Financial Management

No business activity can be undertaken without finance. Finance is the lifeblood of business. A business cannot even be started without finance. Every kind of business organization, whether it is small, medium or big, it needs finance. Every business activity is an economic activity and these activities require finance. There arises the need for arranging and managing finance in the businesses.

Meaning and Definition of Financial Management

Financial management is concerned with the acquisition of funds and their optimum utilization. It is all about acquiring funds at minimum cost and generate optimum return by its optimum utilization. Funds are acquired to meet financial aspects of business activity.

According to J.S. Massie:
"Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations."

According to Howard and Upton:
"Financial management is the application of planning and controlling functions of finance function."

According to the Guthman and Dougal:
"Business finance can be broadly defined as the activity concerned with planning, raising, controlling, administering of the funds used in the business"

Finance Function

The finance function is concerned with the functions of procuring funds, investing them into profitable projects and distributing the returns earned from those investments.
Thus, Finance Function includes

1. **Investment Decision**: This decision is also known as Capital Budgeting Decision. It is concerned with evaluation and selection of proposals for long-term investments. The returns from these proposals are expected in the future. A thorough evaluation of project in terms of risk and return is made as it required huge amount of funds.

2. **Financing Decisions:** This decision is concerned with choosing the source of finance. major issue involved here is to determine the proportion of equity and debt in the capital structure. Mix of equity and debt is known a capital structure.

3. **Dividend Decision:** It is related with the distribution of profit. The finance manager has to decide what proportion of earning is to be retained and what proportion is to be distributed, whether dividend should be paid in cash or any other form etc.The dividend policy of a firm is critical to its success as it affects the market value of shares.

Nature of Financial Management

1. It is an indispensable organ of management. It is an integral part of business decision-making process.
2. It is a continuous process.
3. It is centralized nature of finance function i.e. investment, financing and dividend decision.
4. Helpful in the decision making of top management.
5. It helps in measurement of performance
6. It is pervasive. All form of business organization, big or small needs to manage finance.
7. It has a wide scope.

Scope of financial management

Financial Management is a sub-system in an organization which has to coordinate with other subsystems such as production, marketing etc. Following are scope of financial management

1. **Financial Management and Economics**
   Economic concepts of micro and macroeconomics are of great relevance in financial management. Micro economic concepts like demand and supply, cost theory, production theory etc. are very useful for any financial manager. In the same way,
   Macroeconomics concepts of inflation, per capita income, aggregate-demand, aggregate supply etc. are also useful for finance manager.

2. **Financial Management and Accounting.**
   A finance manager has to make decisions about future. The accounting records are base for future decisions on the basis of which future decisions are being made. Extensive analysis of historical accounting information is made for future financial decisions. Cost and Management accounting provide useful ccounting data to finance managers..

3. **Financial Management and Mathematics**
   Finance functions make use of various statistical and mathematical tools and techniques. Time value of money, discounting and compounding, economic order quantity etc. are widely used in capital budgeting and working capital management. Nowadays, modern techniques of econometrics are being used in decision making along with correlation, regression and other various methods.

4. **Financial Management and Marketing**
   Marketing managers make various marketing decisions. They frame plans regarding pricing, product promotion, product mix etc. they also make decisions about market segmenting, targeting and positioning, choice & length of distributional channels. Finance managers work with marketing managers on most suitable plans and allocate needed funds. Thus marketing and financial manager are related to each other.

5. **Financial Management and Human Resource**
   HR department provides personnel to all department of a firm. A finance manager has to take decisions about requirement and allocation of funds for recruitment, selection, training and development of manpower in the organisation. Thus, a finance manager is in close contact with HR manager for such decisions and effective decisions related with manpower cannot be taken if both departments don’t work in harmony with each other.

6. **Financial Management and Production Management**
   Factors of productions are employed to undertake production. These include land, labour, capital and entrepreneurship. All these requires returns in the form of rent, wages, and profit. All these payments are sanctioned by finance department.

Objectives of Financial Management

It is essential to identify the objective because all the efforts of finance manager would be to achieve that objective. The two basic objective are profit maximization objective and wealth maximization objective.

