Financial Management

Meaning of Financial Management

Finance is the lifeline of any business. However, finances, like most other resources, are always limited. On the other hand, wants are always unlimited. Therefore, it is important for a business to manage its finances efficiently.

Financial management, is that branch of general management, which has grown to provide specialized and efficient financial services to the whole enterprise; involving, in particular, the timely supplies of requisite finances and ensuring their most effective utilization-contributing to the most effective and efficient attainment of the common objectives of the enterprise. Financial management is management principles and practices applied to finance. General management functions include planning, execution and control. Financial decision making includes decisions as to size of investment, sources of capital, extent of use of different sources of capital and extent of retention of profit or dividend payout ratio.

Definition

"Financial management is the activity concerned with planning, raising, controlling and administering of funds used in the business." – **Guthman and Dougal**

Nature of Financial Management

(i) Financial management is a specialized branch of general management, in the present-day-times. Long back, in traditional times, the finance function was coupled, with production or with marketing; without being assigned a separate status.

(ii) Financial management is growing as a profession. Young educated persons, aspiring for a career in management, undergo specialized courses in Financial Management, offered by universities, management institutes etc.; and take up the profession of financial management.

(iii) Financial management is multi-disciplinary in approach. It depends on other disciplines, like Economics, Accounting etc., for a better procurement and utilization of finances.

(iv) The finance manager is often called the Controller; and the financial management function is given name of controllership function; in as much as the basic guideline for the formulation and implementation of plans.

(v) Financial management is not simply a basic business function along with production and marketing; it is more significantly, the backbone of commerce and industry. It turns the sand of dreams into the gold of reality.

Scope of Financial Management

The finance function encompasses the activities of raising funds, investing them in assets and distributing returns earned from assets to shareholders. While doing these activities, a firm attempts to balance cash inflow and outflow

Thus the finance function includes:

1. Investment decision

2. Financing decision

3. Dividend decision

4. Working Capital decision

1. Investment Decision:

The investment decision, also known as capital budgeting, is concerned with the selection of an investment proposal/ proposals and the investment of funds in the selected proposal.

The investment decision involves the evaluation of risk, measurement of cost of capital and estimation of expected benefits from a project. Capital budgeting and liquidity are the two major components of investment decision. Capital budgeting is concerned with the allocation of capital and commitment of funds in permanent assets which would yield earnings in future.

Capital budgeting is a very important decision as it affects the long-term success and growth of a firm. At the same time it is a very difficult decision because it involves the estimation of costs and benefits which are uncertain and unknown.

2. Financing Decision:

Financing decision is the second important function to be performed by the financial manager. Broadly, he or she must decide when, from where and how to acquire funds to meet the firm's investment needs. The central issue before him or her is to determine the appropriate proportion of equity and debt.

The finance manager must develop the best finance mix or optimum capital structure for the enterprise so as to maximize the long- term market price of the company's shares. A proper balance between debt and equity is required so that the return to equity shareholders is high and their risk is low. The finance department has also to decide the appropriate time to raise the funds and the method of issuing securities.

3. Dividend Decision:

Dividend decision is the third major financial decision. The financial manager must decide whether the firm should distribute all profits, or retain them, or distribute a portion and return the balance. The finance manager should consider the investment opportunities available to the firm, plans for expansion and growth, etc. Decisions must also be made with respect to dividend stability, form of dividends, i.e., cash dividends or stock dividends, etc.

