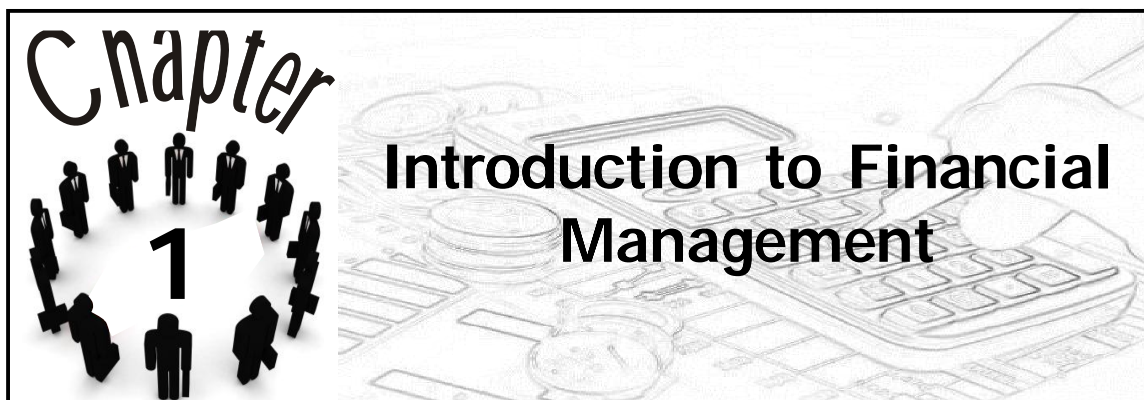

(A) EVOLUTION OF FINANCIAL MANAGEMENT

Financial management emerged as a distinct field of study at the turn of this century. Its evolution may be divided into three broad phases (though the demarcating lines between these phases are somewhat arbitrary): the traditional phase, the transitional phase, and the modern phase

The *traditional phase* lasted for about four decades. The following were its important features:

- The focus of financial management was mainly on certain episodic events like formation, issuance of capital, major expansion, merger, reorganization, and liquidation in the life cycle of the firm.
- The approach was mainly descriptive and institutional. The instruments of financing, the institutions and procedures used in capital markets, and the legal aspects of financial events formed the core of financial management.
- The outsider's point of view was dominant. Financial management was viewed mainly from the point of the investment bankers, lenders, and other outside interests.

A typical work of the traditional phase is *The Financial Policy of Corporations*[1] by Arthur S. Dewing. This book discusses at length the types of securities, procedures used in issuing these securities, bankruptcy, reorganisations, mergers, consolidations, and combinations. The treatment of these topics is essentially descriptive, institutional, and legalistic.

The *transitional phase* being around the early forties and continued through the early fifties. Though the nature of financial management during this phase was similar to that of the traditional phase, greater emphasis was placed on the day-to-day problems faced by finance managers in the areas of funds analysis, planning, and control. These problems, however, were discussed within limited analytical frameworks. A representative work of this phase is *Essays on Business Finance* by Wilford J. Eiteman *et al.*

The *modern phase* began in the mid-fifties and has witnessed an accelerated pace of development with the infusion of ideas from economic theory and application of quantitative methods of analysis. The distinctive features of the modern phase are:

- The scope of financial management has broadened. The central concern of financial management is considered to be a rational matching of funds to their uses in the light of appropriate decision criteria.
- The approach of financial management has become more analytical and quantitative.
- The point of view of the managerial decision maker has become dominant.

Since the being of the modern phase many significant and seminal developments have occurred in the fields of capital budgeting, capital structure theory, efficient market theory, option pricing theory, arbitrage pricing theory, valuation models, dividend policy, working capital management, financial modeling, and behavioural finance. Many more exciting developments are in the offing making finance a fascinating and challenging field.

