UNIT 11 FINANCIAL MANAGEMENT : AN INTRODUCTION

Objectives

The objectives of this unit are to familiarise you:

- with the scope and functions of financial management
- with the objectives of the business firm
- to the major decisions of the finance function and
- with the structure and organisation of finance department.

Structure

11.1 INTRODUCTION

After getting a fairly good idea about accounting, lets, now move on to what Financial Management is?

Financial management is a managerial activity concerned with planning and controlling of the firm's financial resources to generate returns on its invested funds. The raising and using of capital for generating funds and paying returns to the suppliers of capital is the finance function of a firm. Thus the funds raised by the company will be invested in the best investment opportunities, with an expectation of future benefits. As every business activity either directly or indirectly involves the acquisition and use of funds, there is an inseparable relationship between the finance and other functions like production, marketing etc. However, the raising of funds and using of money may not necessarily limit the general running of the business. A firm in a tight financial position will give more priority to financial considerations to devise its marketing and production strategies in tune with its financial constraints. On the contrary, management of a business firm, with plentiful supply of funds, will be more flexible in formulating its production and marketing policies. In fact, the financial policies will be devised to fit the production and marketing decisions under such a situation. Thus although it may be difficult to separate the finance function from the other functions of the business, the finance function can be broadly discussed as:

i. Managerial functions

ii. Routine functions

The managerial functions require greater planning, control and execution of financial activities. Whereas, the routine functions need a greater managerial talent to carry them out. The routine functions are mainly clerical and incidental to the effective handling of the managerial functions. Some of the important routine functions are:

i. Supervision of cash receipts and payments and safeguarding of cash;

ii. Custody and safeguarding of securities, insurance policies and other valuable papers;

iii. Taking care of the methodological procedures of new outside financing;

iv. Preparation of the reports arid keeping of the records.

These routine functions are carried out by the people at the supervisory levels. About three to four decades ago, the scope of finance function was limited to routine activities and the involvement of the financial executive in the managerial finance activities is a very recent origin.

11.2 SCOPE OF FINANCIAL MANAGEMENT

The scope and functions of financial management are divided into two broad categories:

a. Traditional approach

b. Modern approach

Traditional Approach

The traditional approach to the scope of financial management refers to its subject matter in the academic literature in the initial stages of its evolution as a separate branch of study. According to this approach, the scope of financial management is confined to the raising of funds. Hence, the scope of finance was treated by the traditional approach in the narrow sense of procurement of funds by corporate enterprise to meet their financial needs. Since the main emphasis of finance function at that period was on the procurement of funds, the subject was called corporation finance till the mid-1950's and covered discussion on the financial instruments, institutions and practices through which funds are obtained. Further, as the problem of raising funds is more intensely felt at certain episodic events such as merger, liquidation, consolidation, reorganisation and so on. These are the broad features of the subject matter of corporation finance, which has no concern with the decisions of allocating firm's funds. But the scope of finance function in the traditional approach has now been discarded as it suffers from serious criticisms. Again, the limitations of this approach fall into the following categories.

i. The emphasis in the traditional approach is on the procurement of funds by the corporate enterprises, which was woven around the viewpoint of the suppliers of funds such as investors, financial institutions, investment bankers, etc, i.e. outsiders. It implies that the traditional approach was the outsider-looking-in approach. Another limitation was that internal financial decision-making was completely ignored in this approach.

ii. The second criticism leveled against this traditional approach was that the scope of financial management was confined only to the episodic events such as mergers, acquisitions, reorganizations, consolation, etc. The scope of finance function in this approach was confined to a description of these infrequent happenings in the life of an enterprise. Thus, it places over emphasis on the topics of securities and its markets, without paying any attention on the day to day financial aspects.

iii. Another serious lacuna in the traditional approach was that the focus was on the long-term financial problems thus ignoring the importance of the working capital management. Thus, this approach has failed to consider the routine managerial problems relating to finance of the firm.

During the initial stages of development, financial management was dominated by the traditional approach as is evident from the finance books of early days. The traditional approach was found in the first manifestation by Green's book written in 1897, Meades on Corporation Finance, in 1910; Doing's on Corporate Promotion and Reorganisation, in 1914, etc.

