UNIT-I

INTRODUCTION OF FINANCIAL MANAGEMENT

FINANCIAL MANAGEMENT

Financial management, as we take it today, is that managerial activity which is concerned with the planning and controlling of the firm's financial resources. As a separate activity or discipline, it is of recent origin. The finance in the modern business world is the life blood of the business world is the life blood of the business economy. We cannot imagine a business without finance because it is central point of all business activities. No matter the business is big or small, government, semi-government or non-government. The finance function of the management is equally important profit and non-profit organizations.

Financial Management is that specialized function of general management which is related to he procurement of finance and its effective utilization for the achievement of common goal of the organization. It includes each and every aspect of financial activity in the business. Financial Management has been defined differently by different scholars. A few of the definitions are being reproduced below:

1. "Financial Management is an area of financial decision making, harmonizing individual motives and enterprise goals".

   - Weston and Brigham

2. "Financial management is the application of the planning and control functions to the finance function".

   - Howard and Upon

3. "Financial Management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations".

- Joseph and Massie

From the above definitions, it is clear that financial management is that specialized activity which is responsible for obtaining and effectively utilizing the funds for the efficient functioning of the business and, therefore, it includes financial planning, financial administration and financial control.

FUNCTIONS OF FINANCIAL MANAGEMENT

FINANCE FUNCTION

In the modern society finance functions are drawing increasingly more attention of all those who are responsible for running administration. There is always a problem with every organization for managing its expanding and ambitious plans with is limited financial resources. The financial management has, therefore, been assigned the task of planning and controlling the long and short-term financial needs of the firm.

There are three approaches of finance functions. According to one approach it is the task of providing funds needed by the enterprises on the most suitable terms keeping in view the main objective of the firm, on the other extreme, there is another approach which deals with cash only and as because every business transaction is directly or indirectly connected every business. The third and most- appropriate approach is connected with the acquisition of funds and their best utilization in the business.

Finance function for the sake of convenience may broadly be classified into two groups i.e. executive finance function and incidental finance functions.

(A) Executive Finance Functions

Executive finance functions include all those financial decisions of importance which requires specialized administrative skill. Some of the executive functions are given below:

1. **Financial Forecasting-** The first and foremost function of financial management is to forecast the financial needs of the concern. In the initial stage, it is done by promoters but in a going concern, it is generally performed by the executive chief or by the officer in charge of the finance-department in a large scale enterprise. In estimating the financial requirements of the concern help of various budgets i.e., sales budget, production budget etc.
2. **Investment Policy decisions or Establishing Asset-Management Policies-** In order to estimate and arrange for cash requirements and enterprise, it is very necessary to decide how much in short-term or current assets which are normally convertible into cash within a year.
3. **Dividend Policy Decision or Allocation of Net Profit-** How to allocate the net profits of the concern is another problem before the financial managers. After paying all taxes, the available net profits of the concern can be allocated for three purposes- (a) For paying dividends to the shareholders of the company as a return upon this investment (b) For distributing bonus to the employees and company's contribution to other profit sharing plans, and (c) retention of profits for the expansion of business.
4. **Cash Flows and Requirements-** It is the prime responsibility of the financial manager to see that an adequate supply of cash is available at proper time for the smooth running of the business. A good financial executive should ensure that cash inflows and outflows must be continuous and uninterrupted. Inflow of cash originates in sales and cash outflows of cash requirements are closely related to volume of sales. Here the financial manager is to decide how much cash he must

retain to meet the current obligations so that there would be no idle cash balance earning nothing for the company.

5. **Deciding Upon Borrowing Policy-** Every organization plans for the expansion of the business for which he requires additional resources. Personal resources being limited, the cash must be arranged by borrowing money, either from commercial banks, and other financial institutions or by floating new debentures or by issuing new shares. Financial manager will have to decide the financing mix or capital structure or leverage.
6. **Negotiations For New Outside Financial-** Finance function does not stop with the decision to undertake outside financing; it extends towards carrying on negotiations from the outside financing agencies to arrange for it. Finances are needed by an establishment to meet its short-term and long-term requirements. The financial manager must assess short-and long-term financial requirements of he organization and start negotiations for raising these funds.
7. **Checking upon Financial Performance-** The financial manager is under an obligation to check the financial performance of the funds invested in the business. It requires retrospective analysis of the operating period to operating period to evaluate the efficiency of financial planning. An unbiased assessment of financial performance shall be of great value to the business in improving the stands, us, techniques, and procedures of financial control.

