

Finance Is the Oil of Wheel, Marrow of Bones and Spirit of Trade, Commerce and Industry - An Analytical Elucidation

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ABSTRACT: Finance is to business what blood is to the human body. This is the lifeblood of business. Fortunately for the human body there is an automatic regulation of the quantity and quality of blood required. No such auto control is available in the case of a business firm. Hence the necessity to manage 'finance' so that the firm may have at its disposal adequate funds of various types but at the same time avoiding idleness of funds. There was a time when it was thought that financial management consisted merely providing funds required by the various departments or divisions of the firm. This has now changed completely and it is accepted that proper financial management consists of a dynamic approach towards the achievement of firm's objectives.

In general, finance may be defined as the provision of money at the time it is wanted. However, as a management function it has a special meaning. Finance function may be defined as the procurement of funds and their effective utilisation.

KEYWORDS: Distribution of goods and services, barometer of the enterprise, liquidity profitability trade off, Profit maximization, Wealth maximization, Investment Decision, Finance Decision, Long-term financial decision, Financial Analysis, Cash Flow Statement, Fund Flow Statement, Financial Leverages, Stakeholders, Executive Function, Incidental Function.

I. INTRODUCTION

Of all the branches of management, financial management is of the highest importance. The primary purpose of a business firm is to produce and distribute goods and services to the society in which it exists. We need finance for the production of the goods and services as well as their distribution. The efficiency of production, personnel and marketing operations is directly influenced by the manner in which the finance function of the enterprise is performed by the finance personnel. Thus it may be stated that all the functions or activities of the business are ultimately related to finance function. The success of the business depends on how best all these functions can be co-ordinated.

A tree keeps itself green and growing as long as its roots sap the life juice from the soil and distribute the same among the branches and leaves. The activities of an organisation also keep going smoothly so long as finance flows through its veins. Any and every business activity will ultimately be reflected through its finance the mirror and also the barometer of the enterprise functions.

Finance and Other Functional Areas of Management

Financial Management and Research and Development: The R & D manager has to justify the money spent on research by coming up with new products and process which would help to reduce costs and increase revenue. If the R & D department is like a bottomless pit only swallowing more and more money but not giving any positive results in

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return, then the management would have no choice but to close it. No commercial entity runs a R & D department for conducting infructuous basic research.

For instance, until 5 years ago, 80% of the R & D efforts of Bush India, the 45 year old consumer electronics company, well known for its audio systems, was in TVs and only 20% was in audio. But the fact that a 15-year stint in the TV market starting from 1981 when the company shifted its interest from the audio line to TV manufacture, led the company's decline to near oblivion, pushing the once-famous Bush brand name to near anonymity, called for a change in production and re-orientation of R&D strategy. The company has also identified and shut down some of its non-productive divisions and trimmed to workforce. At the beginning of 1992, Bush had 872 employees, by the end this was cut down to 550. The company had to further cut it down to 450 by the end of 1993.

Financial Management and Materials Management: Likewise the materials manager should be aware that inventory of different items in stores is nothing but money in the shape of inventory. He should make efforts to reduce inventory so that the funds released could be put to more productive use. At the same time, he should also ensure that inventory of material does not reach such a low level as to interrupt the production process. He has to achieve the right balance between too much inventory and too little inventory. This is called the 'liquidity-profitability trade-off' about. The same is true with regard to every activity in an organisation. The results of all activities in an organisation are reflected in the financial statements in rupees.

Financial Management and Production Management: In any manufacturing firm, the Production Manager controls a major part of the investment in the form of equipment, materials and men. He should so organise his department that the equipments under his control are used most productively, the inventory of work-in-process or unfinished goods and stores and spares is optimised and the idle time and work stoppages are minimised. If the Production Manager can achieve this, he would be holding the cost of the output under control and thereby help in maximising profits. He has to appreciate the fact that whereas the price at which the output can be sold is largely determined by factors external to the firm like competition, government regulations, etc., the cost of production is more amenable to his control. Similarly, he would have to make decisions regarding make or buy or lease etc., for which he has to evaluate the financial implications before arriving at a decision.

Financial Management and Marketing Management: Marketing is one of the most important areas on which the success or failure of the firm depends to a very great extent. The philosophy and approach to the pricing policy are critical elements in the company's marketing effort, image and sales level. Determination of the appropriate price for the firm's products is importance both to the marketing and the financial managers and, therefore, should be a joint decision of both. The marketing manager provides information as to how different prices will affect the demand for the company's products in the market and the firm's competitive position while the finance manager can supply information about costs, change in costs at different level of product and the profit margins required to carry on the business. Thus, the finance manager contributes substantially towards formulation of the pricing policies of the firm.