As stated earlier, in this traditional approach all these writings emphasized the financial problems from the outsiders' point of view instead of looking into the problems from managements, point of view. It over emphasized long-term financing lacked in analytical content and placed heavy emphasis on descriptive material. Thus, the traditional approach omits the discussion on the important aspects like cost of the capital, optimum capital structure, valuation of firm, etc. In the absence of these crucial aspects in the finance function, the traditional approach implied a very narrow scope of financial management. The modern or new approach provides a solution to all these aspects of financial management.

Modern Approach

After the 1950's, a number of economic and environmental factors, such as the technological innovations, industrialization, intense competition, interference of government, growth of population, necessitated efficient and effective utilisation of financial resources. In this context, the optimum allocation of the firm's resources is the order of the day to the management. Then the emphasis shifted from episodic financing to the managerial financial problems, from raising of funds to efficient and effective use of funds. Thus, the broader view of the modern approach of the finance function is the wise use of funds. Since the financial decisions have a great impact on all other business activities, the financial manager should be concerned about determining the size and nature of the technology, setting the direction and growth of the business, shaping the profitability, amount of risk taking, selecting the asset mix, determination of optimum capital structure, etc. The new approach is thus an analytical way of viewing the financial problems of a firm. According to the new approach, the financial management is concerned with the solution of the major areas relating to the financial operations of a firm, viz., investment, and financing and dividend decisions. The modern financial manager has to take financial decisions in the most rational way. These decisions have to be made in such a way that the funds of the firm are used optimally. These decisions are referred to as managerial finance functions since they require special care with extraordinary administrative ability, management skills and decision - making techniques, etc.

11.3 FINANCE FUNCTIONS

Finance functions can be divided into three major decisions, which the firm must make, namely the investment decision, the finance decision, and the dividend decision. Each of these decisions must be considered in relation to the objective of the firm: an optimal combination of the three decisions will maximize the value of the share to its shareholders. Since, these decisions are interrelated, we must consider their joint impact on the market price of the firm's stock. Now, in the following pages we will briefly discuss each of these decisions.

A. Investment Decision

The investment decision is the most important one among the three decisions. It relates to the selection of assets in which funds are invested by the firm. The assets, which can be acquired, fall into two broad groups:

i. Long-term assets which will yield a return over a period of time in future,

ii. Short-term I current assets which are convertible into cash in the normal course of business usually within a year.

Accordingly, the asset selection decision of a firm is of two types. The first of these involving the first category of assets is popularly known as capital budgeting. The other one, which refers to short-term assets, is designated as liquidity decision.

i. Capital budgeting decision

It is the most crucial financial decision of a firm which relates to the selection of an investment proposal whose benefits are likely to arise in future over the life-time of the project. The first aspect of the capital budgeting decision is the choice of the investment out of the available alternatives. The selection will be always based on the relative benefits and returns associated with it. Therefore, the measurement of the worth of the investment proposal is a major element in the capital budgeting decision. Another aspect of the capital budgeting decision is the analysis of risk and uncertainty. As, the benefits from the proposed investment relate to the future period, their accrual is uncertain. Thus, an element of risk in the sense of uncertainty of future benefits is involved in this exercise. Therefore, the return from the proposed investment should be evaluated in relation to the risk associated with it. Finally, this return should be judged with a certain norm, which is referred by several names such as cut-off rate, required rate, hurdle rate, minimum rate of return, etc. The correct standard to use for this purpose is the company's cost of capital, which is another important aspect of the capital budgeting decision.

ii. Liquidity decision

The liquidity decision is concerned with the management of the current assets, which is a pre-requisite to long-term success of any business firm. The main objective of the current assets: management is the trade - off between profitability and liquidity. There is a conflict between these two concepts. If a firm does not have adequate working capital, it may become illiquid and consequently fail to meet its current obligations thus inviting the risk of bankruptcy. On the contrary, if the current assets are too large, the profitability is adversely affected. Hence, the key strategy and the main consideration in ensuring a trade-off between profitability and liquidity is the major objective of the liquidity decision. Besides, the funds should be invested optimally in the individual current assets to avoid inadequacy or excessive locking up of funds in these assets. Thus, the liquidity decision should obtain the basic two ingredients, i.e. overview of working capital management and the efficient allocation of funds on the individual current assets.

B. Financing Decision

The second major decision of the firm is the financing decision for determining the best financing mix of the firm.

After determining the asset-mix, the financial manager must decide the mode of raising the funds to meet the firm's investment requirements. The major issue in this decision is to determine the proportion of equity and debt capital. Since the involvement of debt capital affects the return and risk of shareholders, the financial manager should get the optimal capital structure to maximise the shareholders' return with minimum risk, in other words the cost of capital is the lowest and the market value of the share is the highest at that combination of debt and equity. Thus, the financing decision covers two inter-related aspects: (i) capital structure theory, and (ii) capital structure decision.