(B) Incidental finance Functions

We have already discussed the executive finance functions in the foregoing paragraphs. Now we shall discuss the various incidental finance functions.

1. Supervision of cash receipts and disbursement and safeguarding of cash balance.
2. Proper custody and safeguarding of the important and valuable papers, securities and insurance policies.
3. Taking care of all mechanical details of financing.
4. Record- keeping and reporting.
5. Cash planning and credit management.

Objectives of financial management

The objectives provide a framework for optimum financial decision making. The knowledge of objectives of financial management is necessary to make wise decisions. It is concerned with designing a method of operating the internal investment and financing of firm.

It is discussed in two parts.

1. Profit maximization.
2. Wealth maximization.

Profit Maximisation

According to this approach, actions that increase profits should be undertaken and those that decrease profits are to be avoided. It implies that investment financing and dividend policy decisions of a firm should be oriented to the maximization of profits. Profitability refers to a situation where output exceeds inputs that is, the value created by the use of resources is more than the total of the inputs, resources used in this sense. Profitability maximization would imply that a firm should be guided in financial decision making by one test, select assets, projects and decisions which are profitable and reject those which are not. The profit maximization criterion has been criticized on general grounds. The main technical drawn backs are definition of profits, timing of benefit, quality of benefits.

Definition of Profit

Firm profit is open to different interpretations to different people. It may mean short term profit, long term profit, profit after tax, and profit before tax, return on total capital, and return on equity and so on. If profit maximization is objective than question is which profit.

Timing of Profit

Profit maximization says the “bigger is, better it is” but the basic dictum of financial planning is “The earlier it is better it is” It is because earlier we get the returns, we can employ it to other profitable projects. Study the following. Illustration Time pattern of benefit.

	Project A (Rs. Lacs)	Project B
Period I	50	-
Period II	100	100
Period III	50	100
	200	200

According to profit maximization both projects A and B are equally beneficial because both yield same profits (200) but according to “earlier it is, better it is” project A should be preferred because benefit are received earlier. In second year. A gives 150 while B gives 100. the profit maximization criterion does not consider the distinction between returns received in different time period and treats benefits irrespective of timing equally, which is not practical.

Quality of Returns

The streams of benefits may possess different degree of uncertainty. Two firms may have same total expected earnings but if the earning but if the earnings of one firm fluctuate considerably as compared to the other it will be more risky. Possibly owners of the firm would prefer smaller but surer profit to a larger but less certain stream of benefits.

Maximizing Earning per Share

If maximizing earning per share is taken as financial objective of the firm it will also not ensure the maximization of owner economic welfare. It also suffers from the flows of time and risk of the expected benefit. It also has certain deficiencies as a financial objective. It implies that the market value of the company's share is a function of earning per share, which may not be true in many instances. If the market value is not a function of earning per share then maximization of the latter will not necessarily result in the highest possible price for the company's share. Maximization of earning per share further implies that the firm should make no dividend policy may not always be to the shareholder's advantage.

Thus, it is clear that maximizing earning per share as the financial objectives fails to maximize the economic welfare of owners. Both methods do not take account of time and uncertainty of benefits.

Shareholder's Wealth Maximisation

The objective of shareholders wealth maximization is an appropriate and operationally feasible criterion to choose among the alternative financial actions. Shareholder's wealth maximization means maximizing the net present value of a course of action to shareholders. The net present value (NPV) if a course of action is the difference between the present value of its benefit and the present value of its costs. A financial action that has a positive NPV creates wealth for shareholder and therefore is desirable. A financial action resulting in negative NPV should be rejected. Between a numbers of mutually exclusive projects the one with the highest NPV should be adopted. The objective of shareholders wealth maximization takes care of the question of the timing and risk of expected returns. From the shareholders point of view, the wealth created by a company through its actions is reflected in the market value of the company's shares. The wealth maximization principle implies that the fundamental objective of a firm is to maximize the market value of its shares. The value of the company's share is represented by their market price which in turn is a reflection of a firm's financial decision.

Social Responsibility

Maximizing shareholders wealth does not mean the management should ignore social responsibility such as protecting the consumer, paying fair wages to employees, maintaining fair hiring practices and safe working conditions, supporting education and becoming involved in such environmental issues as clean air and water. It is appropriate for management to consider the interest of stockholders other than share holders. Stockholders include creditors, employees, customers, suppliers, communities in which a company operates and others.

