Meaning and Definition of Financial Management

Financial management is that managerial activity which is concerned with the *planning and controlling of the firm's financial resources*. In other words, it is concerned with *acquiring, financing and managing assets to accomplish the overall goal of a business enterprise* (mainly to maximize the shareholder's wealth).

"Financial management is concerned with the *efficient use of an important economic resource*, namely capital funds"

- Solomon Ezra & J. John Pringle

"Financial management is the *operational activity of a business that is responsible for obtaining and effectively utilizing the funds* necessary for efficient business operations"

- J.L Massie

"Financial Management is concerned with managerial decisions that result in the acquisition and financing of long-term and short-term credits of the firm. As such, it deals with the situations that require selection of specific assets (or combination of assets), the selection of specific liability (or combination of liabilities) as well as the problem of size and growth of an enterprise. The analysis of these decisions is based on the expected inflows and outflows of funds and their effects upon managerial objectives".

- Phillippatus

Need/ Importance of Financial Management

Finance is the lifeblood of business organization. It needs to meet the requirement of the business concern. Each business concern must maintain adequate amount of finance for their smooth running of the business concern and maintain the business carefully to achieve the goal of the business concern. The business goal can be achieved only with the help of effective management of finance. We cannot neglect the importance of finance at any time at and at any situation.

Some of the importance of the financial management is as follows:

1. Financial Planning: Financial management **helps to determine the financial requirement of the business concern and leads to take financial planning** of the concern. Financial planning is an important part of the business concern, which helps to promotion of an enterprise.

2. Acquisition of Funds: **Financial management involves the acquisition of required finance to the business concern**. Acquiring needed funds play a major part of the financial management, which involve possible source of finance at minimum cost.

3. Proper Use of Funds: **Proper use and allocation of funds leads to improve the operational efficiency** of the business concern. When the finance manager uses the funds properly, they can reduce the cost of capital and increase the value of the firm.

4. Financial Decision: **Financial management helps to take sound financial decision** in the business concern. Financial decision will affect the entire business operation of the concern. Because there is a direct relationship with various department functions such as marketing, production personnel, etc.

5. Improve Profitability: **Profitability of the concern purely depends on the effectiveness and proper utilization of funds** by the business concern. Financial management helps to improve the profitability position of the concern with the help of strong financial control devices such as budgetary control, ratio analysis and cost volume profit analysis.

6. Increase the Value of the Firm: **Financial management is very important in the field of increasing the wealth of the investors** and the business concern. Ultimate aim of any business concern will achieve the maximum profit and higher profitability leads to maximize the wealth of the investors as well as the nation.

7. Promoting Savings: Savings are possible only when the business concern earns higher profitability and maximizing wealth. Effective financial management helps to promoting and mobilizing individual and corporate savings.

Functions/ Decision areas of Financial Management

Financial management is mainly concerned with the following decisions:

A. Investment Decisions

A firm must decide where to invest the funds such that it can earn *maximum returns*. Such decisions are known as investment decisions and can be classified as long-term and short-term investment decisions.

- Long-term investment decisions:
  - ✓ It refers to *long-term investment decisions* such as investment in a new fixed asset, new machinery or land.
  - ✓ They are also known as *Capital Budgeting decisions*.
  - ✓ It affects a firm's long-term earning capacity and profitability and has long-term implications on the *business*.
  - ✓ Moreover, such investment involves a *large amount of money*, so it is very difficult to revert such decisions.
  - ✓ Example: Decision to purchase a new fixed asset, opening a new branch etc.

- Short-term investment decisions
  - ✓ These decisions are also known as working capital decisions and affect day-to-day business operations.
  - ✓ It also affects the liquidity and profitability of a business.
  - ✓ Example: Decisions related to cash management, inventory management etc.

B. Financial Decisions

- ✓ Financing decisions involve decisions with regard to the *volume of funds* to be raised from *various sources*.
- ✓ These decisions also include *identification of sources of finance*.
- ✓ There are two main sources of raising funds, namely *shareholders' funds* (Equity) and *borrowed funds* (Debt).
- ✓ Taking into consideration factors such as *cost, risk and profitability*, a company must *decide an optimum combination of debt and equity*.

- ✓ For example, while **debt proves to be cheaper than equity**, it involves greater financial risk.
- ✓ Financial decisions must be taken judiciously as they have an *impact on the overall cost of capital* of the firm and also involves financial risk.
- ✓ Generally, a mixture of both debt and equity funds proves to be beneficial for the company.

C. Dividend Decisions

- ✓ Dividend decisions involve decisions regarding how the company would *distribute* its profit or surplus.
- ✓ Dividend is a part of profit, which is distributed to shareholders.
- ✓ The company decides whether to distribute it to *equity shareholders in the form of dividends* or to keep it in the form of *retained earnings*.
- ✓ So, the main decision is regarding how much profit is to be distributed and how much is to be retained in the business.
- ✓ This decision is generally taken considering the objective of maximizing shareholder's wealth and retaining earnings to increase the future earning capacity of the organization.

Scope of Financial Management

Financial management is one of the important parts of overall management, which is directly related with various functional departments like personnel, marketing and production. Financial management covers wide area with multidimensional approaches. The following are the important scope of financial management.

