

EVOLUTION OF FINANCIAL MANAGEMENT

Financial management has emerged as a distinct field of study, only in the early part of this century, as a result of consolidation movement and formation of large enterprises. Its evolution may be divided into three phases

1. The Traditional phase,
2. The Transitional phase and
3. The Modern phase.

1. The Traditional Phase: This phase lasted for about four decades. Its finest expression was shown in the scholarly work of Arthur S. Dewing, in his book titled "the Financial Policy of Corporation in 1920s." In this phase the focus of financial management was on four selected aspects.

(i) It treats the entire subject of finance from the outsider's point of view (investment banks, lenders, other) rather than the financial decision-maker's viewpoint in the firm.

(ii) It places much importance on corporation finance and too little on the financing problems of non-corporate enterprises.

(iii) The sequence of treatment was on certain episodic events like formation, issuance of capital, major expansion, merger, reorganisation and liquidation during the life cycle of an enterprise.

(iv) It placed heavy emphasis on long-term financing, institutions, instruments, procedures used in capital markets and legal aspects of financial events. That is it lacks emphasis on the problems of working capital management.

It was criticised throughout the period of its dominance, but the criticism is based on matters of treatment and emphasis. Traditional phase was only outsiders looking approach, due to its over emphasis on episodic events and lack of importance to day-to-day problems.

2. The Transition Phase: It began around the early 1940s and continued through the early 1950s. The nature of financial management in this phase is almost similar to that of earlier phase but more emphasis was given to the day-to-day (working capital) problems faced by the finance managers. Capital budgeting techniques were developed in this phase only.

3. The Modern Phase: It begun in the mid 1950s. It has showed commendable development with a combination of ideas from economic and statistics that has lead financial management to be more analytical and quantitative. The main issue of this phase was rational matching of funds to their uses, which leads to the maximisation of shareholders' wealth. This phase witnessed significant developments. The areas of advancements are: capital structure. The study says that the cost of capital and capital structure are independent in nature. Dividend policy, suggests that there is the effect of dividend policy on the value of the firm. This phase has also seen one of the first applications of linear programming. For estimation of

opportunity cost of funds, multiple rates of return-gives way to calculate multiple rates of a project. Investment decisions under conditions of uncertainty, gives formulas for determination of expected cash inflows and variance of net present value of projects and gives how probabilistic information helps the firm to optimise investment decisions involving risk. Portfolio analysis gives the idea for allocation a fixed sum of money among the available investment securities. Capital Asset Pricing Model (CAPM), suggests that some of the risks in investments can be neutralised by holding diversified portfolio of securities. Arbitrage Pricing Model (APM), argued that the expected return must be related to risk in such a way that no single investor could create unlimited wealth through arbitrage. CAPM is still widely used in the real world, but APM is slowly gaining momentum. Agency theory emphasises the role of financial contracts in creating and controlling agency problems. Option Pricing Theory (OPT), applied Martingale pricing principle to the pricing of real estates. Cash management of models (working capital management) by Baumol Model, Miller and Orlgers. Baumol models helps to determine optimum cash conversion size; Miller model reorder point and upper control points and Orlgers model helps to determine optimal cash management strategy by adoption of linear programming application. Further, new means of raising finance with the introduction of new capital market instruments, such as Pads, Fads, PSBs and Capps, etc. Financial engineering that involves the design, development and implementation of innovative financial instruments and formulation of creative optional solutions to problems in finance. While the above developed areas of finance are remarkable, but understanding the international dimension of corporate finance was little, which is not sufficient in the globalised era.

SCOPE OF FINANCIAL MANAGEMENT

From the above discussion it is evident that Financial management as an academic discipline has undergone notable changes over the years in its scope and areas of coverage finance manager's role has also undergone fundamental changes over the years. Study of the changes that have taken place over the years is known as "scope of financial management". In order to have easy understanding and better exposition to the changes, it is necessary to divide the scope into two approaches: (1) The Traditional Approach and (2) The Modern Approach.

1. Traditional Approach

Financial management emerged as a separate field of study in the early 1900s. The role of financial management is limited to fund raising and administering needed by the corporate enterprises to meet their financial needs. Enterprise requires funds for certain episodic events like merger, formation of new firms, reorganisation, liquidation and so on. To put it simply, the scope of financial management in traditional approach was in the narrow sense. The field of financial management was interrelated with aspects, viz..

(a) Raising of funds from financial institutions,

(b) Raising of funds through financial instruments-shares and bonds from the capital markets.

