the uncertainty of expected returns. Therefore, businesses focus more on wealth maximisation rather than profit maximisation.

## Risk-Return Trade-Off

The firm's financial policies affect the market value of its shares as they have an impact on risk and return. The equation below shows the relationship between risk and return.

**Return = Risk-free rate + Risk premium**

The risk-free rate compensates for time and risk premium for risk coverage. The firm needs to strike a balance between risk and return in order to maximise the market value of its shares. This balance is called the **Risk- Return Tradeoff**.

The following figure illustrates the functions of financial management.

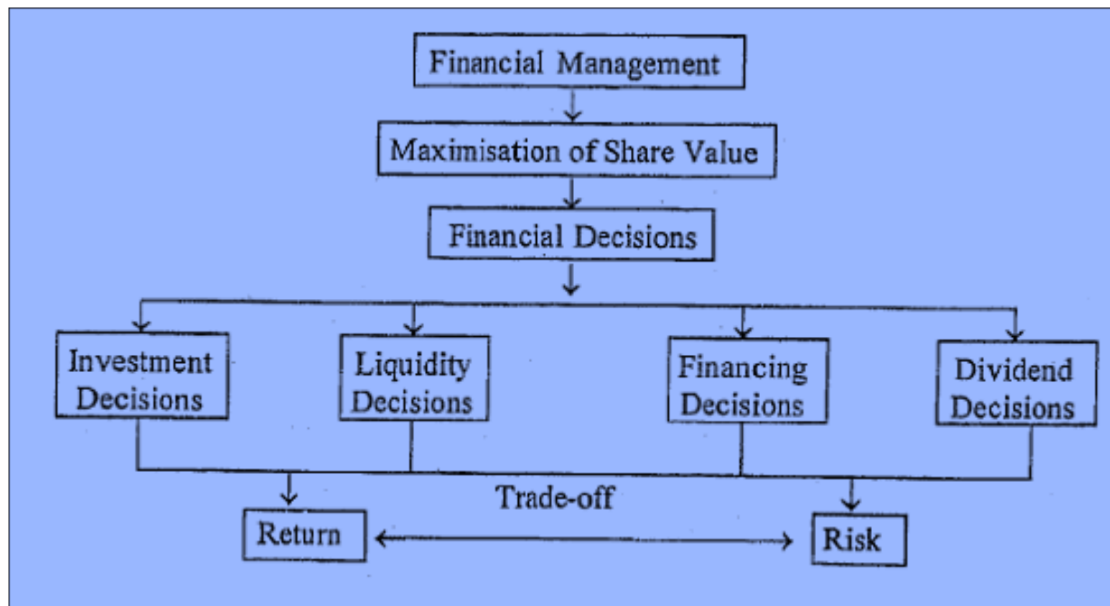


**Figure 11.1**: An overview of financial management

## Conflict Of Goals: Management Vs. Owners

Management is responsible for decision-making in joint stock organisations. In this case, management goals might not always be aligned with the objectives of shareholders. It is possible that the management would have their own agenda, e.g., job security, rather than focusing on wealth maximisation for shareholders. This is mainly due to the separation of ownership from control in joint stock companies. However, it is not really possible for managers to pursue their personal goals unchecked, because they are constantly being supervised by owners and the government and being observed by employees, suppliers, etc.

Each stakeholder in the organization will evaluate the management's performance in light of their own set of objectives and if it is determined that the management has failed to achieve the wealth maximization objective, then, that could threaten the managers' position. It is usually assumed that all parties have the wealth maximization objective as their focus. Conflict between management and shareholders arises when managers create enough wealth to satisfy shareholders but fail to reach the optimum level (or maximise wealth) by playing too safe. This attitude would eventually frustrate the shareholders.

