SECTION A

FINANCIAL MANAGEMENT FUNCTION

A1

STUDY GUIDE A1: THE NATURE AND PURPOSE OF FINANCIAL MANAGEMENT

Get Through Intro

Finance is the lifeline of a business. The function of finance in a business is similar to the function of the heart in the human body. The heart ensures a steady supply of blood to all the organs of the body. Similarly, the function of finance is to ensure a steady supply of money to all the activities of a business.

Financial management involves the effective management of the long and short term financial resources of an organisation in order to achieve that organisation's objectives. The financial manager will make decisions on investing, financing, investments and dividend policy.

This Study Guide gives the overall outline of the subject. It explains the broad spectrum of activities which you may have to undertake in the future in your role as a financial manager or a professional consultant. It also explains the relationship between financial management and financial and management accounting. The technical details of the concepts are discussed later in the respective Study Guides.

Learning Outcomes

a) Explain the nature and purpose of financial management.
b) Explain the relationship between financial management and financial and management accounting.

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Introduction

Financial Management involves the effective management of the finances of an organisation in order to achieve that organisation's objectives. It requires **financial planning** and **financial control**. Financial planning ensures that sufficient funds are available to meet the short, medium and long-term capital needs of the organisation. Once these funds are raised the financial manager must ensure that they are used appropriately (control). This Study Guide provides overview of the various responsibilities of the financial manager.

1. Explain the nature and purpose of financial management.[1]

[Learning Outcome a]

1.1 What is finance?

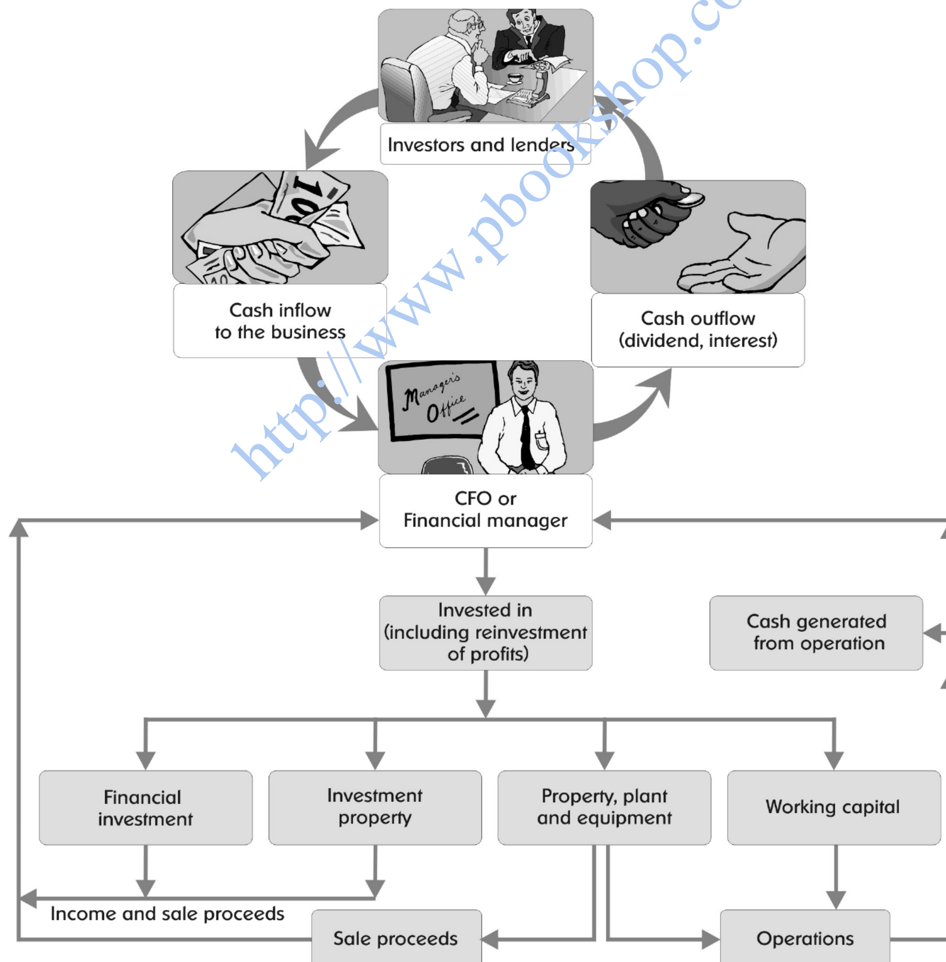
Definition

The word **finance** has been defined by the Oxford English Dictionary as "the management of large amounts of money by governments or large organisations".