(c) The legal and accounting relationships between an enterprise and its sources of funds (creditors).

Thus, the traditional approach of financial management is only raising of funds needed by the corporation, externally that also limited the role of the finance manager. Apart from raising the funds externally, the expected functions are: preparation and preservation of financial (statements) reports on the enterprises financial status and managing cash level that is needed to pay day-to-day maturing obligations

Traditional approach to the scope of financial management evolved during 1920 and continued to dominate academic thinking during the forties and through the early fifties. But criticism was stated on this approach in the later fifties due to the following:

Ignored Day-to-day Problems: The traditional approach gives much importance to funds raising for episodic events that are stated in the above discussion. Put in simple words the approach is confined to the financial problems arising in the course of episodic events.

Outsider-looking-in Approach: This approach equated the function with the issues involved in raising and administering funds. Thus, the subject of finance moved around the suppliers of funds (investors, financial institutions (banks), etc.) who are outsiders. It indicates that the approach was outsider-looking-in approach and ignored insider-looking-out approach, since it completely ignored internal decision-making.

Ignored Working Capital Financing: The approach gave over emphasis on long-term financing problems. It implies that it ignored working capital finance, which is in the purview of the finance function.

Ignored Allocation of Capital: The main function of this approach is procurement of funds from outside. It did not consider the function of allocation of capital, which is the important one.

The capital issues of financial management were outside the purview of the traditional phase, which was rightly described by Solomon.

(i) Should an enterprise commit capital funds to certain purposes?

(ii) Do the expected returns meet financial standards of performance?

(iii) How should these standards be set and what is the cost of capital funds to the enterprise?

(iv) How does the cost vary with the mixture of financing methods used?

Traditional approach failed to provide answers to the above questions due to narrow scope, but modern approach explained below provide answers to the questions, or it overcomes the shortcomings of traditional approach.

2. Modern Approach

Modern approach was started during mid-1950s. Its scope is wider since it covers conceptual and analytical framework for financial decision-making. In other words, it covers both procurement of funds as well as their allocation. Allocation is not just haphazard allocation, it is efficient allocation/optimum utilisation among various investments, which will help maximise shareholders' wealth. The main contents or the analytical information of the new approach are:

- (a) What is the total volume of funds an enterprise should commit?
- (b) What specific assets should an enterprise acquire?
- (c) How should the required funds be financed?

The above three questions are related to the three decisions of financial management:

- (i) Financing decision,
- (ii) Investment decision and
- (iii) Dividend decision.

The shareholders value maximisation focus continuously as we begin the 21st century. However, two other trends are gaining momentum, viz., (a) Increased use of information technology and (b) Globalisation of business. Both these trends provide companies with new opportunities to reduce risks and thereby, increase profitability. But these trends are also leading to increased competition and new tasks.

GOALS OF FINANCIAL MANAGEMENT

Equity shareholders are the owners' of a company. Any person becomes the owner of any company by purchasing (in primary market or secondary market) stocks and he/she expects financial return in the form of dividends and increase in stock price (capital gain). Shareholders elect directors, who then hire managers to run the company on day-to-day basis. Financial manager requires the existence of some objectives or goals without which judgment as to whether or not a financial decision is efficient must be made in the light of some standard. In other words, the goals provide a framework for optimum financial decision-making. Although various goals or objectives are possible, we assume in this book that the management's prime goal is stockholders wealth maximisation, since the managers are working on behalf of the shareholders. This objective translates into maximising the price of the firm's equity stock. Maximisation of shareholders' wealth is possible only when the decisions of the managers' are helpful to increase profit. Therefore, Financial manager is always guided by two objectives (1) Profit maximisation and (2) Wealth maximisation. A brief look at the twin objectives is as under:

1. Profit Maximisation: Profit is a primary motivating force for any economic activity. Firm is essentially being an economic organisation, it has to maximise the interest of its stakeholders. To this the firm has to earn profit from its operations. In fact, profits are an useful intermediate beacon towards which a firm's capital should be directed. McAlpine rightly remarked that profit cannot be ignored since it is both a measure of the success of

business and the means of its survival and growth. Profit is the positive and fruitful difference between revenues and expenses of a business enterprise over a period of time. If an enterprise fails to make profit, capital invested is eroded and if this situation prolongs, the enterprise ultimately ceases to exist. The overall objective of business enterprise is to earn at least satisfactory returns on the funds invested, consistent with maintaining a sound financial position.