C. Dividend Decision

The third important decision of a firm is its dividend policy. The financial manager must decide whether the firm should distribute all profits or retain it in the firm or distribute part and retain the balance. The dividend decision should be taken in terms of its impact on the shareholders' wealth. The optimum dividend policy is one, which maximizes the market value of share. Thus, if the shareholders are not indifferent to the firm's dividend policy, the financial manager must determine the optimum dividend-payout ratio. Another important aspect of the dividend decision is the factors determining dividend policy of the firm in practice.

To summarise, the financial management involves the solution of the three decisions of the firm according to the modern approach. The traditional approach with a very narrow perception was devoid of an integrated conceptual and analytical framework. In contrast the modern approach has broadened the scope of financial management to ensure the optimum decisions by fulfilling the objectives of the business firm.

11.4 OBJECTIVES OF THE FIRM

It is clear from the above discussion that the modern approach to financial management is to give answers for three questions: where to invest and in what amounts how to raise and in what amount, and when to pay dividends. These aspects relate to the firm's investment, financing and dividend policies. In order to meet them rationally, the firm must have an objective. It is generally agreed that the financial objective of the firm should be the maximisation of owners' economic welfare. However, there is a disagreement as to how the economic welfare of the owners can be maximised. The two well known and widely discussed criteria in this respect are:

a. Profit maximisation, and

b. Wealth maximisation

A. Profit Maximisation

According to this concept, actions that increase the firm's profit are undertaken while those that decrease profit are avoided. The profit can be maximised either by increasing output for a given set of scarce input or by reducing the cost of production for a given output. The modern economics states that the profit maximisation is nothing but a criterion for economic efficiency as profits provide a yardstick by which economic performances can be judged under condition of perfect competition. Besides, under perfect competition, profit maximisation behaviour by firms leads to an efficient allocation of resources with maximum social welfare. Since, the capital is a scarce material, the financial manager should use these capital funds in the most efficient manner for achieving the profit maximisation. It is, therefore, argued that profitability maximisation should serve as the basic criterion for the ultimate financial management decisions.

The profit maximisation criterion has, however, been questioned and criticised on the following grounds:

i. its vagueness

ii. it ignores the timing of benefits

iii. it ignores risk

One practical difficulty with profit maximisation criterion is that the term profit is vague and ambiguous as it is amenable to different interpretations, like, profit before tax or after tax, total profit or rate of return, etc. If profit maximisation is taken to be the objective, the problem arises, which of these variants of profit to be maximised? Hence, a vague concept of profit cannot form the basis of operation for financial management.

A more important technical objection to profit maximisation is that it ignores the differences in the time pattern of the cash inflows from investment proposals. In other words, it does not recognise the distinction between the returns in different periods of time and treat them at a par which is not true in real world as the benefits in earlier years should be valued more than the benefits received in the subsequent years.

Another limitation of profit maximisation as an operational objective is that it ignores the quality aspect of benefits associated with a financial course of action. The quality here refers to the degree of certainty with which benefits can be obtained. As a matter of fact, the more certain the expected return, the higher the quality of the benefits. Conversely, the more uncertain the expected returns, the lower the quality of benefits, which implies risk to the investors. Generally, the investors want to avoid or at least to minimise the risk. Hence, the concept of profit maximisation is unsuitable as an operational criterion for financial management, as it only considers the size of benefits but gives no weight to the degree of uncertainty of future benefits.

Therefore, from the above discussion, it clear that the profit maximisation concept is inappropriate to a firm from the point of view of financial decisions, i.e. investment, finance and dividend policies. It is not only vague and ambiguous but also it does not recognise the two basic aspects, i.e., risk and time value of money. The most appropriate operational decision criteria should consist of the following aspects:

i. it must be precise and exact;

ii. it should consider both quality and quantity dimension of the receipts;

iii. it should be based on the bigger the better principle; and

iv. it should recognise the time value of money.

An alternative to profit maximisation, which solves these issues is the wealth maximisation objective.

B. Wealth Maximisation

The most widely accepted objective of the firm is to maximise the value of the firm for its owners. The wealth maximisation goal states that the management should seek to maximise the present value of the expected returns of the firm. The present value of future benefits is calculated by using its discount rate (cost of capital) that reflects both time and risk. The discount rate (capitalisation rate) that is applied is, therefore, the rate that reflects the time and risk preferences of the suppliers of capital.