Profit Maximization Objective

It is implied objective of any business activity. Every business activity is started with the ultimate aim of making profit. Profit maximization objective in financial management means that all financial decisions are made with a view to maximise profit of the firm with all its investments and savings. This objective helps measure of economic performance and efficiency of any business concern.

Favourable Arguments for profit Maximization objective

1. **Rationality:** It is rational that every business activity is undertaken to earn maximum profit.
2. **It ensures effective utilization of resources:** The limited resources are employed to earn maximum profits and costs are reduced to minimum.
3. **It measures success of any business decisions and operations:** whether the implemented decisions were good or bad, whether the business operations were efficient are not could be known with the help of amount of profit earned.
4. **Profit is main source of finance:** Fund is needed to carry out business operations, expansion and diversification. So, for upcoming years the retained part of profits could be used.
5. **Maximization of social benefit:** A business enterprise could fulfill social responsibility obligations in the form of social activities like health, education etc. it is possible only when the enterprise earns maximum profits.
6. **Profit reduces risk of business:** The future is uncertain. There are many risks involved in businesses, if a firm has sufficient profits, it could cope with such risks.

Unfavorable Argument for Profit Maximization Objective

1. **It is Vague and ambiguous:** The term profit is not clear. It has not ee defined precisely and accurately. Whether it is Profit after tax or before tax, accounting profit or incremental profit etc.
2. **It ignores time value of money:** It is based on the concept of “bigger is better” which means higher benefit is better it better for firm. But it does not consider the time period of occurrence of the benefit. It is incorrect to treat cash inflows occurring at different point of time as same.
3. **It ignores risk factor:** there are many internal as well as external risks involved which is not taken into consideration in profit maximization objective.
4. **It leads to exploitation of workers and consumer:** To earn more profit an enterprise tries to charge more price and to take more work from workers with less pays.
5. **It leads to unethical, corrupt, unfair trade practices.**

Wealth Maximization Objective of Financial Management

Wealth Maximization Objective is also known as "Value Maximization" or "Net Present Worth Maximization." This objective is recognized appropriate for decision making. Wealth means wealth of shareholders. Wealth of shareholders is determined by market value of shares.
Wealth also signifies Net Present Value(NPV) which is the difference between present value of cash inflows and present value of cash outflows. In this way, wealth maximization objective considers time value of money and assign different values to cash inflows occurring at different point of time. So, investments should be made in such a way that it maximizes Net Present Value to shareholders.

Arguments in favor of Wealth Maximization objective

1. **It is superior:** This objective is superior to profit maximization as its main aim is to maximise shareholder's wealth.
2. **It is precise and unambiguous:** It is based on the concept of cash flows rather than profit.
3. **Considers time value of money:** Wealth maximization objective takes into account the time value of money as it considers timing of cash inflows. The cash inflows occurring at different period of time are discounted with appropriate discount rate.
4. **Considers risk:** This objective also considers future risk associated with occurrence of cash flow. This is done with the help of discounting rate. Higher the discount rate, higher the risk and vice-versa.
5. **Ensures efficient allocation of resources:** Resources are allocated wisely to increase shareholder's wealth.
6. **Ensures economic interest of society:** When wealth of shareholder is maximized, it ultimately upholds economic interest of society.

Unfavorable arguments for wealth maximization objective

1. **Creates owner-management problem:** The concept of wealth maximization creates owner-management problem as owners want to maximize their profits and management want to maximize shareholder's wealth.
2. **Ignores other stakeholders:** This objective has been criticized on the ground that it is inclined towards wealth maximization of shareholders only and ignores other stakeholders such as creditors, suppliers, employees etc.
3. **Criteria of market value is not fair:** The criteria of wealth maximization is based on market value of shares which is not a correct measure. Because value of shares could increase or decrease due to other economic factors which are beyond the control of the firm.
4. **It is just another form of profit maximization:** Ultimate aim is to earn maximum profits. Without earning profits wealth cannot be maximized.
5. **Management alone enjoy certain benefits.**

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