Limitations: The goal of profit maximisation has, however, been criticised in recent times because of the following reasons:

(a) Vague: The term "profit" is vague and it does not clarify what exactly does it mean. It has different interpretations for different people. Does it mean short-term or long-term; total profit or net profit; profit before tax (PBT) or profit after tax (PAT); return on capital employed (ROCE). Profit maximisation is taken as objective, the question arises which of the about concepts of profit should an enterprise try to maximise. Apparently, the vague expression like profit can form the standard of efficiency of financial management.

(b) Ignores Time Value of Money: Time value of money refers a rupee receivable today is more valuable than a rupee, which is going to be receivable in future period. The profit maximisation goal does not help in distinguishing between the returns receivable in different periods. It gives equal importance to all earnings through the receivable in different periods. Hence, it ignores time value of money.

(c) Ignores Quality of Benefits: Quality refers to the degree of certainty with which benefits can be expected. The more certain expected benefits, the higher are the quality of the benefits and vice versa. Two firms may have same expected earnings available to shareholders, but if the earnings of one firm shows variations considerably when compared to the other firm, it will be more risky.

Profit maximisation objective leads to exploiting employees and consumers. It also leads to colossal inequalities and lowers human values that are an essential part of ideal social systems. It assumes perfect competition and in the existence of imperfect competition, it cannot be a legitimate objective of any firm. It is suitable for self-financing, private property and single owner firms. A company is financed by shareholders, creditors and financial institutions and is managed and controlled by professional managers. Apart from these people, there are some others who are interested towards company; they are: employees, government, customers and society. Hence, one has to take into consideration all these parties' interests, which is not possible under the objective of profit maximisation. Wealth maximisation objective is the alternative of profit maximisation.

2. Shareholders' Wealth Maximisation: On account of the above-discussed limitations of profit maximisations, shareholders wealth maximisation is an appropriate goal for financial decision-making. Finance theory rests on the proposition that the goal of a firm should be to maximise shareholders' wealth. It is operationally feasible since it satisfies all the three requirements of a suitable operational objective of financial courses of action, namely exactness, quality of benefits and the time value of money. It provides an unambiguous measure of what financial management should seek to maximise in making investment and financing decisions on behalf of the owners. Firms do, of course, have other goals - in

particular the managers decisions are interested in their own personal satisfaction, in their employees' welfare and in the good of the community and society at large. Still stock price maximisation is the most important goal for majority of the companies.

Shareholders' wealth maximisation means maximising net present value (or wealth) of a course of action to shareholders.

A financial decision that has a positive NPV creates wealth for ordinary shareholders and therefore preferable and vice versa. The wealth will be maximised if this criterion is followed in making financial decisions. From shareholders' point of view, the wealth created by a corporation through financial decisions or any decision is reflected in the market value of the company shares. For example, take Infosys Co., whose share price is increasing year by year, even by issue of bonus shares, and the company is trying to put its shares at popular trading level. Therefore, the wealth maximisation principle implies that the fundamental objective of a firm is to maximise market value of its shares. In other words, the market value of the firm is represented by its market price, which in turn is a reflection of a firm's financial decisions. Hence, market price acts as a firm's performance indicator. A shareholders' wealth at a period of time can be computed by the following formula:

3. Alternative Goals: Apart from the above-discussed goals, there are several alternative goals, which will again help to maximise value of the firm or market price per share. They are:

- Maximisation of return on equity (ROE).
- Maximisation of earnings per share (EPS),
- Management of reserves for growth and expansion.

INTERFACE OF FINANCIAL MANAGEMENT WITH OTHER DISCIPLINES

As all of us know that organisation is a group of people (employees) working together consciously towards organisation's goal. The employees are divided based on their specialisation and are put under different departments. Generally, there are departments - Human Resource, Finance, Production, Marketing, R&D and MIS. All these departments are integrated. There is no single department that works independently.

Financial management has relationship with almost all functional departments. But it has close relationship with economics and accounting.

