Financial Management

Definition of Financial Management

- Managerial activities which deals with planning and controlling of firms and financial sources.

- Financial management is an area of financial decision making, harmonsing individual motives and enterprise goals.

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Scope of financial management

- The scope and functions of financial management is classified in two categories.

  - Traditional approach

  - Modern approach

Traditional approach

- According to this approach, the scope of the finance function is restricted to “procurement of funds by corporate enterprise to meet their financial needs.
- The term ‘procurement’ refers to raising of funds externally as well as the inter related aspects of raising funds.

Traditional approach

- The inter related aspects are the institutional arrangement for finance, financial instruments through which funds are raised and legal and accounting aspects between the firm and its sources of funds.

- In traditional approach the resources could be raised from the combination of the available sources.

Limitations of traditional approach

- This approach is confirmed to ‘procurement of funds’ only.
- It fails to consider an important aspects i.e. allocation of funds.
- It deals with only outside I.e. investors, investment bankers.

Limitations of traditional approach

- The internal decision making is completely ignored in this approach.
- The traditional approach fails to consider the problems involved in working capital management.
- The traditional approach neglected the issues relating to the allocation and management of funds and failed to make financial decisions.

Modern approach

- The modern approach is an analytical way of looking into financial problems of the firm.
- According to this approach, the finance function covers both acquisition of funds as well as the allocation of funds to various uses.
- Financial management is concerned with the issues involved in raising of funds and efficient and wise allocation of funds.

Main Contents of Modern approach

- How large should an enterprise be and how far it should grow?
- In what form should it hold its assets?
- How should the funds required be raised?

- Financial management is concerned with finding answer to the above problems.

Functions of Finance

- There are three finance functions
  - Investment decision
  - Financing decision
  - Dividend decision

Investment Decision

- Investment decision relates to selections of asset in which funds will be invested by a firm.
- The asset that can be acquired by a firm may be long term asset and short term asset.

Investment Decision

- Decision with regard to long term assets is called capital budgeting.
- Decision with regard to short term or current assets is called working capital management.

Capital Budgeting

- Capital budgeting relates to selection of an asset or investment proposal which would yield benefit in future. It involves three elements.

- The measurement of the worth of the proposal

Capital Budgeting

- Evaluation of the investment proposal in terms of risk associated with it and
- Evaluation of the worth of the investment proposal against certain norms or standard. The standard is broadly known as cost of capital

Financing Decision

- Determination of the proportion of equity and dept is the main issue in financing decision.

- Once the best combination of debt and equity is determined, the next step is raising appropriate amount through available sources.

Working Capital Management

- Working capital management or current asset management is an important part of investment decision.
- Proper management of working capital ensures firm's liquidity and solvency.
- A conflict exists between profitability and liquidity while managing current asset.

Working Capital Management

- If a firm does not invest sufficient funds in current assets it may become illiquid and may not meet its current obligations.
- If the current asset are large, the firm would lose its profitability and liquidity.
- The financial manager should develop proper techniques of managing current assets so that neither insufficient nor unnecessary funds are invested in current assets.

Management of Working Capital

- The management of working capital has two aspects.

  - Overview of working capital management and

  - Efficient management of individual current asset such as cash, receivable and inventory.

Financing Decision

- Financing decision is concerned with the financing mix or capital structure.
- The mix of debt and equity is known as capital structure.

Dividend Decision

- A firm distribute all profits or retain them or distribute a portion and retain the balance with it.
- Which course should be allowed? The decision depends upon the preference of the shareholders and investment opportunities available to the firm.

Dividend Decision

- Dividend decision has a strong influence on the market prize of the share.
- So the dividend policy is to be determined in terms of its impact on shareholder’s value.
- The optimum dividend policy is one which maximizes the value of shares and wealth of the shareholders.

Dividend Decision

- The financial manager should determine the optimum pay out ratio I.e. the proportions of net profit to be paid out to the shareholders.
- The above three decisions are inter related. To have an optimum financial decision the three should be taken jointly.

Objectives of financial management

- The term ‘objective’ refers to a goal or decision for taking financial decisions.
    - Profit maximisation
    - Wealth maximisation

Profit maximisation

- The term profit maximisation is deep rooted in the economic theory.
- It is need that when firms pursue the policy of maximising profits.
- Society's resources are efficiently utilised.

Profit maximisation

- The firm should undertake those actions that would profits and drop those actions that would decrease profit.
- The financial decisions should be oriented to the maximisation of profits.
- Profit provides the yardstick for measuring performance of firms.

Profit maximisation

- It makes allocation of resources to profitable and desirable areas.
- It also ensures maximum social welfare.

Wealth maximisation

- Wealth maximisation or net present value maximisation provides an appropriate and operationally feasible decision criterion for financial management decisions.

Sources of Finance

- Capital required for a business can be classified under two main categories, viz.,

  - Fixed Capital, and
  - Working Capital.

- every business needs funds for two purposes.

- for its establishment and to carry out its day-to-day operations.

Sources of Finance

- Long term funds are required to create production facilities through purchase of fixed assets such as
  - plant,
  - machinery,
  - land,
  - building,
  - furniture, etc.

Sources of Finance

- Investment in these asset represent that part of firm's capital which is blocked on permanent or fixed basis and is called fixed capital.

- Funds are also needed for short-term purposes for the purchase of raw materials, payment of wages and other day to day expenses, etc. These funds are known as working capital.

Sources of Finance/Funds

- In our present day economy, finance is defined as the provision of money at the time when it is required.
- Every enterprise, whether big or medium or small, needs finance to carry on its operations and to achieve its targets.

Sources of Finance/Funds

- In fact finance is so indispensable today that is rightly said that it is the life blood of enterprise.
- With out adequate finance, no enterprise can possibly accomplish its objectives.
- In every concern there are two methods of raising finance, viz.,
  - Raising of owned capital,
  - Rising of borrowed capital

Sources of Finance/Funds

- The financial requirements may be for a long term, medium term or short term.

Financial Requirements

Short-Term	Medium-Term	Long-Term
Bank Credit	Issue of Debentures	Issue of shares
Customer advances	Issue of Preference shares	Issue of Debentures
Trade Credit	Bank Loan	Ploughing back of profits
	Public deposit / Fixed deposit	Loan from spec.financial institutions
	Loans from financial institutions	

Issue of shares

- The company’s owned capital is split into large number of equal parts,such a part being called a “share”.
- The person holding the share as shareholder and becomes part-owner of the company.
- For this reason, the capital so raised is known as “owned capital” and the shares are called “ownership securities”.

Issue of shares

- The share capital of the company is ideal for meeting the long term requirements.
- It need not be paid back to the shareholders within the life time of the company.
- The only exception is the sum raised by the issue of redeemable preference shares.

Types of shares

- A public company can issue two types of share.
    - Equity share
    - Preference share

Equity share

- Equity share has number of special features
- The dividend on these shares are paid after the dividend on preference share has been paid.
- The rate of dividend depends upon the amount of profits available and the intention of directors.

Equity share

- The Equity shareholders have the chance of earning good dividends in times of prosperity and run the risk of earning nothing in times of adversity.
- The equity shareholders have a residual claim on the company's asset in case of liquidation.
- The company is controlled by the equity shareholders and they are entitled to vote in the meetings of the company.

Preference shares

- Preference shares are those which carry preferential right over other class of shares with regard to payment of dividend and repayment of capital.

- The rate of dividend on preference share is a fixed one.