1.1 INTRODUCTION

Financial Management is concerned with planning, directing, monitoring, organizing and controlling monetary resources of an organization. Financial Management simply deals with management of money matters. Management of funds is a critical aspect of financial management. The process of financial management takes place: at the individual as well as organization levels. Our area of dealing is from the viewpoint of organization.

‘Financial Management’ is a combination of two words, ‘Finance’ and ‘Management’. Finance is the lifeblood of any business enterprise. No business activity can be imagined, without finance. It has been rightly said that business needs money to make more money. However, money begets money, when it is properly managed. Efficient management of business is closely linked with efficient management of its finances. Financial Management is that specialized function of general management, which is related to the procurement of finance and its effective utilization for the achievement of common goal of the organization.

1.2 MEANING OF FINANCE

Finance is defined as the provision of money at the time, it is required. Finance is the art and science of managing money. There is no human being, without blood. Similarly, there is no organization that does not require finance, irrespective of the activity, it is engaged in. The way blood is needed for a person to live, so is the requirement of finance to any firm for its survival and growth. Without adequate finance, no organization can possibly achieve its objectives.
Ray G. Jones and Dean Dudley observe that the word ‘finance’ comes directly from the Latin word ‘finis’. As a management function, finance has special meaning. Finance function may be defined as the procurement of funds and their effective utilization.

Howard and Upton (1952) defined finance as “the administrative area or set of administrative function in an organization which have to do with the management of flow of cash so that the organization will have the means to carry out its objectives as satisfactory as possible and, at the same time, meet its obligations as they become due.”

**Distinction between Money and Finance:** Money is expressed in currency. Money can be any country’s currency, which is in the hands of any person or organization. Finance is also money, any country’s currency, which is owned by any person or organization, but lent to others, used to buy an asset or make investment opportunities. The distinction between money and finance can be explained in another way.

If you hold currency, it is money, while you lend it over to others for buying or investing in investment opportunities, it becomes finance.

It is curious to find that the same currency changes its role from ‘Money’ to ‘Finance’, with the change of hands. Let us illustrate. Money raised by a bank, in the form of deposits from public, becomes finance when it is lent to borrowers. If it is granted to buy/construct a home, it becomes a home loan. It is a vehicle loan, when the amount is lent for buying a car. The amount becomes ‘Project Finance’, if lent to entrepreneur to start or expand a project.

If you hold money, it does not give any return. You part money in the form of finance, either by way of loan or investment, it starts getting return. Is it not interesting?

**1.3 FUNCTIONS AND IMPORTANCE OF FINANCE**

In general, the term “Finance” is understood as the provision of funds, as and when needed. Finance is the essential requirement—*sine qua non*—of every organization.

**Required Everywhere:** All activities, be it production, marketing, human resources development, purchases and even research and development, depend on the adequate and timely availability of finance both for commencement and their smooth continuation to completion. Blood is needed for every human being. Similarly, there is no organization that does not require finance, irrespective of its activities. The way blood is required for a person to live, so be the finance to any firm for its survival and growth. Finance is regarded as the life-blood of every business enterprise.

**Efficient Utilization—More Important:** Finance function is the most important function of all business activities. The efficient management of business enterprise is, closely, linked with the efficient management of its finances. The need of finance starts with the setting up of business. Its growth and expansion require more funds. Funds have to...
be raised from various sources. Such sources have to be selected keeping in view their relation to the implications, in particular, its risks attached. Receiving money, alone, is not important. Terms and conditions, while receiving money are more important. Cost of funds is an important element. Its utilization is rather more important. If funds are utilised properly, repayment would be possible and easier, too. Care has to be exercised to match the inflow and outflow of funds. Needless to say, profitability of any firm is dependent on its cost as well as its efficient utilization.

1.4 FINANCE AND RELATED DISCIPLINES

Financial Management is not an independent area, but an integral part of overall management. As a subject too, Financial Management had been a branch of Economics till 1890. Later, it has evolved into a separate discipline. It draws heavily on Economics to explain its theoretical concepts, even today. The subject is of immense interest to academicians and practicing managers. Academicians take interest as there are several controversies and no unanimous opinion is, still, found. Again, the subject is a matter of great challenge to practicing managers as business affords a lot of scope to expand, with ever-growing competition. Every decision-making process involves finance, demanding new innovative products and techniques to use them to the utmost advantage of the firm. Finance managers often do feel in real life why this subsequent thinking did not come to them earlier, to solve their problems. Threat to survive sharpens the thinking process.