Thus, it will be seen that the financial management is closely linked with all others areas of management. As a matter of fact, the financial manager has a grasp over all areas of the firm because of his key position. Moreover, the attitude of the firm towards other management areas is largely governed by its financial position. A firm facing a critical financial position will devise its recruitment, production and marketing strategies keeping the overall financial position in view. While a firm having a comfortable financial position may give flexibility to the other management functions, such as, personnel, materials, purchase, marketing and other policies.

Evolutionary Change in the Concept of Finance

1. Finance means Cash only: Starting from the early part of the present century, finance was described to mean *cash* only. The emphasis under this approach is only on liquidity and financing of the firm. Since nearly every business transaction involves cash, directly or indirectly, finance is concerned with everything that takes place in the conduct of the business. However, it must be noted that this meaning of finance is too broad to be meaningful.

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2. Finance is raising of funds: The second grouping, also called the 'traditional approach', is *concerned with raising funds used in an enterprise*. It covers; (a) instruments, institutions, practices through which funds are raised and (b) the legal and accounting relationships between a company and its sources of funds, including the redistribution of income and assets among these sources. This concept of finance is, of course, broader than the first as it is concerned with raising of funds. Finance, during the forties through the early fifties, was dominated by this traditional approach emphasised the perspective of an outsider lender. It only analysed the firm and did not emphasis decision-making within the firm. Second, this approach laid heavy emphasis on areas of external sources of long-terms finance. However, short-term finance, i.e., working capital is equally important. Third, the function of efficient employment of resources was totally ignored.

3. Finance is raising and utilisation of funds: The third grouping is called the integrated Approach or 'Modern Approach'. According to this approach, the concept of finance is concerned not only with the optimum way of raising of funds but also their *proper utilisation* too in time and low cost in a manner that each rupee is made to work at its optimum without endangering the financial solvency of the firm. This approach to finance is concerned with (a) determining the total amount of funds required in the firm, (b) allocating these funds efficiently to the various assets, (c) obtaining the best mix of financing-type and amount of corporate securities, (d) use of financial tools to ensure proper and efficient use of funds.

In general, finance may be defined as the provision of money at the time it is wanted. However, as a management function it has a special meaning. Finance function may be defined as the procurement of funds and their effective utilisation.

Financial management is intimately interwoven into the fabric of management itself. Not only is this because the results of managements 'actions are expressed in financial terms, but also principally because the central role of financial management is concerned with the same objectives as those of management itself and with the way in which the resources of the business are employed and how it is financed. Because it is about making profits and profits will be determined by the way in which the resources of the business in terms of people, physical resources, capital, and any other specific talents are organised.

Financial management is concerned with identifying sources of profit and the factors which affects profit. That is to say with operating activities in the way in which the assets are used, and from a longer term point of view, the process of allocating funds to use within the business. In these activities, financial managers from part of a management team applying their specialist advice and processing and marshalling the data upon which decision are based.

Goals of Financial Management

The goal of the financial management should be to achieve the objective of the business's owners, who are the suppliers of capital. In the case of company, the owners are shareholders. The financial manager's function is not to fulfill his own objectives, which may include higher salaries earning reputation or maintaining and advancing his personal power and prestige. It is, rather to manager is successful in this endeavour, he will also achieve his personal objectives. It is generally agreed that the financial objective of the firm should be the maximisation of owner's wealth. However, there is disagreement as to how the economic welfare of owners can be maximised. Two well known and widely discussed criteria which are put forth for this purpose are (a) profit maximisation, (b) wealth maximisation.

(a) Profit Maximisation: Traditionally, the business has been considered as an economic institution and profit has come to be accepted as a rationally valid criterion of measuring efficiency. As a goal, however, profit maximisation suffers from certain basic weaknesses: (1) it is vague, (2) it is a short-run point of view, (3) it ignores risk and (4) it ignores the timing of returns.

An unambiguous meaning of the profit maximisation objective is neither available nor possible. It is rather very difficult to know about the following. Does it mean short-term profits or long-term profits? Does it refer to profit before or after tax? Does it refer to total profits or profit per share? Besides it is being ambiguous, the profit maximisation

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objective takes a short-run point of view. **Prof. Drucker and Prof. Galbraith** contradict the theory of profit maximisation and observe that exclusive attention on profit maximisation misdirects managers to the point where they may endanger the survival of the business. Prof. Galbraith gives the following points in argue his line of reasoning: (1) it undermines the future for today's profit;(2) it short-changes research promotion and other investments; (3) it may shy away from any capital expenditure that may increase the invested capital base against which profits are based, and the result is dangerous obsolescence of equipment. In other words, the managers are directed into the worst practices of management. Risk and timing factors are also ignored by this objective. The streams of benefits may possess different degrees of certainty and uncertainty. Two firms may have same total expected earnings, but if the earnings of one firm fluctuate considerably as compared to the other, it will be more risky. Also, it does not make a difference between returns received in different time periods i.e., it gives no consideration to the time value of money and value benefits received today and benefits after six months or one year.

