NATURE OF FINANCIAL MANAGEMENT: FINANCE & RELATED DISCIPLINE

Financial management can be defined as the management of flow of funds and it deals with the financial decision making. It encompasses the procurement of the funds in the most economic and prudent manner and employment of these funds in the most optimum way to maximize the return for the owner. Since raising of funds and their best utilization is the key to the success of any business organization, the financial management as a functional area has got a place of prime relevance in every firm.

Finance as an area of study is concerned with two distinct areas namely the financing and the investing. Financing deals with the management of sources of capital. The financing area concentrate on the type, size and composition of capital resources. Investing, on the other hand deals with management of uses of capital. The investing area, therefore, concentrate on the type, size and composition of investment of capital. Both these areas of study are considered as part of financial studies.

SCOPE OF FINANCIAL MANAGEMENT

The scope of financial management as a separate study area of management has undergone major changes in the twentieth century i.e. from traditional phase to the modern phase.

Traditional Approach

According to this approach, scope of financial management was limited to raise and administer funds needed by companies to meet their financial needs. This approach laid more and more emphasis on procurement of funds by companies to meet their financial needs. This emphasis has led to:

- Emergence of more and more financial institutions to finance the need of business.
- Development of various financial instruments like shares, debentures, bonds etc., through which funds could have been raised.
- Development of legal and accounting practices to regulate the relationship between a corporation and the supplier of funds.

Hence, the traditional approach centred around the task of determining how required funds can best be raised from the combination of sources available. Besides doing routine function of keeping accounting records, preparing reports etc., the major functions of financial manager were limited to:

(1) Raising of required funds from best available sources and then administering those funds.

(2) Deciding on the mode of raising finance i.e., deciding on instruments like share, debentures, bonds etc. through which funds are to be raised.

(3) Managing legal and accounting relationship between a company and its suppliers of funds

(4) Raising of finance for episodic events like merger, acquisition etc.

The basic criticism of this approach is that it laid emphasis on the procurement of funds only. The more important aspect of funds i.e. its wise use or allocation was completely ignored. Therefore, this approach has completely ignored investment and financing decisions.

As per this approach, the finance function was centred around raising and administering of funds. It laid emphasis on the relationship between corporation and suppliers of funds. Hence, everything was looked from the viewpoint of suppliers of funds, i.e. outsiders. Issues like wise use of funds, forecasting expected returns, minimising cost of capital etc. were completely ignored. Therefore, the finance function was looked from the point of view of investment bankers rather than that of the financial decision maker within an enterprise

The traditional approach has placed heavy emphasis on long-term financing. The problems relating to short-term financing i.e. financing working capital needs were completely ignored.

Issues like determination of working capital needs, receivable management, payable management, efficient cash management, inventory management have not been mentioned in the scope of traditional approach of financial management. These are very important areas in today's financial management. Success and failure of a business too depends on efficient management of these functions in an enterprise. Core issues of financial policy like wise use of collected funds and process involved in matching the potential uses against the cost of alternative potential sources to achieve broader financial goals have been ignored.

Modern Approach

Modern approach, covers both acquisition of funds as well as their proper and wise allocation in various assets of an enterpirse. This approach views financial management as an integrated part of overall management and provides a conceptual and analytical framework for financial decision making.

Prof. Ezra Solomon has pointed out that financial management should make judgements about whether an enterprise should hold, reduce or increase its investments in all forms of assets that require company funds.

(i) The first prerequisite to financial decision making is the establishment of an explicit goal towards which all actions must be directed. All decisions should be directed towards the achievement of the most appropriate goal or objective which is to maximise the present worth of shareholders (Wealth maximisation).

(ii) The second prerequisite is the establishment of a systematic and correct basis for directing the funds. This contains two component elements:
   a. An organizational framework within which relevant information on all available courses of investment and financing can be assembled.
   b. Body of analysis which will provide the operating criteria for investment decisions to accomplish the wealth maximisation objective of the firm.

(iii) The third prerequisite is the establishment of a suitable approach to the problem of selecting an optimum combination of different kinds of sources of finance. This approach must take into account the cost of different sources of finance.