- Early 1900: instrument, institution, and procedures of capital market and money market
- Around 1920: focus on security and banking sector, and investment in common stock
- Around 1930: focus on liquidity, debt, regulation, bankruptcy, reorganization
- Early 1940 and 1950: internal analysis, planning and controlling cash flow
- End of 1950: capital budgeting, valuation, and dividend policy
- Around 1960: development of portfolio theory
- Around 1970: CAPM model and APT model that can be used to value the financial assets
- Around 1980: focus on uncertainty, asymmetric information, financial signaling
- Around 1990: multinational financial management, behavioral finance, enterprise risk management, good corporate governance.

(B) 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.

(C) IMPORTANCE OF FINANCIAL MANAGEMENT

In a big organisation, the general manger or the managing director is the overall incharge of the organisation but he gets all the activities done by delegating all or some of his powers to men in the middle or lower management, who are supposed to be specialists in the field so that better results may be obtained.

For example, management and control of production may be delegated to a man who is specialist in the techniques, procedures, and methods of production. We ma designate him "Production Manager". So is the case with other branches of management, i.e., personnel, finance, sales etc.

The incharge of the finance department may be called financial manger, finance controller, or director of finance who is responsible for the procurement and proper utilisation of finance in the business and for maintaining co-ordination between all other branches of management.

Importance of finance cannot be over-emphasised. It is, indeed, the key to successful business operations. Without proper administration of finance, no business enterprise can reach its full potentials for growth and success. Money is a universal lubricant which keeps the enterprise dynamic-develops product, keeps men and machines at work, encourages management to make progress and creates values. The importance of financial administration can be discussed under the following heads:

(i) **Success of Promotion Depends on Financial Administration.** One of the most important reasons of failures of business promotions is a defective financial plan. If the plan adopted fails to provide sufficient capital to meet the requirement of fixed and fluctuating capital an particularly, the latter, or it fails to assume the obligations by the corporations without establishing earning power, the business cannot be carried on successfully. Hence sound financial plan is very necessary for the success of business enterprise.

(ii) **Smooth Running of an Enterprise.** Sound financial planning is necessary for the smooth running of an enterprise. Money is to an enterprise, what oil is to an engine. As, Finance is required at each stage f an enterprise, i.e., promotion, incorporation, development, expansion and administration of day-to-day working etc., proper administration of finance is very necessary. Proper financial administration means the study, analysis and evaluation of all financial problems to be faced by the management and to take proper decision with reference to the present circumstances in regard to the procurement and utilisation of funds.

(iii) **Financial Administration Co-ordinates Various Functional Activities.** Financial administration provides complete co-ordination between various functional areas such as marketing, production etc. to achieve the organisational goals. If financial management is defective, the efficiency of all other departments can, in no way, be maintained. For example, it is very necessary for the finance-department to provide finance for the purchase of raw materials and meting the other day-to-day expenses for the smooth running of the production unit. If financial department fails in its obligations, the Production and the sales will suffer and consequently, the income of the concern and the rate of profit on investment will also suffer. Thus Financial administration occupies a central place in the business organisation which controls and co-ordinates all other activities in the concern.

(iv) **Focal Point of Decision Making.** Almost, every decision in the business is take in the light of its profitability. Financial administration provides scientific analysis of all facts and figures through various financial tools, such as different financial statements, budgets etc., which help in evaluating the profitability of the plan in the given circumstances, so that a proper decision can be taken to minimise the risk involved in the plan.

(v) **Determinant of Business Success.** It has been recognised, even in India that the financial manger splay a very important role in the success of business organisation by advising the top management the solutions of the various financial problems as experts. They present important facts and figures regarding financial position an the performance of various functions of the company in a given period before the top management in such a way so as to make it easier for the top management to evaluate the progress of the company to amend suitably the principles and policies of the company. The financial manges assist the top management in its decision making process by suggesting the best possible alternative out of the various alternatives of the problem available. Hence, financial management helps the management at different level in taking financial decisions.