## Financial Goals and Firm's Objectives

In the quest to maximize wealth for shareholders it is important not to lose sight of an important question: Is wealth maximization for shareholders the only objective of a firm? The answer is, no. The firm exists beyond the goal of wealth maximisation. The survival and growth of a business organization are determined by customer satisfaction with its product. The firm must provide satisfactory goods and services to its customers in order to survive in a competitive market. It has various factors to consider other than wealth maximisation, such as, technological advancement, the welfare of its employees, market share, company image, and style of leadership, etc. The firm has to define its strategies regarding production, technology, marketing, finance, and management, etc. and therefore, it has to make decisions that are in line with those strategies. Wealth maximisation comes after these factors, as it is a way to be economically efficient.

It is up to the managers to align the interests of shareholder with those of its customers, suppliers, creditors and employees. Managers act as agents and trustees of the firm's owners.

## Organization of Finance Function

Top management such as the board of directors, managing directors, chief executives and committee of the board are responsible for executing the finance policy of the firm. Finance functions vary from one firm to another, depending on the nature of business, size of the organization, financial philosophy and the ability of management. The title of the Chief Executive of the Finance Department is also assigned to different people in different firms. For example, in some organizations they are Finance managers, while in others they are Vice President (Finance), Director (Finance), or the Financial Controller.

