International Journal of Research Publication and Reviews

Journal homepage: www.ijrpr.com ISSN 2582-7421

The Scope of Financial Management and its Objectives

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ABSTRACT

Financial management is concerned with efficient financing of funds i.e. (selection of efficient financial resources) and allocation of funds (investment in assets, working capital etc.). In modern times, financial management, apart from receipt of funds, also involves three different types of decisions, namely investment, financing and dividend. In this, evaluating the opportunity of low cost financial resources while properly searching for investment opportunities for good returns is an important aspect. It also has to be decided how to satisfy the shareholders, whether to give them dividends or to show growth in the business by increasing the share holders' value. Important decisions of management have a good or bad effect on the value of the firm or business. Good decisions taken by the management increase the value of the business; For example, if managers have entered into a contract on green sources of energy in the business which reduces the consumption and cost of energy in the business, then it is a positive decision for the business which will increase the future profits of the business and will also increase the value of the firm. Therefore, under financial management, the future picture can be seen by evaluating the internal information or decisions of the firm.

Key words: *Finance, Management, Revenue, Expenditure, Dividend, Bookkeeping, Shareholders, Business Policy, Investment, Growth, Current Value, Rate, Loan, Forecast, Interest*

1. Introduction

Financial management is the managerial activity which is concerned with the planning and control of the financial resources of the firm. In other words, it is concerned with the acquisition, financing and management of assets to accomplish the overall goal of a business enterprise (primarily to maximize shareholders wealth). In today's world where positive cash flow is more important than book profit, financial management can also be defined as the future planning of a business enterprise to ensure positive cash flow. Some experts also call financial management the science of money management. It may be defined as follows:

"Financial management includes forecasting, planning, organizing, directing, coordinating and controlling all activities relating to the acquisition and application of financial resources of an enterprise having regard to its financial objectives.

Another very elaborate definition is given by Philippattus:

"Financial management is concerned with managerial decisions which result in the acquisition and financing of short-term and long-term credit for the firm."

It thus deals with situations which require the selection of specific assets (or combinations of assets), the size of an enterprise and the specific problem of its development. These decisions are analysed on the basis of the expected inflow and outflow of funds and their impact on managerial objectives.

Financial management has two basic aspects, namely, the receipt of funds and the effective utilisation of these funds to meet business objectives.

Aspects of Financial Management, Receipt of Funds, Utilisation of Funds

1.1 Raising of Funds

Since funds can be obtained from various sources, their sourcing is always considered a complex problem by business entities. Some of the sources of funds for a business enterprise are: Debentures and Bonds, In the scenario of global competition, it is not enough to rely on the available methods of raising finance but resources have to be raised in innovative ways on financial products that can meet the needs of investors. We are constantly seeing new and creative sources of funds that help modern businesses grow rapidly. For example: Carbon credits are becoming another source of business financing. Funds obtained from different sources have different characteristics in terms of risk, cost and control. The cost of funds should be at the minimum level for which a proper balance of risk and control factors can be made. Another important consideration in the selection of the source of finance for a new business is to strike a balance between equity and debt to ensure that the financing structure suits the business.

Some of the sources of funds are as follows:

(a) Equity: Funds raised by issuing equity shares are the best in terms of risk for the firm, as there is no question of return of equity capital except if the firm is under liquidation. However, in terms of cost, equity capital is usually the most expensive source of funds. This is because the expectations of shareholders regarding dividends are generally higher than the prevailing interest rate and also because dividends are appropriations of profits, which are not allowed as expenditure under the Income Tax Act. Also, the issue of new shares to the public may reduce the control of existing shareholders.

b) Debentures: As a source of funds, debentures are relatively cheaper than shares because of their tax benefits. The interest that the company pays on debentures is tax-free, unlike dividend payments which are made from taxed profits. However, even in tough times, interest on debenture debt must be paid, unlike dividend payments. However, debentures carry higher risk as they have to be repaid as per the terms of the agreement. Also, interest has to be paid whether the company makes a profit or not.

(c) Financing from Banks: Commercial banks play a vital role in financing business enterprises. Apart from helping businesses in their regular operations (deposits, payments, etc.), they play a vital role in meeting the long-term and short-term requirements of any business enterprise. Various credit services provided by commercial banks are:- Credit services, Fund based, Non-fund based, Cash credit Overdraft, Term loan, Working capital term, Bill purchase/discounting, Letter of credit

(d) International Financing: Today financing is not confined to the domestic market. With liberalisation and globalisation, business enterprises have options to raise capital from international markets as well. Foreign Direct Investment (FDI) is available in the form of ADRs (American Depository Receipts) and GDRs (Global Depository Receipts) besides

(e) Angel Financing: Angel financing is a form of equity-financing where the angel investor is a wealthy individual who invests capital for start-up or expansion in exchange for ownership equity in the company. Angel investors have idle cash available and are looking for higher returns than the returns from traditional investments. Typically, angels as they are called, will invest about 25 to 60 percent to help start a company. This source of finance is sometimes the last resort for startups that are not eligible for bank financing and are too small to be funded by venture capital.