For the reasons given above the profit maximisation objective cannot be taken as the objective of financial management.

(b)**Wealth Maximisation:** The maximisation of wealth is a more viable objective of financial management. The same objective if expressed in other terms, would convey the idea of net present worth maximisation. Any financial action which creates wealth or which has a net present worth is a desirable one and should be undertaken. Wealth of the firm is reflected in the maximisation of the present value of the firm i.e., the present worth of the firm. This value may be readily measured if the company has shares that are held by the public, because the market price of the share is indicative of the value of the company. And to a shareholder, the term 'wealth' is reflected in the amount of his current dividends and the market price of share.

Ezra Solomon has defined wealth maximisation objective in the following manner. "The gross present worth or a course of action is equal to the capitalised value of the flow of future expected benefits, discounted (or capitalised) at a rate which reflects the certainty or uncertainty. Wealth or net present worth is the difference between gross present worth and the amount of capital investment required to achieve the benefits."

From the above clarification, one thing is certain that the wealth maximisation is a long-term strategy that emphasises raising the present value of the owner's investment in a company and the implementation of projects that will increase the market value of the firm's securities. This criterion, if applied, meets the objections raised against earlier criterion of profit maximisation. The financial manager also deals with the problem of uncertainty by taking into account the trade-off between the various returns and associated levels of risks. It also takes into account the payment of dividends to shareholders. All these ingredients of the wealth maximisation objective are the result of the investment, financing and dividend decisions of the firm.

II. SCOPE OF FINANCE FUNCTION

The question of 'scope of finance function' determines the decisions or functions to be carried out by the financial manger in pursuit of achieving the objective of wealth maximisation. The various functions of the financial manager relate to the estimation of financial requirements, investment of funds in long-term and short-term assets, determining the appropriate capital structure, identification of the various sources of finance, decision regarding retention of earnings and distribution of dividend, and administering proper financial controls. In the following discussion, these decisions have been categorised into two broad grouping:

(1) Long-term financial decisions:

- (i) investment decision (capital allocation for fixed and current assets),
- (ii) financing decision (capital sourcing), and
- (iii) dividend decision

(2) Short-term financial decision: (Working capital management):

- (i) cash, (ii) investments (marketable securities), (iii) receivables, and (iv) inventory.

A brief description of these financial decisions is given below.

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(1) **Long-Term Financial Decisions** : The long term financial decisions pursued by the financial manager have significant long term effects on the value of the firm. The results of these decisions are not confined to a few months but extend over several years and these decisions are mostly irreversible. It is, therefore, necessary that before committing the scarce resources of the firm a careful exercise is done with regard to the likely costs and benefits of the various decisions.

Investment Decision: Investment decision (also known as Capital-budgeting decision) is concerned with the allocation of given amount of capital to fixed assets of the business. The important characteristic of fixed assets is that their benefits are realised in the future (generally after one year). Thus, capital-budgeting decision adds to the total fixed assets of the concern by selecting and investing in new investments. It must be properly understood at this stage that because the future benefits are not known with certainty, investment proposals necessarily involve risk. Consequently, they must be evaluated in relation to their expected income and risk they add to the firm as a whole. Obviously, the management will select investments adding something to the value of the firm. The criteria of judging the profitability of projects is the difference between the cost of the investment proposals and its expected earnings. The important methods employed to judge the profitability of the investment proposals and its expected earnings. The important methods employed to judge the profitability of the investment proposals are: (a) Payback method; (b) Average rate of return method, (c) Internal-rate of return method, and (d) Net present value method. A careful employment of these methods helps in determining the contribution of investment projects to owners' wealth.

Financing Decision: Financing decision (also known as Capital Structure decision) is intimately tied with the investment decision. To undertake investment decision the firm needs proper finance. The solution to the question of raising finance is solved by financing decision. These are number of sources from which funds can be raised..The most important sources of financing are equity capital and debt capital. The central tasks before the financial manager are to determine the proportion of equity capital and debt capital. He must endeavour to obtain that financing mix or optimal capital structure for the firm where overall cost of capital is the minimum or the value of the firm is maximum. In taking this decision, the financial manager must bear in mind the likely effects on shareholders and the firm. The use of debt capital, for instance, affects and return and risk of the shareholders. The return on equity will not only increase, but also the risk. A proper balance will have to be struck between return and risk. When the shareholder's return is maximised with minimum risk the market value per share will be maximised and firm's capital structure would be optimum. Once the financial manager is able to determine the best combination of debt and equity, he must raise the appropriate amount through best available sources.

