<u>**SCHOOL OF COMMERCE, DAVV INDORE**</u>

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MBA(Foreign Trade)2 YEARS II SEM

Subject: Financial Management

Financial Management - Meaning, Objectives and Functions

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.

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.
3. Dividend decision - The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two:
    a. 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.

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.

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, maintainance 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.

The Finance Function and the Project Office

Contemporary organizations need to practice cost control if they are to survive the recessionary times. Given the fact that many top tier companies are currently mired in low growth and less activity situations, it is imperative that they control their costs as much as possible. This can happen only when the finance function in these companies is diligent and has a hawk eye towards the costs being incurred. Apart from this, companies also have to introduce efficiencies in the way their processes operate and this is another role for the finance function in modern day organizations.

There must be synergies between the various processes and this is where the finance function can play a critical role. Lest one thinks that the finance function, which is essentially a support function, has to do this all by themselves, it is useful to note that, many contemporary organizations have dedicated project office teams for each division, which perform this function.

In other words, whereas the finance function oversees the organizational processes at a macro level, the project office teams indulge in the same at the micro level. This is the reason why finance and project budgeting and cost control have assumed significance because after all, companies exist to make profits and finance is the lifeblood that determines whether organizations are profitable or failures.

The Pension Fund Management and Tax Activities of the Finance Function

The next role of the finance function is in payroll, claims processing, and acting as the repository of pension schemes and gratuity. If the US follow the 401(k) rule and the finance function manages the defined benefit and defined contribution schemes, in India it is the EPF or the Employee Provident Funds that are managed by the finance function. Of course, only large organizations have dedicated EPF trusts to take care of these aspects and the norm in most other organizations is to act as facilitators for the EPF scheme with the local or regional PF (Provident Fund) commissioner.

The third aspect of the role of the finance function is to manage the taxes and their collection at source from the employees. Whereas in the US, TDS or Tax Deduction at Source works differently from other countries, in India and much of the Western world, it is mandatory for organizations to deduct tax at source from the employees commensurate with their pay and benefits.

The finance function also has to coordinate with the tax authorities and hand out the annual tax statements that form the basis of the employee’s tax returns. Often, this is a sensitive and critical process since the tax rules mandate very strict principles for generating the tax statements.

Payroll, Claims Processing, and Automation

We have discussed the pension fund management and the tax deduction. The other role of the finance function is to process payroll and associated benefits in time and in tune with the regulatory requirements.

Claims made by the employees with respect to medical, and transport allowances have to be processed by the finance function. Often, many organizations automate this routine activity wherein the use of ERP (Enterprise Resource Planning) software and financial workflow automation software make the job and the task of claims processing easier. Having said that, it must be remembered that the finance function has to do its due diligence on the claims being submitted to ensure that bogus claims and suspicious activities are found out and stopped. This is the reason why many organizations have experienced chartered accountants and financial professionals in charge of the finance function so that these aspects can be managed professionally and in a trustworthy manner.

The key aspect here is that the finance function must be headed by persons of high integrity and trust that the management reposes in them must not be misused. In conclusion, the finance function though a non-core process in many organizations has come to occupy a place of prominence because of these aspects.

Role of a Financial Manager Financial activities of a firm is one of the most important and complex activities of a firm. Therefore in order to take care of these activities a financial manager performs all the requisite financial activities.

A financial manger is a person who takes care of all the important financial functions of an organization. The person in charge should maintain a far sightedness in order to ensure that the funds are utilized in the most efficient manner. His actions directly affect the Profitability, growth and goodwill of the firm.

Following are the main functions of a Financial Manager:

1. **Raising of Funds**

   In order to meet the obligation of the business it is important to have enough cash and liquidity. A firm can raise funds by the way of equity and debt. It is the responsibility of a financial manager to decide the ratio between debt and equity. It is important to maintain a good balance between equity and debt.

2. **Allocation of Funds**

   Once the funds are raised through different channels the next important function is to allocate the funds. The funds should be allocated in such a manner that they are optimally used. In order to allocate funds in the best possible manner the following point must be considered

   - The size of the firm and its growth capability
   - Status of assets whether they are long-term or short-term
   - Mode by which the funds are raised

   These financial decisions directly and indirectly influence other managerial activities. Hence formation of a good asset mix and proper allocation of funds is one of the most important activity

3. **Profit Planning**

   Profit earning is one of the prime functions of any business organization. Profit earning is important for survival and sustenance of any organization. Profit planning refers to proper usage of the profit generated by the firm.