1.2 Effective Utilisation of Funds

The finance manager is also responsible for the effective utilisation of funds. He has to point out situations where funds are being kept idle or where funds are not being properly utilised. All funds are raised at a certain cost and after bearing a risk. If these funds are not utilised in such a manner that their income exceeds the cost of raising them, there is no point in running the business. Therefore, it is important to utilise funds properly and profitably. Some aspects of the utilisation of funds are as follows:

(a) Use for Fixed Assets: Funds should be invested in such a manner that the company can produce at its optimum level without endangering its financial solvency. For this, the finance manager would be required to have a good knowledge of the techniques of capital budgeting. Capital budgeting (or investment appraisal) is a planning process used to determine whether a firm's long-term investments such as new machinery, replacement machinery, new plants, new products, and research development projects will earn the desired return.

(b) Uses for Working Capital: The finance manager should also keep in mind the need for adequate working capital and ensure that while the working capital of the companies is at the optimum level, yet they do not keep too much funds blocked in inventory, book debts, cash, etc.

The evolution of financial management has been gradual over the last 50 years. The evolution of financial management has been divided into three phases. Financial management emerged as a separate field of study at the beginning of the century. There are three phases of its evolution: Traditional Phase: During this phase, financial management was considered necessary only during occasional events such as acquisitions, mergers, expansions, liquidations, etc. Further, while taking financial decisions in the organisation, the needs of external people connected with the business (investment bankers, people lending money to the business and such others) were taken into account. Transitional Phase: During this phase, importance was given to the day-to-day problems faced by the financial managers. In this phase more attention was paid to general problems relating to fund analysis, planning and control. Modern Phase: The modern phase is still going on. The scope of financial management has now increased a lot. It is important for a company to carry out financial analysis. This analysis helps in decision making. During this phase, many theories have been developed regarding efficient markets, capital budgeting, option pricing, valuation models and many other important areas in financial management.

1.3 Finance Functions/Financial Decisions

The value of a firm will depend on various finance functions/decisions. It can be expressed as:

$V = f(I,F,D)$. Finance functions are divided into long-term and short-term functions/decisions.

1.3.1 Long Term Finance Functions/Decisions

(a) Investment Decisions (1): These decisions relate to the selection of assets in which funds would be invested by a firm. Funds received from different sources have to be invested in different types of assets. Long term funds are used for various fixed assets and also current assets in a project. Investment of funds in a project should be made after careful evaluation of various projects through capital budgeting. A part of long term funds should also be kept for financing working capital requirements. Asset management policies have to be determined in respect of various items of current assets. Inventory policy will be determined by the production manager and finance manager keeping in view the production requirement and future price projections of raw materials and availability of funds.

(b) Investment Decisions (2): These decisions are related to obtaining optimum finance to meet financial objectives and to manage fixed and working capital effectively. The financial manager must have a good knowledge of the available sources of funds and their respective costs and must ensure that the company has a strong capital structure, i.e., there should be a proper balance between equity capital and debt. Such managers also need to have a very clear understanding of the difference between profit and cash flow, keeping in mind that profit has no meaning unless the organization has sufficient cash to pay for assets and maintain the working capital cycle. Financial decisions also require a good knowledge of risk assessment, for example, excessive indebtedness poses a great risk to the equity of any organization due to priority rights of lenders. A major area of risk decisions is foreign trade, where any organization is vulnerable to currency fluctuations and the manager must be well aware of the various protective procedures available to him such as hedging (it is a strategy designed to minimize, reduce or eliminate the risk in another investment). For example, a person who owns a shop reduces the risk of his goods being destroyed by fire by taking out a fire insurance contract.

1.3.2 Short-term Finance Decisions/Actions

Working Capital Management (WCM): Generally short-term decisions are confined to the management of current assets and current liabilities (i.e. working capital management). The importance of financial management cannot be over-emphasized. It is, in fact, the key to successful business operations. Without proper administration of finances, no business enterprise can reach its full potential for growth and success. Money is as important to an enterprise as oil/fuel is to an engine. Financial management is the planning of investments, financing the investments, managing the expenditures against the budget and the profits arising from the investments. Financial management means the management of all matters relating to the finances of an organization.