1.4.1 Finance and Economics

Economics has two broad areas, viz. Macroeconomics and Microeconomics.

Macroeconomics is concerned with overall institutional and international environment in which the firm must operate. In other words, macroeconomics is the environment in which an industry operates, which is not controllable by any individual firm. They are the external factors, which are beyond the control of the company. They relate primarily to

- State of the economy
- Government policy

When we analyse our problems from the viewpoint of the whole economy, it is a macro economics. Institutional environment encompasses banking system, capital markets, financial intermediaries, credit policies of The Reserve Bank of India, structure and growth of financial system, monetary and economic policies of the government, which vary periodically. Their awareness and adoption to change for the firm is vital. Business firms operate in the macroeconomic environment. Unless the finance managers understand the implications of the policy and assess the impact they make to the business, and change accordingly, business firms cannot survive, let alone grow. Finance managers have to understand the broad economic environment in which their firms work. To be successful, they cannot afford to function in isolation. They should recognize the impact of each
decision, be it monetary or credit policy, in terms of their relative cost and availability of funds. For example, when the economy faces slump, it is not advisable to go for expansion activities. Similarly, when the economy experiences an uptrend, firm can opt for trading on equity for financing as larger profits are assured to most of the firms. That policy helps the firm to increase earnings per share. Finance managers have to update their knowledge and make detailed analysis in respect of matters affecting the company to apprise the management for the timely changes to be introduced.

Microeconomics is firm’s specific environment and also controllable. Microeconomic factors deal with the internal conditions of the firm. A few important factors are as under:

1. **Nature and Size of Enterprise:** Firms differ in activities and their size. Their capital structure and methods of financing also depend on their size. A manufacturing firm or public utility organization would require more fixed assets, so their capital structure is large. Small firms can obtain their fixed assets even on lease. But, large firms would construct their own building and assemble their own plants. Unlike big firms, small firms do not enjoy goodwill in the capital market and are largely dependent on internal finances.

2. **Level of Risk and Stability in Earnings:** Risk influences the financial decisions of the firm. Greater the risk, firm has to retain more profits, rather than adopting a liberal dividend policy. Firms that enjoy stable earnings prefer fixed-cost capital, such as preference shares and debentures as they can pay the fixed amount of interest, without difficulty, from their earnings. Where stable earnings do not exist, financing is done through equity as there is no commitment to pay fixed and regular dividend.

3. **Liquidity Position:** Dividend, normally, is paid out of cash. Firms with a sound liquidity position can adopt liberal dividend policy. If there is illiquidity in the firm, it affects nature of financing and dividend decisions.

4. **Pattern of Ownership:** In a closely-held company, ownership lies in a few hands. It is easier to convince them that a conservative dividend policy is good to them, if the policy is in the interests of the company. Where there are many shareholders, their wishes matter the most in decision-making. Their preferences cannot be ignored, while designing dividend policy.

5. **Attitude of Management:** Though listed last, importance of attitude of management is not the least. If the firm is conservative, greater importance is given to liquidity, rather than the profitability. More investment is made in current assets. The finance manager tries to tread a beaten path, preferring to avoid fixed obligations for raising additional capital, even if debt capital is advantageous. On the other hand, finance manager in an aggressive firm stresses profitability, sacrificing importance of liquidity. Additional capital is raised by debt, accepting the risk of debt to take advantage of the debt. Alternatively, preference may be given to conduct the business with lesser current assets.
An experienced finance manager, with prudence, can manoeuvre and absorb the impact of internal and external factors to some extent.

**A prudent finance manager would prefer a compromise between risk and return, equally between profitability and liquidity.**

Supply and demand relationship, profit maximization, pricing strategies, risk and return determination and marginal analysis are the few examples of relevant microeconomic theories used in financial management. The rationale of deprecating assets is rooted in microeconomic theory. Product pricing strategies is one of the common issues that are, often faced. The primary principle of financial management, *Marginal Analysis or Cost Benefit Analysis*, is one of the important areas that is frequently applied. Comparison of cost with the corresponding benefit is essential for decision-making, as benefit in excess of cost only increases profit. Knowledge of basic microeconomics is essential for all finance managers.