   Profit arises due to many factors such as pricing, industry competition, state of the economy, mechanism of demand and supply, cost and output. A healthy mix of variable and fixed factors of production can lead to an increase in the profitability of the firm.

   Fixed costs are incurred by the use of fixed factors of production such as land and machinery. In order to maintain a tandem it is important to continuously value the depreciation cost of fixed cost of production. An opportunity cost must be calculated in order to replace those factors of production which has gone thrown wear and tear. If this is not noted then these fixed cost can cause huge fluctuations in profit.

4. **Understanding Capital Markets**

   Shares of a company are traded on stock exchange and there is a continuous sale and purchase of securities. Hence a clear understanding of capital market is an important function of a financial manager. When securities are traded on stock market there involves a huge amount of risk involved. Therefore a financial manger understands and calculates the risk involved in this trading of shares and debentures.

   It's on the discretion of a financial manager as to how to distribute the profits. Many investors do not like the firm to distribute the profits amongst share holders as dividend instead invest in the business itself to enhance growth. The practices of a financial manager directly impact the operation in capital market.

WORKING CAPITAL MANAGEMENT

Working capital is the capital used for running day-to-day operations of a business. Commonly the gap between the current assets and current liabilities is called the working capital. Current assets include cash and bank balance, accounts receivable, inventory or any other assets which can be liquidated within a period of one year. Similarly, current liabilities are liabilities that are due for payment within a period of one year.

Working capital requirement is influenced by various factors. Majority activities of the company affect the working capital requirements of the company. The magnitude of influence may be different. Some important of them are listed below:

FACTORS INFLUENCING WORKING CAPITAL MANAGEMENT

- **NATURE OF THE INDUSTRY / BUSINESS**

The management of working capital is completely different from industry to industry. A simple comparison of the service industry and manufacturing industry can clarify the point. In the service industry, there is no inventory and therefore, one big component of working capital is already avoided. So, the nature of the industry is a factor in determining the working capital requirement.

- **SEASONALITY OF INDUSTRY AND PRODUCTION POLICY**

Businesses based on seasons like manufacturing of ACs whose demand peaks in summer and dips in winter. The requirement of working capital will be more in summer compared to winter if they are produced in the fashion of their demand. The policy of producing throughout the year can smoothen the fluctuation of the working capital requirement.

- COMPETITION

If the industry is competitive, quick response to customer needs is compulsory and therefore a higher level of inventory is maintained. Liberal credit terms are also mandatory with good service to survive in the market. So, higher the competition, higher would be the requirement of working capital.

- PRODUCTION CYCLE TIME

The production cycle time refers to the time required for converting the raw materials into finished goods. Higher, this time, higher would be the time of blocking funds in the working capital.

- CREDIT POLICY

Liberal credit policy demands a higher level of working capital and tight credit policy reduces it.

- GROWTH AND EXPANSION

Some industries are static and others are growing. Obviously, growing industry grows the requirement of working capital also as compared to static industry.

- SHORTAGE OF SUPPLY OF RAW MATERIAL

If the raw material supply is not smooth for any reason, companies tend to store more of raw materials than needed and that increased requirement of working capital.

- **TAXES**

Taxes are often paid in advance. This also blocks a part of working capital. Depending on the tax environment of the industry, working capital needs are also affected.

- DIVIDEND POLICY

Dividend policy determines the level of retained profits with the business and retained profits are also used for working capital. This is how; dividend policy affects the need for working capital.

- PRICE LEVELS

The price levels of inventory and other expenses such as labor rates etc increase the working capital requirement. If the company also is able to increase the price of their finished goods, it reduces this impact.

Other factors that determine or impact the working capital in some or the other way are as follows:

- Cash Requirements
- Volume of Sales
- Terms of Purchase and Sales
- Inventory Turnover
- Current Assets Requirements

- Operation Efficiency
- Change in Technology
- Firm’s Finance and Dividend Policy
- Attitude towards Risk
- Raw material Holing period.
- Work In Progress Holding period
- Finished Goods Holding Period.
- Average Collection Period.
- Average Payment Period.
- Working Capital Cycle.
- Safety Stock of Raw Material.
- Cash Balance to be maintained.