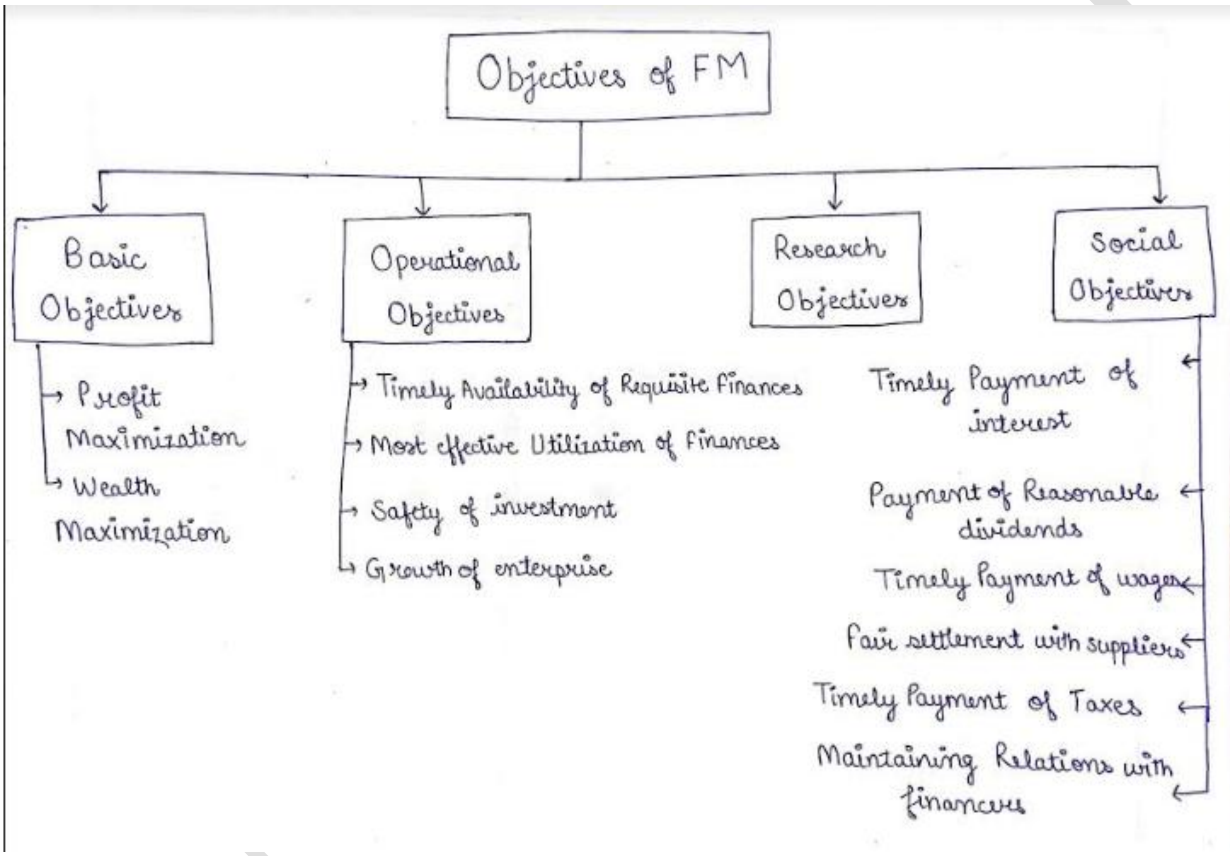
The proportion of profits distributed as dividends is called the dividend-payout ratio and the retained portion of profits is known as the retention ratio. Like the debt policy, the dividend policy should be determined in terms of its impact on the shareholders' value.

4. Working Capital Decision:

Working capital decision is related to the investment in current assets and current liabilities. Current assets include cash, receivables, inventory, short-term securities, etc. Current liabilities consist of creditors, bills payable, outstanding expenses, bank overdraft, etc. Current assets are those assets which are convertible into cash within a year. Similarly, current liabilities are those liabilities, which are likely to mature for payment within an accounting year.

Objectives of Financial Management

Objectives of financial management may be multiple; as this branch of general management encompasses the entire organizational functioning.



(1) Basic Objectives:

(i) Profit-Maximization:

Since time immemorial, the primary objective of financial management has been held to be profit-maximization. That is to say, that financial management ought to take financial decisions and implement them in a way so as to lead the enterprise along lines of profit maximization.

(ii) Wealth-Maximization:

Discarding the profit-maximization objective; the real basic objective of financial management, now-a-days, is considered to be wealth maximization. Wealth maximization is also known as value-maximization or the net present worth maximization. Since wealth of owners is reflected in the market-value of shares; wealth maximization means the maximization of the market price of shares. Accordingly, wealth maximization is measured, by the market value of shares.

(2) Operational Objectives:

(i) Timely Availability of Requisite Finances:

A very important operational objective of financial management is to ensure that requisite funds are made available to all the departments, sections or units of the enterprise at the needed time; so that the operational life of the enterprise goes smoothly.

(ii) Most Effective Utilization of Finances:

Throughout the enterprise, the finances must be utilized most effectively. This is yet, another important operational objective of the financial, management.

(iii) Safety of Investment:

The financial management must primarily look to the safety of investment i.e. the channels of investment might bring in less returns; but investment must be safe. Loss of investment, in any one line, might lead to capital depletion; and ultimately tell upon the financial health of the enterprise.

(iv) Growth of the Enterprise:

The financial management must plan for the long-term stability and growth of the enterprise. The limited finances of the enterprise must be so utilized that not only short run benefits are available.

(3) Social Objectives:

(i) Timely Payment of Interest:

The financial management must see to it that interest on bonds, debentures or other loans of the company is paid in time. This will not only keep the creditors satisfied with the company adding to its goodwill; but also prevent any untoward consequences of the non-payment of interest, in time.

(ii) Payment of Reasonable Dividends:

An important social objective of financial management is that shareholders i.e. the equity members of the company must get at least some regular dividends.

(iii) Timely Payment of Wages:

The financial management must make a provision for a timely payment of wages to workers. This is necessary to keep the labor force satisfied and motivated. Further, if wages are paid on time; the legal consequences of non-payment of wages, under the ' Payment of Wages Act', need not frighten management.

(iv) Fair-Settlement with Suppliers:

The financial management must make it a point to settle accounts with suppliers and fellow-businessmen in time, in a fair way; otherwise the commercial reputation of the enterprise will get a setback.

(v) Timely Payment of Taxes:

An important objective of financial management would be to make timely payment of taxes to the Government – so as to avoid legal consequences; and also fulfill its social obligations towards the State.

(vi) Maintaining Relations with Financiers:

The financial management must develop and maintain friendly relations with financiers i.e. banks, financial institutions and various segments of the money market and capital market

(4) Research Objectives:

The successful attainment of various objectives by the financial management requires it to follow a research approach. It must research into new and better sources of finances; and also into new and better channels for the investment of finances.