The next feature of wealth maximisation criterion is that it takes; both the quantity and quality dimensions of benefits along with the time value of money. Other things being equal, income with certainty are valued more than the uncertain ones. Similarly, the benefits received in earlier period should be valued more than the benefits received in later period, in this criterion. Thus, the objective of wealth maximisation has a number of distinct merits.

It is quite clear that the wealth maximisation is, no doubt, superior to the profit maximisation objective. The wealth maximisation objective involves a comparison of present value of future benefits to the cash outflow. If the activity results in positive net present value, i.e. the present value of future stream of cash flows exceeds the present value of outflows, reflecting both time and risk, it can be said to create wealth and such actions should be undertaken. Conversely, actions with value less than its cost reduce the wealth of the firm and should be rejected. In case of mutually exclusive projects, when only one is to be chosen, the alternative with the greatest net present value should be selected.

According to Ezra Solomon's symbols and methods, the net present wealth can be ascertained as under:

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

According to the modern approach the objective of the financial management is to maximise the wealth of the firm.

The objective of wealth maximisation can also be explicitly defined by short-cut method symbolically as under:

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

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

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

C_o is the cost of the project

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

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

It is abundantly clear from the above discussion that the wealth maximization criterion recognizes the time value of money and also tackles the risk, which is ascertained by the uncertainty of the expected benefits. That is why, it is rightly said that maximization of wealth is more useful than minimization of profits as a statement of the objective of most business firms.

11.5 RISK-RETURN TRADE-OFF

The financial decisions of the firm are interrelated as they jointly affect the market value of the shares by influencing return and risk. This relationship between return and risk can be expressed as:

Return = Risk-free rate + Risk premium

Here the risk free rate is a compensation for time and risk premium for risk coverage. In order to maximise the market value of the firm's shares, a proper balance between return and risk should be maintained. Such a balance is called as risk-return trade-off. It is the overview of the functions of financial management, which is depicted, in the following figure:

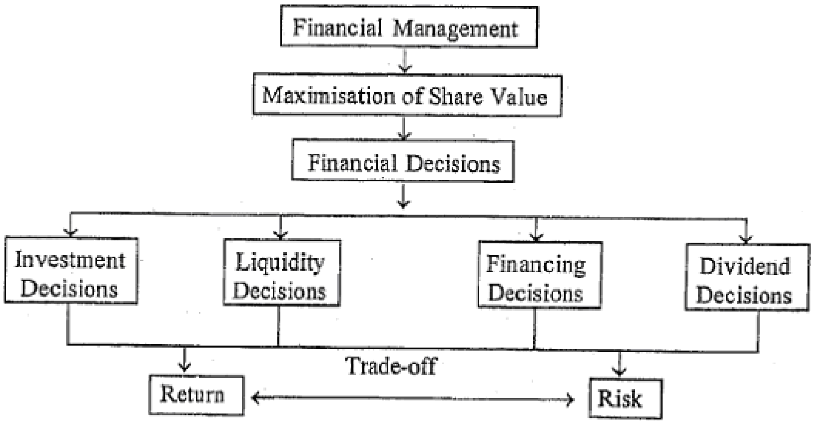

Figure 11.1: An overview of financial management

11.6 CONFLICT OF GOALS: MANAGEMENT VS OWNERS

In the joint stock company form of organisations, the decision-making lies in the hands of its management. While taking the decisions, the management need not necessarily act in the best interest of the shareholders and may pursue their own personal welfare, job security, etc. In other words, there may be a divergence between the shareholders' wealth maximization goal and the actual goals pursued by the management of the business firm. The main reason, which has been attributed for this, is the separation of ownership and control (management) in these organisations. But in practice, the possibility of pursuing exclusively the managernents personal welfare is considered remote because the continuous supervision by the owners, employees, creditors, customers, government will restrict management's freedom to act for their own interests. Every group connected with the company will evaluate the management performance from their point of view. The survival of the management will be threatened if their objectives remain unfulfilled. The wealth maximization criterion may be generally in accordance with the interests of the parties who are related to the organisation. However, situations arise where a conflict may occur between the shareholders' and managements goals, that is the management may play safe and create satisfactory wealth for the shareholders which may not be the maximum one. Such type of attitude of management towards the shareholders goal will frustrate the objective of shareholders wealth maximization.