The best way to demonstrate the importance of good financial management is to describe some of the tasks involved:-

Taking care not to over-invest in fixed assets, balancing cash outflows with cash inflows,

Ensuring an adequate level of short-term working capital, setting sales revenue targets that provide growth, increasing gross profit by pricing products or services correctly, controlling the level of general and administrative expenses by finding more cost-efficient ways to run day-to-day business operations, and doing tax planning that will reduce the taxes paid by the business.

3.1 Scope of Financial Management

As an integral part of overall management, financial management is primarily concerned with the acquisition and use of funds by an organization. Based on the financial management concept of financial management of financial management guru Ezra Solomon, the following aspects are taken up in detail under the study of financial management:

(a) Determining the size of the enterprise and determining the growth rate.

(b) Determining the structure of assets of the enterprise.

(c) Determining the mix of financing of the enterprise, i.e. considering the level of debt to equity etc.

(d) Analysing, planning and controlling the financial affairs of the enterprise.

4.1 Objectives of Financial Management

Efficient financial management requires the existence of certain objectives or goals, as the decision about whether a financial decision is efficient or not must be made in the light of some objective. Though various objectives are possible, we will take two objectives of financial management for detailed discussion. These are: profit maximization, wealth/value maximization

4.2 Profit Maximization

Traditionally it has been argued that the primary objective of a company is to earn profit: hence the objective of financial management is also to maximize profit. This implies that the finance manager has to take his decisions in such a way as to maximize the profit of the company. Therefore, each alternative should be viewed in terms of whether it gives maximum profit or not. However, profit maximization cannot be the sole objective of a company. It is a limited objective. If undue importance is given to profit, a number of problems may arise. Some of these are discussed below:

(I) The term profit is ambiguous. It does not explain what it really means. It conveys a different meaning to different people. For example, profit may be in the short term or long term, it may be total profit or rate of profit etc.

(ii) Profit maximization should be attempted, taking into account the risks involved. There is a direct relationship between risk and profit. Many risky proposals yield greater profits. The higher the risk, the greater the probability of profit. If profit maximization is the only objective, the risk factor is completely ignored. This implies that finance managers will accept even highly risky proposals if they yield greater profits. In practice, however, risk is a very important consideration, and it must be balanced with the profit objective.

(iii) Profit maximization as an objective does not take into account the time pattern of returns. Proposal “A” may yield higher profits than proposal “B”, yet if the returns of proposal “A” start coming in after 10 years, proposal “B” may be preferred whose time benefit may be less, but the flow of returns is more prompt and sharp.

(iv) Profit maximization as an objective is too narrow a concept. It fails to take into account social considerations as well as the obligations to workers, consumers, various interests of the society as well as ethical business practices. If these factors are ignored, a company cannot survive for long. Maximizing profit at the cost of social and ethical obligations is a short-sighted policy.

4.3 Wealth maximization/Value creation

We must first define what the wealth maximization model is. The wealth of shareholders is the result of cost benefit analysis adjusted for their time and risk, i.e. the time value of money. Therefore,

Wealth = Present value of capital / Present value of costs

It is important that the profit measured by the finance manager is in terms of cash flows. The finance manager should emphasize cash flows for investment or financing decisions and not on accounting profits. The shareholder value maximization model holds that the primary goal of a firm is to maximize its market value and implies that business decisions should attempt to maximize the net present value of the firm's economic profits. Therefore, to measure and maximize shareholders' wealth, the finance manager should follow the following: Cash flow approach, not accounting profits Cost benefit analysis Use of the time value of money. How do we measure the value of a firm? According to Van Horne, “The value of a firm is represented by the market value of the company's common stock. The primary goal of a firm is to maximize its market value and implies that business decisions should attempt to maximize the net present value of the firm's economic profits. Therefore, to measure and maximize shareholders' wealth, the finance manager should follow the following: Cash flow approach, not accounting profits Cost benefit analysis Use of the time value of money. How do we measure the value of a firm?

Stockholders hire managers to run their firms because stockholders have absolute power to hire and out the managers. Managers put their own interests aside and maximize stock prices because markets are efficient. Stockholder wealth is maximized because creditors are fully protected from the actions of stockholders. Firm value is maximized because no cost is created to society.

Social wealth is maximized.

Value of firm (V) = Number of shares (N) Market value of shares (MP) or

V = Value of equity (Vet) + Value of debt (V)

Wealth maximization works because business enterprises have other goals. Some other goals of a business enterprise may be:- To achieve high growth rate, to gain large market share, to achieve market leadership in terms of products and technology, to promote employee welfare, to increase customer satisfaction, to solve problems, to improve community life, to support education and research, to solve social problems etc.

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