Let us illustrate. A proposal has come for consideration to replace an existing manual stone crusher by a mechanized stone crusher. Existing stone crusher can be sold at ₹ 10,000, while the new mechanized stone crusher involves a cash outlay of ₹ 75,000. The total benefits from the new mechanized stone crusher and manual crusher are ₹ 1,20,000 and ₹ 22,000 respectively. Applying Marginal Analysis, we get:

<table>
<thead>
<tr>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefits from new crusher</td>
</tr>
<tr>
<td>Less: Benefits from old crusher</td>
</tr>
<tr>
<td><strong>Marginal Benefit (A)</strong></td>
</tr>
<tr>
<td>(Incremental Benefit)</td>
</tr>
<tr>
<td>Cost of new crusher</td>
</tr>
<tr>
<td>Less: Proceeds from the sale of old crusher</td>
</tr>
<tr>
<td><strong>Marginal Cost (B)</strong></td>
</tr>
<tr>
<td>(Additional Cost)</td>
</tr>
<tr>
<td><strong>Net Benefits (A–B)</strong></td>
</tr>
</tbody>
</table>

As the decision results into a net benefit, cost benefit analysis recommends acceptance of the proposal to the firm.

**Stated simply, economics is closely intertwined with finance, the subject of finance has since long been known as ‘Economics of Finance’.

1.4.2 Finance and Accounting

Much of the modern business is not possible without accounting information. It is an accepted fact that business is finance oriented. It is the process of using money to make money. Accounting generates information/data related to activities/operations of a firm, dealing in goods or services. Necessary input is provided by accounting for finance function. Accounting is a source of most information, which management uses for decision-making. Management is heavily dependant on accounting for operating facts.
Finance is closely related to accounting. Accounting is the data collection process, dealing with accurate reporting, while finance is a managerial or decision-making process. Accounting provides the input for finance. Finance is wide, while accounting is its part. Finance is referred to with greater respect than accounting. In many organizations, finance is entrusted only to those who enjoy the trust of the top management.

End products of accounting—profit and loss account, balance sheet, sources and application of funds statement and cash flow statement—assist finance managers in assessing the past performance and understanding the future directions of the firm.

There are two key differences between accounting and finance. One relates to treatment of funds and the other relates to decision-making.

**Treatment of Funds:** Accrual system of accounting is the backbone of accounting, which forms the basis for determination of operating results. Revenue is recognized at the point of sale, irrespective of its realization of sale proceeds. In other words, collection of cash has no significance. Similarly, expenses are recognized when they are incurred, not at the time of payment. Payment of expense is not relevant at all. A firm may be quite profitable in the accounting sense, but, still, struggling, even, to make small cash payments due to liquidity problems. In fact, such a book profit firm cannot survive very long. Solvency is always a challenge, if it is not the focus of the firm.

For treatment of funds, finance is based on cash flows. Funds mean inflow and outflow of cash. Sales, when actually realized, are inflows and expenses when paid are outflows. Here, the importance is on solvency, i.e. ability to maintain cash obligations as and when they fall due for payment. Insolvency situation is avoided. The goal of the firm is to maintain the necessary cash flows, to meet its obligations and finance the assets needed for the firm.

Let us illustrate with a small example the difference in treatment between accounting and finance for transactions in a year:

<table>
<thead>
<tr>
<th>₹</th>
<th>Accounting View</th>
<th>Financial View</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>20,00,000</td>
<td>Cash inflows</td>
</tr>
<tr>
<td>Cost of sales or purchases</td>
<td>14,00,000</td>
<td>Less: Cash outflow</td>
</tr>
<tr>
<td>Opening &amp; Closing stock</td>
<td>Nil</td>
<td>12,00,000</td>
</tr>
<tr>
<td>Collections from sales</td>
<td>4,00,000</td>
<td>*Net Cash outflow</td>
</tr>
<tr>
<td>Payments to suppliers</td>
<td>12,00,000</td>
<td>(8,00,000)</td>
</tr>
</tbody>
</table>