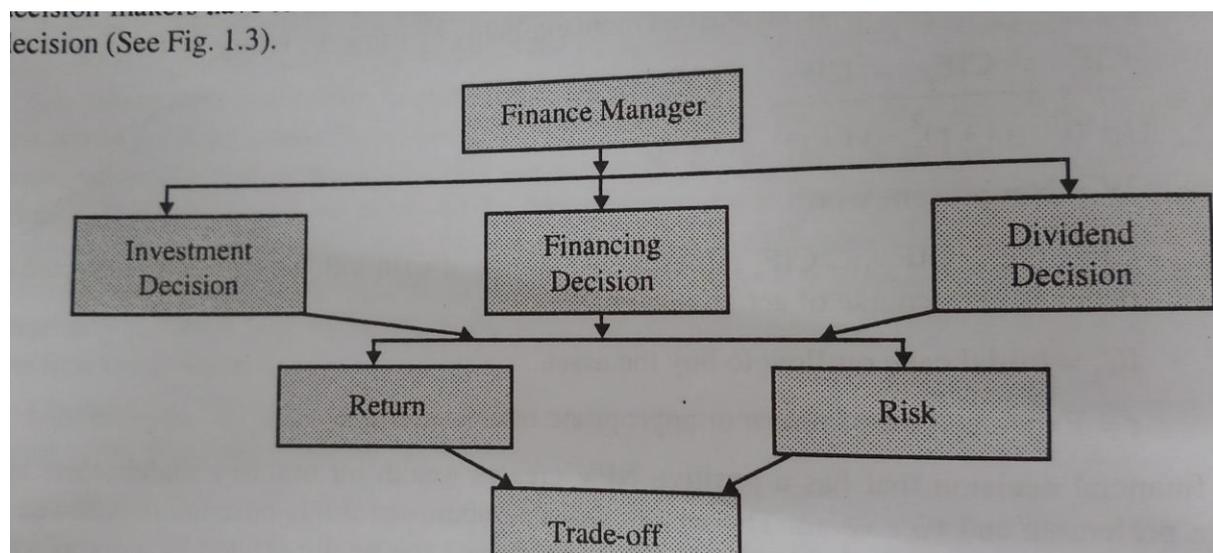
Relationship to Economics

The relationship between finance and economics can be studied under two prime areas of economics. They are macroeconomics, and microeconomics. Macroeconomics is the environment in which an industry operates, which is not controllable. The macroeconomic factors include, economy growth rate, domestic savings rate, structure and growth of financial system, fiscal policies, monetary policies, and so on. It is important for financial

managers to understand changes in macroeconomics environment analysis helps in opportunities and threats.

Microeconomics is the firm's specific environment, and also controllable one. It is concerned with the determination of optimum operational strategies. In other words, financial managers uses economic theories as guidelines for efficient business operations. Supply and demand relationship, res profit maximisation, pricing strategies; risk and return determination; marginal analysis are the few examples of relevant economic theories used in financial management. Marginal analysis is the prime principle used in financial decision-making. That is all financial decisions of a firm are made on the basis of marginal cost, and marginal revenue. Therefore, it is necessary to understand the relationship between finance and economics.

Relationship to Accounting



If you observe the Figure above, you can find the relationship between finance and accounting. Finance (Treasurer) and Accounting (Controller) are the two prime domains of Chief Finance Manager (Vice-President Finance). Finance and accounting are not separable and generally, considered as overlapping activities of the Chief Finance Officer (CFO).

However, it is important for the student to know the relationship and difference between finance and accounting. The following discussion reveals that these are the differences and relationship between finance and accounting.

1. Objective: Financial accounting is concerned with developing and reporting data for measuring performance of the firm whereas finance is concerned with the maximisation of value of the firm, by selecting and executing feasible projects.
2. Method: Finance accounting prepares records on the accrual basis whereas the financial manager takes decisions on the basis of cash flows (inflows and outflows).

3. Data: Financial accounting deals with past data (certainty) whereas finance deals with future data (uncertainty).

Relationship to HR

HR activities include recruitment, training, development, fixing compensation, incentives, promotion, and providing other benefits. All these activities need finance. Therefore, before going to take any of these decisions HR manager needs to consult finance manager. Finance manager takes decisions after studying the impact of HR activity on organisations. Therefore, there is a relation to HR function.

Relationship to Production

Production department is another functional area that involves huge investment on fixed assets (machines and tools). For example, production of new products requires new machinery, which involves capital investment. Before going to select a machinery, he/she needs to evaluate the machine or equipment and select some cases changing manufacturing process. Improper evaluation involves huge consequences on the firm. The production manager and finance manager needs to work closely for effective investment (optimum investment) on plant and machinery.

Relationship to Marketing

Marketing functions involves selection of distribution channels and promotion policies. These two are the primary activities of the marketing department and involves huge cash outflows. Therefore finance and marketing managers need to work with co-ordination to maximise value of the firm.

Relationship to R&D

Innovation of products and process is the only way to survive in the competitive market. Innovation needs to invest funds in R&D. But R&D department does not give guarantee of development. Therefore it does not mean that financial manager should not provide funds, or cut funds heavily to R&D. It should be given importance and try to make a balance.