Lastly, profit planning is also an important area which cannot be ignored by financial manager. The profit planning involves decisions regarding pricing, costs, volumes in different product lines of a firm. Investment and financing decisions cannot be taken without considering these pieces of information. Another important area of financial management is the dividend decision. Dividend decision involves deciding the amount or percentage of dividends to be distributed to shareholders and their impact on the value of the firm. The approach also lays down the overall objective of financial management ie. wealth maximisation of shareholders. It further suggested the selection of appropriate criteria or approach to take these decisions so as to achieve the overall objective of the firm.

PROFIT MAXIMIZATION v/s WEALTH MAXIMIZATION

Profit Maximization is the core objective of many businesses that represent the pursuit of strategies to achieve the highest possible net income. This involves identifying optimal production levels, pricing strategies, and cost management practices to ensure that revenues exceed costs, leading to increased profitability. In essence, it is about striking the right balance between income generation and cost management to ensure sustained financial success.

Wealth maximization is a financial management and economic concept that focuses on enhancing the long-term value of a business for its shareholders. Unlike profit maximization, which emphasizes short-term gains, wealth maximization takes a broader perspective by considering the overall value creation for the company’s owners.

Basis	Profit Maximization	Wealth Maximization
Objective	Focuses on short-term gains by maximizing net income.	Aims for long-term value creation for shareholders.
Time Horizon	Short-term orientation.	Long-term orientation.
Emphasis	Primarily on maximizing profits.	Considers a broader set of factors beyond profits.
Inclusion of Factors	Mainly concerned with revenue generation, cost control, and profitability.	Considers factors such as risk management, sustainability, and corporate social responsibility (CSR).
Holistic Approach	Tends to be more narrow and focused on financial metrics.	Offers a holistic approach by considering financial and non-financial aspects for sustained success.
Shareholder Value	May benefit shareholders through increased dividends and stock prices.	Aims to enhance shareholder wealth through long-term value creation and sustainable business practices.
Flexibility	Less flexible, as it may prioritize short-term gains at the expense of long-term considerations.	More flexible, allowing adaptation to changing market conditions and ensuring long-term viability.
Risk Tolerance	It may involve higher risk tolerance for the sake of immediate profits.	Generally, it involves a balanced approach to risk management to ensure long-term stability.
Financial Ratios	Return on Investment (ROI), Net Profit Margin, Inventory Turnover Ratio, and Accounts receivable Turnover Ratio are all relevant metrics in this case.	Price-to-earnings (P/E) ratio, price-to-book (P/B) ratio, and earnings per share (EPS) are important ratios for wealth maximization.
Corporate Social Responsibility (CSR)	Typically, CSR may be a secondary consideration.	Emphasizes CSR as an integral part of business strategy, considering the impact on society and the environment.

TYPES OF FINANCIAL DECISIONS

1. **Investment Decisions**: Firms have scarce resources that must be allocated among competitive uses. The financial management provides a framework for firms to take these decisions wisely. The investment decisions include not only those that create revenues and profits (e.g., introducing a new product line) but also those that save money (e.g., introducing a more efficient distribution system). Assets represent investment or uses of the funds that the firm makes in expectation of earning a return for its investors. Broadly, these assets can be classified into fixed assets and current assets, and therefore, the investment decisions can also be bifurcated into **Capital Budgeting decisions** (relating to fixed assets) and the **Working Capital Management** (relating to current assets).
The fixed assets of a firm are the primary factors and the determinants of the profitability of a firm. The earnings of the firm are basically caused by the fixed assets composition and also the total fixed assets vis-a-vis total assets of the firm. The **Capital Budgeting decisions** are more crucial for any firm. A finance manager may be asked to decide about (1) which asset should be purchased out of different alternative options, (2) to buy an asset or to get it on lease, (3) to produce a part of the final product or to procure it from some other supplier, (4) to buy or not an other firm as a running concern, (5) proposal of merger of other group firms to avail the synergies of consolidation, etc. All these decisions have long-term ramifications and are generally irreversible. The objective of Capital Budgeting decisions is to identify those assets which are worth more than they cost.
Working Capital Management, on the other hand, deals with the management of current assets of the firm. Though the current assets do not contribute directly to the earnings, yet their existence is necessitated for the proper, efficient and optimum utilization of fixed assets. There are dangers of both the excessive working capital as well as the shortage of working capital. A finance manager has to ensure sufficient and adequate working capital to the firm.
2. **Financing Decisions**: Another group of decisions taken by a finance manager is known as Financing Decisions, which deal with the financing pattern of the firm. As firms make decisions concerning where to invest these resources, they have also to decide how they should raise resources. There are two main sources of finance for any firm, the shareholders funds and the borrowed funds.
The key distinction between these two sources lies in the fixed commitments created by borrowed funds to pay interest and the principal. The borrowed funds are always repayable (except when the debt instrument is convertible into shares) and require payment of a committed cost in the form of interest on a periodic basis. The borrowed funds are relatively cheaper but always entail a risk. This risk is known as the **financial risk** i.e., the risk of insolvency due to non-payment of interest or non repayment of capital amount.
The shareholders funds is the main source of funds to any firm. This may comprise of the equity share capital, preference share capital and the accumulated profits. There is no committed outflow for equity shares capital neither in the form of a return nor in the form of repayment of capital.
3. **Dividend Decision**: Another major area of decision making by a finance manager is known as the Dividend decisions which deal with the appropriation of after tax profits. These profits are available to be distributed among the shareholders (subject to legal provisions) or can be retained by the firm for reinvestment within the firm. The profits which are not distributed are impliedly retained in the firm. All firms whether small or big, have to decide how much of the profits should be reinvested back in the business and how much should be taken out in form of