11.7 FINANCIAL GOALS AND FIRM'S OBJECTIVES

In the shareholders' wealth maximisation criterion a question may arise: Is wealth maximisation the objective of the firm? Does a firm exist with the sole objective of serving the interests of owners? The business firms do not exist with the main objective of maximising the welfare of shareholders. The survival and the future growth of the firm always depends on how it satisfies its customers through the quality of goods and services. Further, the firms in practice set their vision or mission concerned with technology, leadership, market share, image, welfare of employees, etc. Hence, the firm designs its strategy around such basic objectives in the areas of technology, production, purchase, marketing, finance, etc. For this, the firm takes its decisions, which are consistent with its strategies. Therefore, the wealth maximisation objective is the second level criterion, which ensures to meet the minimum standard of the economic performance. As a matter of fact, the management is not only the agent of owners, but also trustee for the owners. Hence, it is the responsibility of the management to harmonise the interests of owners with that of creditors, employees, government, society, etc.

11.8 ORGANISATION OF FINANCE FUNCTION

Since the finance function is a major functional area, the ultimate responsibility for carrying out the financial management functions lies with the top management: Board of directors / Managing director / chief executive / committee of the Board. However, the exact nature of the organisation of the finance function differs from firm to firm depending upon the factors such as size of the firm, nature of the business, ability of the financial executive, financial philosophy, etc. similarly, the designation of the chief executive of the finance department also differs widely in case of different firms. In some cases, they are known as finance managers while in others as vice-president (Finance), or Director (Finance), or Financial controller, etc.

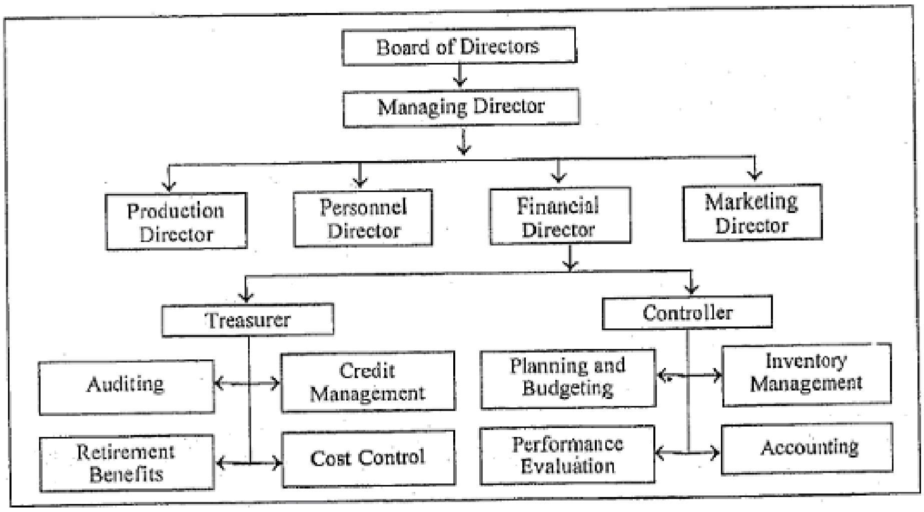

Figure 11.2 : Organisation for finance function

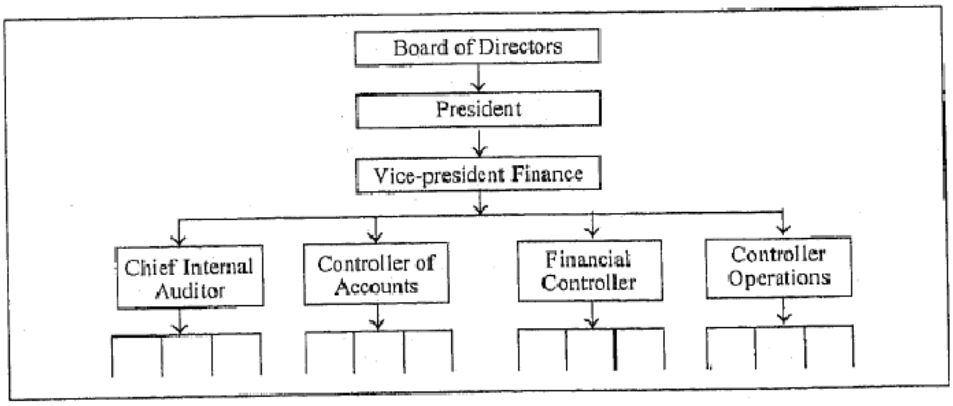

Figure 11.3: Organisation for finance function in a multi-divisional Indian company

Under the chief executive, there are controllers, treasurers, who will be looking after the sub functions viz., accounting and control; and financing activities in the firm. The functions of treasurer includes obtaining finance; maintaining relations with investors, banks, etc., short-term financing, cash management, credit administration while the controller is related to the functions like financial accounting; internal audit; taxation, management accounting and control, budgeting, planning and control, economic appraisal, etc. Figure 11.2 shows that the finance function is one of the major functional areas, and the financial manager / director is under the control of the board of directors.

