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. As an introduction to financial management, in this article, we will look at the nature, scope, and significance of financial management, along with financial decisions and planning.

In a nutshell, financial management –

- Endeavors to reduce the cost of finance
- Ensures sufficient availability of funds
- Deals with the planning, organizing, and controlling of financial activities like the procurement and utilization of funds

DEFINITIONS

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

"Financial management is that area of business management devoted to a judicious use of capital and a careful selection of the source of capital in order to enable a spending unit to move in the direction of reaching the goals." – **J.F. Brandley**

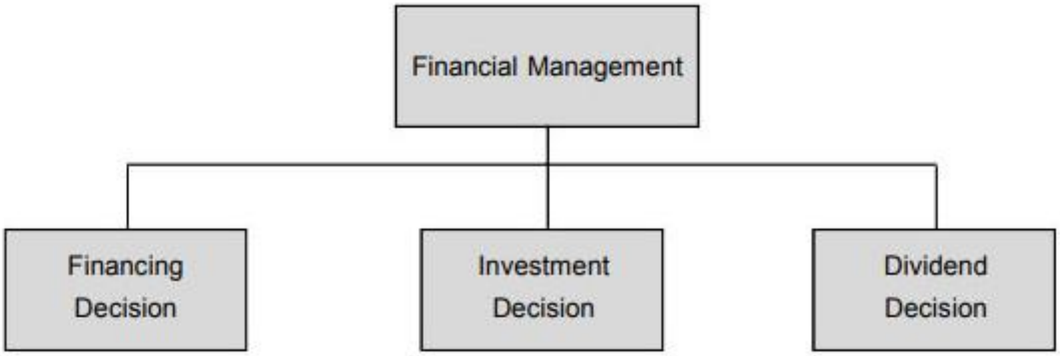
"Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations."**- Massie**

Scope of Financial Management

The introduction to financial management also requires you to understand the scope of financial management. It is important that financial decisions take care of the shareholders' interests.

Further, they are upheld by the maximization of the wealth of the shareholders, which depends on the increase in net worth, capital invested in the business, and plowed-back profits for the growth and prosperity of the organization.

The scope of financial management is explained in the diagram below:



You can understand the nature of financial management by studying the nature of investment, financing, and dividend decisions.

Financial Management Decisions

In organizations, managers in an effort to minimize the costs of procuring finance and using it in the most profitable manner, take the following decisions:

Investment Decisions

Managers need to decide on the amount of investment available out of the existing finance, on a long-term and short-term basis. They are of two types:

- **Long-term investment decisions** or Capital Budgeting mean committing funds for a long period of time like fixed assets. These decisions are irreversible and usually include the ones pertaining to investing in a building and/or land, acquiring new plants/machinery or replacing the old ones, etc. These decisions determine the financial pursuits and performance of a business.

- **Short-term investment decisions** or Working Capital Management means committing funds for a short period of time like current assets. These involve decisions pertaining to the investment of funds in the inventory, cash, bank deposits, and other short-term investments. They directly affect the liquidity and performance of the business.

Financing Decisions

Managers also make decisions pertaining to raising finance from long-term sources (called Capital Structure) and short-term sources (called Working Capital). They are of two types:

- **Financial Planning decisions** which relate to estimating the sources and application of funds. It means pre-estimating financial needs of an organization to ensure the availability of adequate finance. The primary objective of financial planning is to plan and ensure that the funds are available as and when required.

- **Capital Structure decisions** which involve identifying sources of funds. They also involve decisions with respect to choosing external sources like issuing shares, bonds, borrowing from banks or internal sources like retained earnings for raising funds.

Dividend Decisions

These involve decisions related to the portion of profits that will be distributed as dividend. Shareholders always demand a higher dividend, while the management would want to retain profits for business needs. Hence, this is a complex managerial decision.

Objectives of Financial Management

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

1. To ensure regular and adequate supply of funds to the concern.
2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
4. To ensure safety on investment, i.e., funds should be invested in safe ventures so that adequate rate of return can be achieved.
5. To plan a sound capital Structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

Functions of Financial Management

1. **Estimation of capital requirements:** A finance manager has to make estimation with regards to capital requirements of the company. This will depend upon expected costs and profits and future programmes and policies of a concern. 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. This involves short- term and long- term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.

3. **Choice of sources of funds:** For additional funds to be procured, a company has many choices like:

    a. Issue of shares and debentures

    b. Loans to be taken from banks and financial institutions

    c. Public deposits to be drawn like in form of bonds.

    Choice of factor will depend on relative merits and demerits of each source and period of financing.

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:

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

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

6. **Management of cash:** Finance manager has to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintainance of enough stock, purchase of raw materials, etc.

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. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.