* Net Cash outflow is the resultant of current year operations. This is negative, indicating that opening cash balance has gone towards reduction of cash flow, resulting in reduced closing cash balance at the end of the year.
The picture clearly shows that the firm is highly profitable in the accounting sense. However, if this type of performance continues, there would be heavy shortage of cash, resulting in liquidity crunch. Very soon, the firm would not survive, due to inadequate cash flows to meet its obligations. Financial collapse is imminent. In financial terms, firm is heading for insolvency. In other words, a highly profitable firm, in accounting sense, is heading towards insolvency.

Financial view exposes what accounting treatment eclipses.

**Decision-making:** Accounting and finance differ in their purpose. The purpose of accounting is collection and presentation of data. The data so made available is used by the finance manager for decision-making. It does not mean that accountants never make decisions and finance managers never collect data. Their focus is different. Accountants collect accurate data and finance managers plan, control and make decisions. In a way, finance begins where accounting ends.

### 1.4.3 Finance and Other Related Disciplines

Finance also draws support from other related disciplines, such as production, marketing and quantitative methods. Finance is a service function to meet the needs of production and marketing. If the firm decides to produce and sell more, capital expenditure projects may be needed, for which finance manager has to arrange funds. Such a decision also would have impact on the projected cash flows. In those areas, production and finance managers need to work closely for optimum investment in plant and machinery. Finance is becoming a complex area and so tools of analysis developed in the quantitative methods area are helpful in analyzing the complex financial management problems.

**Fig. 1.1:** Impact of important disciplines on financial management
1.5 MEANING AND DEFINITION—FINANCIAL MANAGEMENT

The general meaning of finance refers to the provision of funds, as and when needed. However, as management function, the term ‘Financial Management’ has a distinct meaning. Financial management deals with the study of procuring funds and its effective and judicious utilization, in terms of the overall objectives of the firm, and expectations of the providers of funds. The basic objective is to maximize the value of the firm. The purpose is to achieve maximization of share value to the owners, i.e. equity shareholders.

The objective of every company is to create value for its shareholders. Market price of equity share is the barometer for showing the real ‘Value’. The basic objective of financial management is to maximize the shareholders’ wealth, represented by the market value of equity shares.

Financial Management is concerned with three activities:

- Anticipating financial needs, which means estimating requirements of the firm in terms of long-term and short-term needs or investment in fixed and current assets.
- Acquiring financial resources from different sources to meet the financial needs.
- Allocating funds to maximize shareholders’ wealth.

The term financial management has been defined differently by various authors. Some of the authoritative definitions are given below:

1. “Financial Management is concerned with the efficient use of an important economic resource, namely, Capital Funds.” – Solomon
2. “Financial Management is concerned with the managerial decisions that result in the acquisition and financing of short-term and long-term credits for the firm.” – Phippiopatus
3. “Financial Management is concerned with the acquisition, financing and management of assets with some overall goal in mind.” – James C. Van Horne

From the above definitions, two basic aspects of financial management emerge.

A. Procurement of funds.
B. Effective and judicious utilization of funds.

Financial management has become so important that it has given birth to Financial Management as a separate subject.
1.6 NATURE OF FINANCIAL MANAGEMENT

Financial management refers to that part of management activity, which is concerned with the planning and controlling of firm’s financial resources. Financial management is a part of overall management. All business decisions involve finance. Where finance is needed, role of finance manager is inevitable. **Financial management deals with raising of funds from various sources, dependent on the availability and existing capital structure of the organization.** The sources must be suitable and economical to the organization. Emphasis of financial management is more on its efficient utilization, rather than raising of funds alone.

The scope and complexity of financial management has been widening with the growth of business in different diverse directions. As business competition increases, with a greater pace, more support of financial management is needed, in a more innovative way to make the business grow, ahead of others.

1.7 IMPORTANCE—FINANCIAL MANAGEMENT

The main importance of financial management can be listed as under:

1. It is necessary for the smooth running of the organization.
2. It facilitates to evaluate the profitability of operational activities of the organization.
3. From the view point of profitability, decision-making is geared at all functional levels.