11.9 FINANCE AND RELATED DISCIPLINES

There is an inseparable relationship between finance on the one hand and other related disciplines and subjects on the other. It draws heavily on related disciplines and fields of study. The most important of these are accounting and economics, but the subjects like marketing, production, quantitative methods, etc. also have an impact on the finance field. In the following sections these disciplines are noted.

FINANCE AND ACCOUNTING

The relationship between finance and accounting, has two dimensions:

i. They are closely related to the extent that accounting is an important input in financial decision making;

ii. There are certain differences between them.

Accounting is a necessary input into the finance function. It generates information through the financial statements. The data contained in these statements assists the financial managers in assessing the past performance and future directions of the firm and in meeting certain legal obligations. Thus, accounting and finance are functionally inseparable.

The key differences between finance and accounting are relating to the treatment of funds and decision-making, which are discussed as under:

a. Treatment of funds:

The measurement of funds in accounting is based on the accrual concept. For instance, revenue is recognised at the point of sale and not on collection of credit. Similarly, expenses are recognised when they are incurred but not at the time of actual payment of these expenses. Where as in case of finance the treatment of funds is based on cashflows. That means here the revenue is recognised only when actually received - or actually paid in cash.

b. Decision Making:

The purpose of accounting is collection and presentation of financial data. The financial manager uses these data for financial decision-making. It does not mean that accountants never make decisions or financial managers never prepare data. But the primary focus of the function of accountants is collection and presentation of data while the financial manager's major responsibility relates to financial planning, con trolling and decision-making. Thus, the role of finance begins, where the accounting ends.

ECONOMICS AND FINANCE

The development of the theory of finance began in the 1920s as an offshoot of the study of the theory of the firm in economic theory. The financial manager uses microeconomics when developing decision models that are likely to lead to the most efficient and successful modes of operation within the firm. Further, the marginal cost and revenue concepts are used in making the investment decisions, managing working capital, etc in the finance field.

11.10 SUMMARY

In this unit we have tried to introduce you to an overview of financial management emphasizing its importance in a firm. We also discussed how the traditional concept of 'Corporation Finance' which considers only the provision of funds required by the business firm was replaced by the modern concept which treats finance as an integral part of the overall management rather than mere raising of funds and the scope of finance. Then the shift of the emphasis to the managerial problems from raising of funds to efficient and effective use of funds. The objectives of profit maximisation, wealth maximisation and their importance has been discussed. Finally, we had covered about the organisation of finance function and related disciplines of finance.

11.11 KEY WORDS

Financial Management: It is an activity concerned with planning and controlling of the firm's financial resources to generate returns on its invested funds to achieve the objectives of the firm.

Profit Maximisation: It is one of the objectives of the firm to earn higher returns on its resources, which means higher dividends to the investors. It is nothing but a criterion for economic efficiency as profits provide a yardstick by which economic performances can be judged under condition of perfect competition.

Wealth Maximisation: It is the most widely accepted objective of the firm for its owners, which states that the management should seek to maximise the present value of the expected returns of the firm.

11.12 SELF ASSESSMENT QUESTIONS

1. Write in brief about Financial Management and discuss the scope and functions of Financial Management.
2. Distinguish between Profit Maximisation and Wealth Maximisation objectives of the firm?
3 In what ways is the role of a finance manager different from that of an accountant?
4. What are the important decisions of finance functions? Explain their importance and relevance in Financial Management.
5. Discuss the different approaches to Financial Management.
6. What is the nature of the risk-return trade off faced in financial decision making?
7. Discuss the problems of a finance manager in the management of finance functions in the Indian context?

11.13 FURTHER READINGS

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Soloman, Ezra and Pringle John, 1993. *An Introduction to Financial Management,* Prentice Hall of India Private Ltd.: New Delhi