1. Financial Management and Economics

Economic concepts like micro & macroeconomics are directly applied with the financial management approaches. Investment decisions, micro & macro environmental factors are closely associated with the functions of financial manager. Financial management also uses the economic equations like money value, discount factor, economic order quantity etc. Financial economics is one of the emerging area, which provides immense opportunities to finance, and economical areas.

2. Financial Management and Accounting

Accounting records includes the financial information of the business concern. Hence, we can easily understand the relationship between the financial management and accounting. In the olden periods, both financial management and accounting are treated as a same discipline and then it has been merged as Management Accounting because this part is very much helpful to finance manager to take decisions. However, financial management and accounting discipline are separate and interrelated.

3. Financial Management or Mathematics

Modern approaches of the financial management applied large number of mathematical and statistical tools and techniques. They are also called as econometrics. Economic order quantity, discount factor, time value of money, present value of money, cost of capital, capital structure theories, dividend theories, ratio analysis and working capital analysis are used as mathematical and statistical tools and techniques in the field of financial management.

4. Financial Management and Production Management

Production management is the operational part of the business concern, which helps to multiple the money into profit. Profit of the concern depends upon the production performance. Production performance needs finance, because production department requires raw material, machinery, wages, operating expenses etc. These expenditures are decided and estimated by the financial department and the finance manager allocates the appropriate finance to production department. The financial manager must be aware of the operational process and finance required for each process of production activities.

5. Financial Management and Marketing

Produced goods are sold in the market with innovative and modern approaches. For this, the marketing department needs finance to meet their requirements. The financial manager or finance department is responsible to allocate the adequate finance to the marketing department. Hence, marketing and financial management are interrelated and depends on each other.

6. Financial Management and Human Resource

Financial management is also related with human resource department, which provides a power to all the functional areas of the management. Financial manager should carefully evaluate the requirement of manpower to each department and allocate the finance to the human resource department as wages, salary, remuneration, commission, bonus, pension and other monetary benefits to the human resource department. Hence, financial management is directly related with human resource management.

Objectives of Financial Management

Broadly, there are two alternative objectives that a business firm can pursue.

- Profit Maximization
- Wealth Maximization

Profit Maximization (Traditional Approach)

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 shareholders**, 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 Cutthroat 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.

Wealth Maximization (Modern Approach)

Wealth maximization is one of the modern approaches, which involves latest innovations and improvements in the field of the business concern. The term wealth means shareholder wealth or the wealth of the persons those who are involved in the business concern. Wealth maximization is also known as value maximization or net present worth maximization. This objective is a universally accepted concept in the field of business.

Favorable Arguments for Wealth Maximization

(i) Wealth maximization is superior to the profit maximization because the main aim of the business concern under this concept is to improve the value or wealth of the shareholders.

(ii) Wealth maximization considers the comparison of the value to cost associated with the business concern. Total value detected from the total cost incurred for the business operation. It provides extract value of the business concern.
(iii) Wealth maximization considers both time and risk of the business concern.
(iv) Wealth maximization provides efficient allocation of resources.
(v) It ensures the economic interest of the society.

Unfavorable Arguments for Wealth Maximization

(i) Wealth maximization leads to prescriptive idea of the business concern but it may not be suitable to present day business activities.
(ii) Wealth maximization is nothing, it is also profit maximization, it is the indirect name of the profit maximization.
(iii) Wealth maximization creates ownership-management controversy.
(iv) Management alone enjoy certain benefits.

CONFLICT

Profit Maximization	Wealth Maximization
• Its main objective is to earn large amount of profits.	• Its main objective is to achieve highest market value of common stock.
• It emphasizes short term.	• It emphasizes long term.
• It ignores Time value of money.	• It considers Time value of money.
• It ignores risk and uncertainty.	• It recognizes risk and uncertainty.
• It ignores timing of return.	• It recognizes the timings of return.

Time Value of Money

Definition:

Money has time value. In simpler terms, the value of a certain amount of money today is more valuable than its value tomorrow. It is not because of the uncertainty involved with time but purely because of timing. The difference in the value of money today and tomorrow is referred to as the time value of money.

Money has time value because of the following reasons:

- Risk and Uncertainty

Future is always uncertain and risky. Outflow of cash is in our control as payments to parties are made by us. There is no certainty for future cash inflows. Cash inflows are dependent on our Creditor, Bank etc. As an individual or firm is not certain about future cash receipts, it prefers receiving cash now.

- Inflation

In an inflationary economy, the money received today, has more purchasing power than the money to be received in future. In other words, a rupee today represents a greater real purchasing power than a rupee a year after.

- Consumption

Individuals generally prefer current consumption to future consumption.

- Investment opportunities

An investor can profitably employ a rupee received today, to give him a higher value to be received tomorrow or after a certain period of time. Thus, the fundamental principle behind the concept of time value of money is that, a sum of money received today, is worth more than if the same is received after a certain period of time. For example, if an individual is given an alternative either to receive Rs.10,000 now or after one year, he will prefer Rs. 10,000 now. This is because, today, he may be in a position to purchase more goods with this money than what he is going to get for the same amount after one year.

Thus, the concept of time value of money is a vital consideration in making financial decisions.

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