Profit-Maximisation Vs. Wealth Maximisation

Certain serious objections have been raised against the goal of profit maximization. They are:-

1. Profits cannot be ascertained well in advance. The term profit is also vague.
2. Decision-maker may not have enough confidence in the estimates of future returns.

3. Combination of expected returns with risk variations and related capitalization rate cannot be considered in the concept of profit maximization.
4. The goal of maximization of profits is considered to be a narrow outlook.
5. It ignores time value factor while estimating profits.

Keeping in view the above objections, the thinkers on the subject have come to the conclusion that the aim of the enterprise should be wealth maximization rather than profit maximization.

The importance of financial management?

Funds are needed in every business activity, may it be manufacturing, marketing or hiring of the personnel. A business enterprise requires adequate funds for its commencement, operations, survival and growth. Finance being a source resource, needs to be managed in a profitable manner. This makes financial management so important.

If the finances of an organization are managed properly it contributes largely to the success.

1. It aims at processing funds at favourable terms at minimum costs.
2. It helps to use the funds effectively in various assets, so that such investment yield maximum return and maximize shareholder's wealth.
3. Financial management helps in optimizing the output form a given input of financial resources.
4. It helps in profit planning and monitoring and controlling expenditure and costs.
5. A sound financial management helps in generating sufficient profit to finance, modernization and expansion of the business enterprise, to ensure its stable growth.

Sources of Industrial Finance

There are many sources of finance for the small and large scale industries in India. A brief description of the sources of both the said types of industries is given below-

(I) Financial sources for the Small-scale and Medium Industries.

In the ancient period, there were very few industries units in India and only small-scale and medium scale industries were being run. Before the Second World War, there were three main sources of finance of these industries- (1) Merchants and Bankers, (2) Commercial banks, (3) Industrial Co-operative Banks.

In the modern period, many types of small- scale industries are being run is our country. The industries of sewing machine, electrical goods, shoes, trousers, underwear, etc. generally come under small and medium scale industries. The needs of finance for such industries have greatly increased in the modern period.

National Small Scale Industries Corporation- In order to encourage, protect and to give financial help to the small scale and cottage industries, the Government of India established the National Small Scale Industries Corporation in February, 1955. This Corporation helps the small scale industries in different ways. It procures Government orders for the goods produced in small scale industries, guarantees loans received by these industries from banks and other institutions, provides direct financial assistance to small industries units, makes provision direct financial assistance to small industries and performs many other allied functions.

(II) Financial System of Large Scale Industries

A brief discussion of the financial sources of these industries is given below-

1. Shares and Debentures- Big industrial units derive their finance by issuing a large number of shares and debentures:

(i) Share- A major part of the capital of big industries is made up by issuing shares. For the last several years, the tendency of issuing shares of small value is increasing in the country. The industrial companies ordinarily derive their finance by issuing three types of shares (a) Ordinary, (b) Preferential, and (c) Deferred.

(ii) Debentures- An industrial company can issue shares only equal to its authorized capital, but if it requires more capital then it procures it by issuing debentures. Debentures are, infact, a type of loan bonds, which are issued by the company. A definite rate of interest is given on hem and the money can be returned after a definite period. The debenture-holders are the creditors of the company rather than its share-holders. They are not entitled to share the profits of the company, but are not entitled to charge interests on the money given to the company in the form of loan.

2. Public Deposits- Public deposits is a unique system of Indian industrial finance. In many countries of the would, the industrial units are not able to collect their finance in this manner. Often it is seen that the people who save money, deposit the same in the banks. This not only ensures the security of their money but they get interest on it also Besides this it is also seen that many people deposit their savings in big mills and companies. The companies given comparatively more interest on such deposits. This system has been prevalent in India for a very long time. A major part of the finance of cotton mills of Ahmedabad and Bombay consists of this type of deposits.