1.8 NEED OF FINANCIAL MANAGEMENT

Financial management is concerned with optimum utilization of resources. Resources are limited, particularly in developing countries like India. So, the focus, everywhere, is to take maximum benefit, in the form of output, from the limited inputs.

Financial management is needed in every type of organization, be it public or private sector. Its importance exists equally in both profit oriented and non-profit organizations. In fact, need of financial management is more in loss-making organizations to turn them to profitable enterprises. Study reveals many organizations have sustained losses, due to absence of professional financial management.

1.9 SCOPE—FINANCIAL MANAGEMENT

Over the years notable changes have occurred in financial management both in its scope and areas of coverage. **Study of changes that have taken place, over the years, is known as “Scope of Financial Management”.**

For easy understanding of changes, it is necessary to divide the scope of financial management into two approaches. Broadly, the two approaches and their emphasis are:
Traditional Approach—Procurement of Funds

Modern Approach—Effective Utilization of Funds

Traditional Approach

The scope of finance function was treated in the narrow sense as procurement or arrangement of funds. A finance manager was treated as just provider of funds, when organization felt its need. **The utilization or administering resources was considered outside the purview of the finance function. It was felt that the finance manager had no role to play in the decision-making for its utilization.** Others used to take decisions regarding its application in the organization, without the involvement of finance personnel. Finance manager had been treated, in fact, as an outsider with a very specific and limited function, supplier of funds, to perform when the need of funds was felt by the organization.

As per this approach, the following aspects only were included in the scope of financial management:

(i) Estimation of requirements of finance.
(ii) Arrangement of funds from financial institutions.
(iii) Arrangement of funds through diverse financial instruments such as shares, debentures, bonds and loans.
(iv) Looking after the accounting and legal work connected with the raising of funds, and
(v) Preparation of financial statements and managing cash levels needed to pay day-to-day maturing obligations.

Limitations

The traditional approach was evolved during the 1920s and 1930s period and continued till 1950. The approach had been discarded due to the following limitations:

(i) **No Involvement in Application of Funds:** The finance manager had not been involved in decision-making of the allocation of funds. He had been ignored in internal decision-making process and treated as an outsider.

(ii) **No Involvement in Day-to-day Management:** The focus was on providing long-term funds from a combination of sources. This process was more of one time happening. The finance manager was not involved in day-to-day administration of working capital management. Smooth functioning of the firm depends on working capital management, where the finance manager was not involved and allowed to play any role.

(iii) **Not Associated in Decision-making—Allocation of Funds:** The issue of allocation of funds was kept outside his functioning. He had not been involved in decision-making for its judicious utilization.
(iv) **Outsider-looking-in Approach:** The subject of finance has moved around the suppliers of funds (investors, financial institutions, banks, etc.) who are outsiders. The approach has been outsider-looking-in approach, since finance manager has never been involved in internal decision-making process.

Raising finance was an infrequent event. Its natural implication was that the issues involved in working capital management were not in the purview of the finance function. In nutshell, during the traditional phase, the finance manager was called upon, in particular, when his speciality was required to locate new sources of funds, as and when the requirement of funds was felt.

The following issues, as pointed by Solomon, were ignored in the scope of financial management, under this approach:

(A) Should an enterprise commit capital funds to a certain purpose?
(B) Do the expected returns meet financial standards of performance?
(C) How should these standards be set and what is the cost of capital funds to the enterprise?
(D) How does the cost vary with the mixture of financing methods used?

The traditional approach has failed to provide answers to the above questions due to narrow scope. Traditional approach has outlived its utility in the changed business situation. The scope of finance function has undergone a sea change, with the emergence of different capital instruments.

The emphasis of Financial Management has been shifted from raising funds to the effective and judicious utilization of funds. The modern approach is an analytical way of looking into the financial problems of the firm.
The main contents of this new approach are:

(A) What is the total volume of funds an enterprise should commit?
(B) What specific assets an enterprise should acquire?
(C) How should the funds required be financed?

Advice of finance manager is required at every moment, whenever any decision with involvement of funds is taken. There is hardly any activity that does not involve funds.

In the words of Solomon, “The central issue of financial policy is the use of funds. It is helpful in achieving the broad financial goals which an enterprise sets for itself”.