dividends i.e., return on capital. On one hand, paying out more to the owners may help satisfying their expectations, on the other, doing so has other implications as a business that reinvests less will tend to grow slower.

RISK-RETURN TRADE OFF IN FINANCE FUNCTIONS

In financial management, the risk is defined as the variability of expected returns from an investment. For example, an investor makes a fixed deposit at an interest of 10% p.a. for a particular period with a scheduled bank. There is virtually no risk attached with this investment since there is no variability associated with the return. However, if the same amount is used to buy the equity shares of a company, then the return in the form of dividends from this investment may vary from one year to another. So, the investment in equity shares is risky as the returns are variable. The risk exists when the decision maker is able to estimate the probabilities associated with the different outcomes. On the other hand, the uncertainty exists when the decision maker has no historical data to develop the probabilities associated with the outcome. Return associated with a decision is measured as the total gain or loss expected over a given period of time by the decision maker. It may be defined as the return on the original investment made in the particular asset/investment. A finance manager takes these decisions in the light of objective of maximization of shareholders' wealth as reflected in the market price of the share. The finance manager should also know as to what are the factors which may affect the market price of a share. The various decisions will then be taken in the light of these factors, otherwise any attempt to achieve the objective of maximizations of the market price of the share may be frustrated. There are numerous factors which may influence the market price of a share. Some of these factors may be political conditions, economic conditions, investment scenario, company considerations, promoter groups, etc. A finance manager may face problems when trying to include all these factors in the decision making process. He is required to optimise these factors while taking financial decisions. He should also understand that every financial decision has two aspects i.e. the risk and the return. There is a risk involved in every decision. The degree of risk, however, may differ from one decision to another. A riskless decision is difficult to be visualized. Further, every decision has a return also. It may be emphasized that the risk and return go together and there is always a conflict between the return from a decision and the risk it brings into the firm. Usually, as the return from an investment increases, its risk also increases. Therefore, a finance manager is often required to trade off between the risk and return. A particular combination of risk and return where both are optimized may be known as **Risk-Return Trade off**. Every financial decision involves such trade off between risk and return. At this level of risk-return, the market price of the share will be maximized. This risk-return composition in fact, ultimately affect the value of the firm reflected in the market price of a share

ORGANIZATION FINANCE FUNCTION

Organization of finance function means the division of functions relating to finance and to set up a sound and efficient organization for performing the finance functions. Since the financial decisions are very crucial for the survival as well as growth and development of the firm, the ultimate responsibility of carrying out the finance function lies with the top management. Hence, a department to organize and carry out the financial activities is created under the direct control of the board of directors. This department is headed by a financial manager. Major financial policy matters will be decided by the financial manager whereas the routine financial matters will be delegated to lower levels

Organization of Finance Function