3. **Commercial Banks-** These Commercial Banks have also made an important contribution in the field of giving loans for industrial finance in India. These commercial banks give financial banks give financial help to the industries by making deductions in the bills, by giving short-term secured loans, by opening case credit accounts and by giving loans on securities of raw materials or finished goods. Before the nationalization of 20 banks in the country, the contribution of commercial banks was nearly half in the field of giving loans and advances to the industrial companies. Even after the nationalization of banks, the banks provide considerable loans for running for running the big industries in different circumstances.
4. **Managing Agents-** The managing agent system is a unique system in India. This system had been prevalent in our country for a very long time. These managing agents make provision of the industrial companies by purchasing their shares and they also give loans for the needs of the working capital of these companies. These managing agents prove to be very much helpful to the industrial companies at the time of crisis. They also prove to be helpful in securing loans for them from companies and banks.
5. **Indigenous Bankers-** The indigenous bankers have also made an important contribution in providing loans to the trade and industries of the country. These bankers manage finance for the industries

companies. Although the rate of interest on the loans given by these bankers is high, yet the system of loans given by them is quite easy. Consequently, the industries have faced very little difficulty in securing loans from these bankers.

6. **Insurance Companies-** The insurance companies of India have also made an important contribution in the economies system of the industries. However, it may be admitted that as compared to other countries, the insurance companies of our country have been able to provide a very limited help in managing the finance for the industrial units. After the nationalization of life insurance, an Investment Board has been constituted to perform this function.
7. **Investment Trust –** In India, Investment Trusts also provide financial help to the industrial units, Many Investment Trusts such as Corporation, etc., have been established to perform these functions. The is why these investment trusts do not prove to be much helpful in the economic system of the industries.
8. **Exchange Market-** The exchange market also contributes in the system of industrial finance by making transaction of sale and purchase of share and debentures the exchange markets of Bombay, Calcutta and Madras are very important from this point of view.
9. **Financial help by the Government-** The state Governments also provide loans to industrial companies. However, keeping in view the financial needs of these industries, the state-Government are not able to provide sufficient help.
10. **Industrial Financial Corporation of India-** On the basis of the recommendations of the Central Investigation Committee of 1931, the Government of India established an Industrial Finance Corporation of

India in 1984. The authorized and working capitals of this Corporation are Rs. 10 crores and Rs. 5 crores respectively. This Corporation grants loans and advances to industrial units. It also performs the functions of evaluation of the debentures issued by the industrial institutions.

11. **State Finance Corporation-** In order to provide financial help to different industries, State Finance Corporation have also been established by different State.

12. **Industrial Development Bank of India-** In the year 1964, the Indian Parliament enacted an Act for the establishment of Industrial Development Bank of India. This bank endeavors to establish harmony among the works of the different institutions providing finance to different industries. This Bank also performs the function of providing direct financial assistance of the industrial units.

13. **Unit Trust of India-** In India there are many such people who are able to save very little amount yet they wish to invest the same in the industries. There is no appreciable profit, in investing little amount of money in industries besides this these people do not have sufficient knowledge about the different industries. If the savings of these people are collected, then it will become a huge amount of money. It will be then advantageous to invest this money in industrial units. Whit this end in view, the Government of India established the Units Trust of India in the year 1964. This Trust collects the savings of the lower and middle people and purchases the shares of old and new units with that money. The initial capital of the Trust is Rs. 5 crores.

Methods to improve the system of Industrial Finance

A brief discussion of the prominent suggestions given by some Committees and study Groups in given below:

1. Banking facilities should be made available in rural areas so that the saving of the rural people may be made mobile. After the nationalization of 20 banks, it is hoped that more and more banking facilities will be provided in rural areas.

2. A strong movement against the hoarding tendency of the people should be started in the country. The tendency of Indian people to hoard money is very detrimental to the industries. This tendency should be removed within the shortest possible time. Small savings scheme should be encouraged in the country.

3. Stock exchange should be opened in almost all the prominent markets (commercial centers) of the country and speculation activities should be checked, if not completely banned. The defects of Company Laws regarding management should be removed. The new Company Law that has been enacted by the Government has removed these defects to a great extent. Many Corporations have been established for providing industrial finance. The Government have been some measures in this connection but they are insufficient and need to be further augmented.

4. Special facilities should be provided for underwriting of industrial finance. With this aim in view, the Government have established some specific finance Corporations.

5. More and more Investment Trusts should be established

6. Insurance laws should be amended so that the restrictions imposed on different insurance companies regarding investment on industrial securities may be removed.

7. The procedure of the Industrial Finance Corporation should be modified.

8. Every possible effort should be made to produce efficient managers.

9. Assurance should be given to the industrial institutions of private sector that they would not be nationalized.

10. In order to collect Indian savings, Middle Banks should be established.