Dividend Decision: The next crucial financial decision is the dividend decision. This decision is the basis of dividends payment policy reserves policy, etc. The dividends are generally paid as some percentage of earnings on the paid-up capital. However, the policy pursued by management concerning dividends payment is generally stable in character. Stable dividends policy implies the payment of same earnings percentage with only small variations depending upon the pattern of earnings. The stable dividends policy among other things, increase the market value of the share. The amount of undistributed profits is called 'retained earnings'. In other words, dividends payout ratio determines the amount of earnings retained in the firm. The amount of earnings or profit to be kept undistributed with the firm must be evaluated in the light of the objective of maximising shareholders wealth.

(2) **Short-Term Financial Decisions:** The job of the financial manager is not just limited to the long-term financial decisions, but also extends to the short-term financial decisions aiming at safeguarding the firm against illiquidity or insolvency. Surveys indicate that the largest portion of a financial manager's time is devoted to the day to day internal operations of the firm; this may be appropriately subsumed under the heading. Working Capital management. Working capital management requires the understanding and proper appreciation of its two concepts-*gross* and *net* working capital. Gross working capital refers to the firm's investment in current assets such as cash, short-term securities, debtors, bills receivable and inventories. Current assets have the distinctive characteristics of being convertible into cash within an accounting year. Net working capital refers to the difference between current assets and current liabilities. Current liabilities are those claims of outsiders which are expected to mature for payment within an

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accounting year and include trade creditors, bills payable, bank overdraft and outstanding expenses. For the financial manager both these concepts of gross and net working capital are relevant.

Investment in current assets affects firm's profitability, liquidity and solvency. In order to ensure the neither insufficient nor unnecessary funds are invested in current assets, the financial manager should develop sound techniques of managing current assets. He should estimate firm's working capital needs and make sure that funds would be made available when needed.

The cost of capital acts as the core in the framework for financial management decision-making. It influences and is in turn influenced by them. The cost of capital leads to the acceptance or rejection of projects, as it is the cut-off criterion in investment decisions. In turn, the profitability of projects raises or lowers the cost of capital. The financing decisions affect the cost of capital because it is the weighted average of the cost of different sources of capital. The need to raise or lower the cost of capital, in turn, influences the financing decisions. The dividend decisions try to meet the expectations of the investors raise or lower the cost of capital. The following figure explains the components of finance functions and their interrelation.

III. FINANCE FUNCTIONS

Executive Functions

- a. Financial forecasting
- b. Investment Policy
- c. Dividend policy
- d. Cash flows & requirements
- e. Deciding upon borrowing policy
- f. Negotiations for new outside financing
- g. Checking upon financial performance

Incidental Functions

1. Cash receipts and payments
2. Custody of valuable papers
3. Keeping mechanical details of financing
4. Record keeping & reporting
5. Cash planning
6. Credit management

Financial Controls: The long-term and short-term decisions, together, determine the value of the firm to its shareholders. In order to maximise the value, the firm should strive for optimal combination of these decisions. In an endeavour to make optimal decisions, the financial manager makes use of certain tools in the analysis, planning and control activities of the firm. Some of such important tools are

- | | |
|-------------------------------------------------|----------------------------------------------|
| a. Financial Accounting Statements | g. Operating Budgeting and Budgetary Control |
| b. Analysis of Financial Ratios | h. Costing and Cost Control Statement |
| c. Funds Flow Analysis and Cash flow Analysis | i. Variance Analysis Reports |
| d. Financial Forecasting | j. Cost-Volume-Profit Analysis |
| e. Analysis of Operating and Financial Leverage | k. Profitability Index |
| f. Capital Expenditure Budgeting | l. Financial Reports |

Organisation for Finance Function: Almost anything in the financial realm falls within such a committee's realm, including questions of financing, budgets, expenditures, dividend policy and future planning. Such is the power of financial committee that in most case their recommendations are approved as a matter of course by the full board of directors. On the operational level, the financial management team may be headed up by a financial Vice-president. This is a recent development, the financial Vice-president answers directly to the president. Serving under him are a treasurer and a controller.

The controller is concerned with the management and control of the firm's assets. His duties include providing information for formulating the accounting and financial policies, preparation of financial reports, direction of internal auditing, budgeting, inventory control, taxes, etc. While the treasurer is mainly concerned with management of the firm's funds, his duties include the following:

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Forecasting the financial needs; administering the flow of cash; managing credit, floating securities; maintain relations with financial institutions and protecting funds and securities.

IV.CONCLUSION

Finance is a key area of Management and any mismanagement in finance will throw the entire organisation out of gear, whether trade, commerce or industry. Financial Management is closely linked to other areas of management. Therefore the Finance Manager should have a firm grip over all areas of the organisation because of his key position. The goal of the financial management should be to achieve the objectives of the owners who invested the money. Therefore the finance is the life line of the management.

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