Financial Management

Meaning of Financial Management

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise. It is concerned with the acquisition and use of funds in a business enterprise to achieve its predetermined objectives effectively.

Scope/Elements of Financial Management OR Major Financial decisions

1. Investment decision: It includes decisions regarding investment in fixed assets (called as capital budgeting) as well as investment in current assets (called as working capital decisions).

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2. Financing decision: It relates to the raising of necessary finance from various sources. It includes the decisions such as type of source, debt-equity ratio, period of financing, and cost of financing.

3. Dividend decision: The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into the following two:

    - Dividend to shareholders- Amount of profit to be declared as dividend to the shareholders has to be decided.

    - Retained profits- Amount of profits to be retained in the business for reinvestment purposes will depend upon the expansion and diversification plans of the enterprise.

Objectives of Financial Management

Financial Management as the name suggests is management of finance. It deals with planning and mobilization of funds required by the firm. There is only one thing which matters for everyone right from the owners to the promoters. That is money. Managing of finance is nothing is but managing of money. Every activities of an organization are reflected in its financial statements. Financial Management deals with activities which have financial implications. The very objective of Financial Management is to maximize the wealth of the shareholders by maximizing the value of the firm. This prime objective of Financial Management is reflected in the EPS (Earning per Share) and the market price of its shares.

The earlier objective of profit maximization is now replaced by wealth maximization. Since profit maximization cannot be the sole objective of a firm it is a limited one. The term profit is a vague phenomenon and if given undue importance problems may arise where as wealth maximization on the other hand overcomes the drawbacks of profit maximization.

Thus the objective of Financial Management is to trade off between risk and return. The objective of Financial Management is to make efficient use of economic resources mainly capital. The functions of Financial Management involves acquiring funds for meeting short term and long term requirements of the firm, deployment of funds, control over the use of funds and to trade-off between risk and return.

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

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- To ensure regular and adequate supply of funds to the concern.
- To ensure adequate returns to the shareholders. It depends upon the earning capacity, market price of the share, expectations of the shareholders.
- To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
- To ensure safety on investment, i.e. funds should be invested in safe ventures so that adequate rate of return can be achieved.
- 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:**

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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 the capital structure:**

Once the estimation of capital requirements has been made, the optimum capital structure of the company is to be decided. This involves the decision regarding the debt-equity mix or composition of long term finance. 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 funds to be procured, a company has many choices like issue of shares, debentures or bonds, loans from banks and financial institutions, public deposits etc. 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:**

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The disposal of net profit decision has to be made by the finance manager. This can be done in two ways:

- Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
- Retained profits - The volume has to be decided which will depend upon expansion and 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, maintenance of enough stock, purchase of raw materials, etc.

7. **<u>Financial controls</u>:**

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.

Relationships between Finance and Other Disciplines

Financial management is an integral part of the overall management of an enterprise and thus, it has a relationship with other disciplines and fields of study like economics, accounting, production, marketing, personnel and quantitative methods. The relationship of financial management with other fields of study is explained as under:

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<u>Finance and Economics</u>

Finance is a branch of economics. Economics deals with supply and demand, costs and profits, production and consumption and so on. The relevance of economics to financial management can be described in two broad areas of economics i.e., micro economics and macro economics. Micro economics deals with the economic decisions of individuals and firms. It concerns itself with the determination of optimal operating strategies of a business firm. These strategies include profit maximization strategies, product pricing strategies, strategies for valuation of firm and assets etc. The basic principle of micro economics that applies in financial management is marginal analysis. Most of the financial decisions should be made taken into account the marginal revenue and marginal cost. So, every financial manager must be familiar with the basic concepts of micro economics. Macro economics deals with the aggregates of the economy in which the firm operates. Macroeconomics is concerned with the institutional

structure of the banking system, money and capital markets, monetary, credit and fiscal policies etc. So, the financial manager must be aware of the broad economic environment and their impact on the decision making areas of the business firm.

Finance and Accounting

Accounting and finance are closely related. Accounting is an important input in financial decision making process. Accounting is concerned with recording of business transactions. It generates information relating to business transactions and reporting them to the concerned parties. The end product of accounting is financial statements namely profit and loss account, balance sheet and the statements of changes in financial position. The information contained in these statements assists the financial managers in evaluating the past performance and future direction of the firm (decisions) in meeting certain obligations like payment of taxes and so on. Thus, accounting and finance are closely related.

Finance and Production

Finance and production are also functionally related. Any changes in production process may necessitate additional funds which the financial managers must evaluate and finance. Thus, the production processes, capacity of the firm are closely related to finance.

Finance and Marketing

Marketing and finance are functionally related. New product development, sales promotion plans, new channels of distribution, advertising campaign etc. in the area of marketing will require additional funds and have an impact on the

expected cash flows of the business firm. Thus, the financial manager must be familiar with the basic concept of ideas of marketing.

<u>Finance and Quantitative Methods</u>

Financial management and Quantitative methods are closely related such as linear programming, probability, discounting techniques, present value techniques etc. are useful in analyzing complex financial management problems. Thus, the financial manager should be familiar with the tools of quantitative methods. In other way, the quantitative methods are indirectly related to the day-today decision making by financial managers.

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