ROLE OF A FINANCIAL MANAGER :

In a large sized business enterprise, the chief financial officer is known as financial manager. He is directly accountable to the managing director, and has equal status with any other departmental head or he can be treated as a member of top management. In the U.S.A. he is known as the vice-president of finance. He occupies a key position in the management of business for last three decades. He is involved in most important decisions pertaining to efficient allocation of the company's funds. His actions have far-reaching influence on the size, profitability and growth of the firm.

It must be remembered, however, that the role of financial manager was not so important before some years. He was considered to be quite an unimportant person. His only function was to raise funds for business and that too on certain occasions only. The popularity of

traditional approach was responsible for this insignificant position of the financial manager. In this context, Shri I. M. Pandey has rightly remarked, "the traditional approach dominated the scope of financial management and limited the role of the financial manager in the initial stages. According to this approach, the scope of financial management and the role of the financial manager are considered to confine to the raising of funds. And it is during the major events, such as promotion, reorganisation, expansion etc. in the life of the firm that the financial manager is called upon to raise funds. In his day-to-day activities, his only significant duty is to see that the firm has enough cash to meet its obligations."

Since last three decades, the role of financial manager has changed. The function of financial manager is not confined to raising of funds only, but efficient allocation of funds has also been included among his functions. As one of the members of top management, he has to take decisions on investment, distribution of income and procurement of funds. In his new role, he has to seek prudent answer for the three important questions stated below:

- (1) How large should an enterprise be and how fast should it grow.
- (2) In what form should it hold its assets ?
- (3) What should be the composition of its liabilities ?

In view of the significance of these questions, the financial manager holds an important place in business unit and his role has changed to a remarkable extent.

The financial manager has to perform following functions to give justice to his new role:

- (1) He has to raise funds for the business, but not so much as to be expensive.
- (2) He has to raise funds in such a manner that cost of raising funds are minimised.
- (3) He has to achieve and maintain enough liquidity and at the same time to achieve optimum level of profitability.
- (4) He has to allocate available funds prudently.
- (5) He has to analyse, plan and control the funds of the business.
- (6) The working capital has to be managed in such a manner that its components such as cash, inventories and receivables are effectively managed,
- (7) He has to analyse the effects of external forces on the financial position of the business and do the needful in this respect.
- (8) There should be a proper balance between retained profits and dividend distribution, so that, on the one hand, the business can have enough resources for future growth and, on the other hand, the shareholders also feel of satisfied.
- (9) It is also the duty of the financial manager to keep top management well informed of the important events pertaining to finance.

Among the assistants of the financial manager, there are two important designations: treasurer and controller. The main functions of the treasurer are with regard to cash, credit, investment etc. while those of the controller are with regard to accounts, budgets, reports etc. The details of the functions of the treasurer and controller are given by Prof. Pandey as under:

Treasurer's Functions:

- (1) Provision of Finance: To prepare and implement the programmes for the provision of the finance required by the business including negotiation for its procurement and maintenance of necessary arrangements.
- (2) Relations with Investors: To establish and develop an adequate market for the company's securities and to maintain adequate contact with its investors.
- (3) Short-term Financing: To maintain adequate sources for the company's short-term funds from the money market.
- (4) Banking and Custody: To maintain arrangements with banks, to receive, keep under custody and disburse the company's moneys and to be responsible for the financial aspects of transactions relating to fixed assets.
- (5) Credit and Collection: To direct the granting of credit and the collection of accounts to the company.
- (6) Investments: To invest company's funds as required and to establish and coordinate policies for investment in pensions and other trusts.
- (7) Insurance: To provide insurance coverage as required.

Controller's Functions:

- (1) Planning and Control: To frame, co-ordinate and administer, a plan for the control of operations. This plan includes profit planning to the extent required, programmes for capital investments and financing, sales forecasts, expense budgets etc.
- (2) Reporting and Interpreting: To compare actual performance with the standards of operations, to interpret the results of operations and to inform all levels of management, to discuss with all levels of management the financial implications of their actions.
- (3) Tax Administration: To frame and execute tax policy and procedures.
- (4) Government Reporting: To supervise and coordinate the preparation of reports to be submitted to the government.
- (5) Protection of Assets To ensure protection of the firm's assets through internal control, internal auditing and through providing insurance coverage.
- (6) Economic Appraisal: To appraise the economic and social forces and government policies and to examine their effects on business.