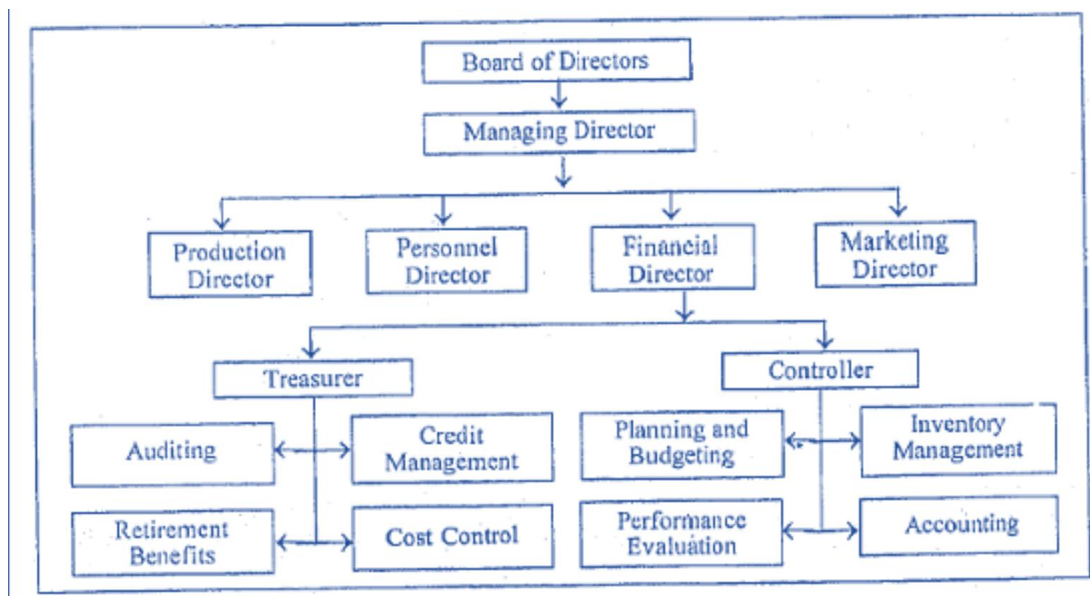


**Figure 11.2** : Organization for a finance function

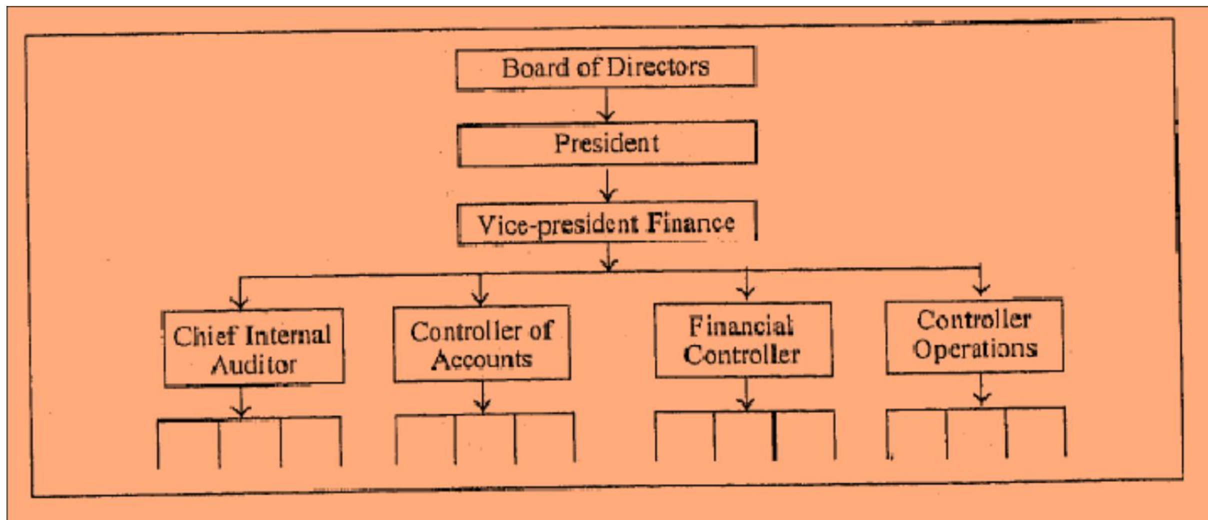


**Figure 11.3**: Organization for finance function in a multi-divisional Indian company

Controllers and Treasurers function under the Chief Executive and are responsible for the organisation's accounting and control functions and its financial activities. There are various functions that a Treasurer has to perform including; obtaining finance, maintaining relationships with investors and banks, short-term financing, cash management, credit administration etc. The Controller, on the other hand, deals with financial accounting, taxations management, internal audit, management accounting, budgeting and control, planning, and economic appraisals, etc. Finance function is one of the most important organizational functions and the Board of Directors supervises Financial Managers/Directors as illustrated in Figure 11.3.

## Finance and Related Disciplines

Finance is intricately linked with other important disciplines, as well and derives a lot from them. These related disciplines not only include accounting and economics, but other subjects, as well, such as, marketing, quantitative methods, and production, etc. The link between finance and some of these disciplines is explained below:

## Finance and Accounting

There are two aspects of this relationship:

i. Accounting is an important input for financial decisions.
ii. Certain differences do exist between finance and accounting.

Accounting provides information through financial statements, which help managers to derive important data from the past, make assessments about the future and fulfill the organisation's legal obligations, as well. Therefore, both accounting and finance are interdependent.

The major differences between accounting and finance are discussed as follows:

**a. The Treatment of Funds:**

Accounting works on the concept of accruals. In simpler words, accounting recognizes revenues when a sale is made, as opposed to when the sale is paid for. Similarly, expenses are recognized when they are incurred and not when they are actually paid for. On the contrary to this, finance only considers cash flows. Revenue and expense are recognized only when cash is received or paid.

**b. Decision Making:**

Accounting deals with collection and presentation of data in the form of financial statements and finance deals with making decisions based on financial statements. This does not imply that accountants never make decisions or financial managers never present or prepare data.

However, accounting's primary objective is recording and presenting data, while the financial managers' main focus is on planning, controlling, and decision-making. In short, the role of the financial manager starts where that of the accountant ends.

## Economics and Finance

Finance came into being in the 1920s as an offshoot of the Economic Theory regarding firms. The financial manager has to rely on theories of microeconomics and microeconomic models to develop strategy and take important financial decisions. Economic concepts such as marginal cost and marginal revenue are the basis of financial elements, such as, investment decisions and working capital management, etc.

### Further Reading:


- ✓ *Eugene F. Brigham, Joel F. Houston, (2012), Fundamentals of Financial Management: Concise Edition*
- ✓ *H. Kent Baker, Gary Powell, (2005), Understanding Financial Management: A Practical Guide*