Now-a-days, the finance manager is required to look into the financial implications of every decision to be taken by the firm. He is involved before taking any decision, during its review and, finally, when the final outcome is judged. In other words, his association has been continuous in every decision-making process from inception till its end.

Check Your Understanding

(A) State whether the following statements are True or False
1. Government monetary policy influences the firm’s financial decisions.
2. Corporate financial decisions are based on microeconomic factors only.
3. The objective of wealth maximization serves the interests of different groups directly or indirectly related to the firm.
4. Macroeconomics deals with the internal factors affecting the firm.
5. An efficient finance manager closely follows both macro and microeconomic factors that influence the activities of the firm.
6. Financial management does not have any relationship with other disciplines.
7. Irrespective of slump or uptrend of economy, expansion activities are to be undertaken.
8. Credit policy of the government influences the nature of a firm’s financial decisions.
9. Analysis of external environment by finance manager helps in identifying opportunities and threats to the firm.
10. Basic knowledge of economics is not necessary for a finance manager.
11. Efficient management of business is closely linked with efficient management of finances.
12. Finance holds key to all economic activities.

(B) Objective Questions  (Identify what is most appropriate)
1. Profit maximization is made when
   (i) marginal revenue is < marginal cost
   (ii) marginal revenue is > marginal cost
   (iii) marginal revenue = marginal cost
2. Corporate financial decisions are influenced by
   (i) macroeconomic factors only
   (ii) microeconomic factors only
   (iii) both macroeconomic and microeconomic factors
3. Traditionally, the role of finance manager was restricted to
   (i) efficient utilization of funds
   (ii) acquisition of funds
   (iii) acquisition and efficient utilization of funds
4. Financial management is mainly concerned with
   (i) efficient management of business
   (ii) providing funds
   (iii) acquisition and efficient utilization of financial resources

Answers
1. (iii) 2. (iii) 3. (ii) 4. (iii)

Descriptive Questions
1. Explain the meaning and importance of finance. (1.1 to 1.3)
2. Draw a distinction between ‘Finance’ and ‘Money’ with suitable examples. (1.1 & 1.2)
3. In what ways do macro and microeconomic factors influence corporate financial decisions? (1.4 & 1.4.1)
4. How finance is related to macro-economic and micro-economic problems? (1.4 & 1.4.1)
5. Describe the close relationship between ‘finance’ and ‘economics’ and explain the need for a finance manager to possess basic knowledge of economics. (1.4 & 1.4.1)
6. “The subject of finance has since long been known as ‘economics of finance’”—Discuss. (1.4 & 1.4.1)
7. What are the major differences between accounting and finance in respect of cash flows? (1.4.2)
8. Describe the relationship between finance and other related disciplines. (1.4 & 1.4.1, 1.4.2 and 1.4.3)
9. Define ‘Financial management’ and explain its nature, need and importance. (1.5 to 1.8)
10. Explain the scope of financial management. (1.5 and 1.9)
11. “The horizons of Financial Management have changed substantially in scope and complexity over the years”—Justify the statement. (1.9)
12. Write short notes on the following:
   (A) Money and Finance (1.2)
   (B) Financial Management (1.5)
13. Market price of equity share is the barometer for showing the real ‘value’ of the company.
14. The basic objective of financial management is to maximize the shareholders' wealth, represented by the market value of equity shares.

15. It is not the function of the finance manager to look into the financial implications of marketing decisions.

Answers


Interview Questions

Q.1. Is there any difference between ‘Money’ and ‘Finance’? If so, illustrate your views?

Ans. ‘Money’ and ‘Finance’ are different. Any form of currency held is money. Money changes its role to finance when it is used as an investment or lent to others. Let us take an example to explain their difference. Money raised by a bank in the form of deposits becomes finance when the amount is lent. It becomes vehicle finance when the loan is sanctioned for the purchase of a vehicle and the same amount, when lent for buying a home, becomes home loan.

Q.2. What is the basic objective of ‘Financial Management’?

Ans. The basic objective of ‘Financial Management’ is to maximize the shareholders’ wealth. Maximization of shareholders’ wealth occurs when the price of the equity share is at its peak.