(vi) **Measure of Performance.** The performance of the firm can be measured by its financial results, i.e., by its size of earnings Riskiness and profitability are two major factors which jointly determine the value of the concern. Financial decisions which increase risks will decrease the value of the firm and on the to the hand, financial decisions which increase the profitability will increase value of the firm. Risk an profitability are two essential ingredients of a business concern.

The importance of financial management can be summarized as follows:

1. It brings economic growth and development through investments, financing, dividend and risk management decision which help companies to undertake better projects.
2. When there is good growth and development of the economy it will ultimately improve the standard of living of all people.
3. Improved standard of living will lead to good health and financial stress will reduce considerably.
4. It enables the individual to take better financial decision which will reduce poverty, reduce debts and increase savings and investments.

Better financial ability will lead to profitability which will create new jobs and in turn lead to more development, expansion and will promote efficiency

(D) SCOPE/ELEMENTS AND OBJECTIVES OF FINANCIAL MANAGEMENT

Scope/Elements

1. Investment decisions includes investment in fixed assets (called as capital budgeting). Investment in current assets are also a part of investment decisions called as working capital decisions.
2. Financial decisions - They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.

   (a) *Dividend decision:* The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two: Dividend for shareholders – Dividend and the rate of it has to be decided.

(b) *Retained profits:* Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

Scope of Financial Management: Financial management has a wide scope. According to **Dr. S. C. Saxena**, the scope of financial management includes the following **five 'A's**.

1. **Anticipation:** Financial management estimates the financial needs of the company. That is, it finds out how much finance is required by the company.
2. **Acquisition:** It collects finance for the company from different sources.
3. **Allocation:** It uses this collected finance to purchase fixed and current assets for the company.
4. **Appropriation:** It divides the company's profits among the shareholders, debenture holders, etc. It keeps a part of the profits as reserves.
5. **Assessment:** It also controls all the financial activities of the company. Financial management is the most important functional area of management. All other functional areas such as production management, marketing management, personnel management, etc. depends on Financial management. Efficient financial management is required for survival, growth and success of the company or firm.

Objectives of Financial Management

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

1. To ensure regular and adequate supply of funds to the concern.
2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
4. To ensure safety on investment, i.e., funds should be invested in safe ventures so that adequate rate of return can be achieved.
5. 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.

(E) CONFLICTS IN PRINCIPLES OF PROFIT VS. VALUE MAXIMISATION

Goals mean financial objective of a firm. Experts in financial management have endorsed the view that the goal of Financial Management of a firm is maximization of economic welfare of its shareholders. Maximization of economic welfare means maximization of wealth of its shareholders. Shareholders' wealth maximization is reflected in the market value of the firms' shares. A firm's contribution to the society is maximized when it maximizes its value. There are two versions of the goals of financial management of the firm:

Profit Maximization: In a competitive economy, profit maximization has been considered as the legitimate objective of a firm because profit maximization is based on the cardinal rule of efficiency. Under perfect competition allocation of resources shall be based on the goal of

profit maximization. A firm's performance is evaluated in terms of profitability. Investor's perception of company's performance can be traced to the goal of profit maximization. But, the goal of profit maximization has been criticized on many accounts:

1. The concept of profit lacks clarity. What does the profit mean?
   (a) Is it profit after tax or before tax?
   (b) Is it operating profit or net profit available to share holders?

   Differences in interpretation on the concept of profit expose the weakness of the goal of profit maximization.
2. Profit maximization ignores time value of money because it does not differentiate between profits of current year with the profit to be earned in later years.
3. The concept of profit maximization fails to consider the fluctuation in the profits earned from year to year. Fluctuations may be attributable to the business risk of the firm but the concept fails to throw light on this aspect.
4. Profit maximization does not make clear the concept of profit as to whether it is accounting profit or economic normal profit or economic supernormal profits.
5. Because of these deficiencies, profit maximization fails to meet the standards stipulated in an operationally feasible criterion for maximizing shareholders wealth.

Value or Wealth Maximization: Wealth Maximization has, been accepted by the finance managers, because it overcomes the limitations of profit maximisation. Wealth maximisation means maximizing the net wealth of the Company's share holders. Wealth maximisation is possible only when the company pursues policies that would increase the market value of shares of the company.

Following arguments are in support of the superiority of wealth maximisation over profit maximisation:

1. Wealth maximisation is based on the concept of cash flows. Cash flows are a reality and not based on any subjective interpretation. On the other hand there are many subjective elements in the concept of profit maximisation.
2. It considers time value of money. Time value of money translates cash flows occurring at different periods into a comparable value at zero period. In this process, the quality of cash flows is considered critically in all decisions as it incorporates the risk associated with the cash flow stream. It finally crystallizes into the rate of return that will motivate investors to part with their hard earned savings. It is called required rate of return or hurdle rate which is employed in evaluating all capital projects undertaken by the firm. Maximizing the wealth of shareholders means positive net present value of the decisions implemented. Positive net present value can be defined as the excess of present value of cash inflows of any decision implemented over the present value of cash out flows associated with the process of implementation of the decisions taken. To compute net present value we employ time value factor. Time value factor is known as time preference rate i.e. the sum of risk free rate and risk premium. Risk free rate is the rate that an investor can earn

on any government security for the duration under consideration. Risk premium is the consideration for the risk perceived by the investor in investing in that asset or security.

X Ltd is a listed company engaged in the business of FMCG (Fast Moving Consumer goods). Listed means the company's shares are allowed to be traded officially on the portals of the stock exchange. The Board of Directors of X Ltd took a decision in one of its Board meeting, to enter into the business of power generation. When the company informs the stock exchange at the conclusion of the meeting of the decision taken, the stock market reacts unfavourably with the result that the next days' closing of quotation was 30 % less than that of the previous day.

The question now is, why the market reacted in this manner. Investors in this FMCG Company might have thought that the risk profile of the new business (power) that the company wants to take up is higher compared to the risk profile of the existing FMCG business of X Ltd. When they want a higher return, market value of company's share declines. Therefore the risk profile of the company gets translated into a time value factor. The time value factor so translated becomes the required rate of return. Required rate of return is the return that the investors want for making investment in that sector.

Any project which generates positive net present value, creates wealth to the company. When a company creates wealth from a course of action it has initiated the share holders benefit because such a course of action will increase the market value of the company's shares.

Functions of Financial Management

1. **Estimation of capital requirements:** 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 capital composition:** Once the estimation have been made, the capital structure have to be decided. This involves short- term and long- term debt equity analysis. 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 additional funds to be procured, a company has many choices like:
   (a) Issue of shares and debentures
   (b) Loans to be taken from banks and financial institutions
   (c) Public deposits to be drawn like in form of bonds.

   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:** The net profits decision have to be made by the finance manager. This can be done in two ways:
   (a) *Dividend declaration:* It includes identifying the rate of dividends and other benefits like bonus.
   (b) *Retained profits:* The volume has to be decided which will depend upon expansional, innovational, 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. **Financial controls:** 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.

EXERCISE

Self Assessment Questions

1. Financial Management deals with procurement of funds at the least cost and _____________ funds.
2. Under perfect competition, allocation of resources shall be based on the goal of _____________.
3. _____________ is based on cash flows.
4. _____________ consider time value of money.
5. _____________ lead to investment in real assets.
6. _____________ relate to the acquisition of funds at the least cost.
7. Formulation of inventory policy is an important element of _____________.
8. Obtaining finance is an important function of _____________.

[**Ans.** 1. Effective utilization, 2. Profit maximisation, 3. Wealth maximization, 4. Wealth maximization, 5. Investment decisions, 6. Financing decisions, 7. Liquidity, 8. Treasurers]

Terminal Questions

1. What are the objectives of financial management?
2. How does a finance manager arrive at an optimal capital structure?
3. Examine the relationship of financial management with other functional areas of a firm.

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