Financial management therefore means the efficient and effective management of money in such a manner as to accomplish the objectives of the organisation. Money which is to be managed in this manner flows between different sources and destinations. It is worthwhile to have a look at this flow before we continue.

1.2 Flow of finance in a business

Diagram 1: Flow of Finance



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As shown in the diagram above, there are different directions funds will flow in a business. The Financial Manager or Chief Financial Officer (CFO) has to make and implement decisions at different stages while managing the flow. The functions of the financial manger may relate to:

- investment
- financing
- dividend policy
- working capital
- overall financial planning and control

Example

Market research carried out recently by a company which manufactures and sells digital cameras has revealed a scope to sell an additional 500,000 cameras per year. However, since the factory is currently operating at full capacity, increasing production would only be possible if the company were to invest in an additional production line. Alternatively, the company could buy cameras from another manufacturer at wholesale prices, and then sell them in their stores. When the financial manager was asked to comment, his views were as follows:

Financial Manager: "Before a decision is made, the financial viability of each proposal must be evaluated; one would have to look at the relevant cash flows and weigh up the cash inflows and outflows. If both proposals are deemed to be financially viable, the proposal that would bring the company the most gain will be accepted; after all, our aim is to maximise our shareholders' return."

"The next issue would be funding. We must consider the total amount of funding required, and the sources of funds available to the firm: are we going to use reserves, issue shares, issue debentures or use loan finance? Of course the choice will depend on what is available to us, the costs associated with each option and our gearing level among other things."

"The working capital needs of the project must also be identified. We will have to decide on the levels of inventories, accounts receivable etc. and how they are going to be financed."

Note: the financial manager has touched on three decisions: investment, funding and working capital. Once funds are raised for the project the financial manager must ensure that they are used appropriately. Once the project begins to yield returns a dividend decision will have to be made i.e. should these be distributed to shareholders or re-invested in the business.

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1.3 Investment decisions

A company invests in order to maintain or improve its profit-earning capacity. Investment decisions usually relate to the acquisition of fixed or non-current assets (capital investments) e.g:

- new equipment
- automated or more advanced production technology
- land and buildings
- business units

Investments must be evaluated for financial viability before being selected or rejected. Factors to consider would include the relevant cash inflows and outflows associated with each project, the projects' risks and returns and the company's cost of capital.

It might be that more than one investment proposal is financially acceptable. In such a case the financial manager would have to consider the capital budget i.e. the amount of funds available to spend on capital investments. If sufficient funds are available, it might be possible to take advantage of all financially viable projects, however, this is not usually the case and the financial manager may have to engage in capital rationing.

Example

Enidan Ltd has $400,000 available for investment purposes. The following information is available regarding potential investments:

Project	Investment ($)	Net cash inflow ($)
A	100,000	50,000
B	250,000	82,000
C	60,000	20,000
D	400,000	100,000

Continued on the next page

Assuming that the company cannot proportionally invest, what will be the optimal investment policy?

It is not possible to invest in all four projects as the amount of funds are limited to $400,000, but total investments come to $810,000. It is obvious in the example that the project earning the highest return in absolute terms is project D, thus it could be considered first. Since project D requires $400,000, the company will be unable to undertake any further investments until more funds made available. The total cash inflow will be $100,000, but is this the only option?

If the company wishes to maximise its cash inflow and spread its risks its optimal investment policy would be to invest in projects A and B. The total investment would be $350,000 and the net -cash inflow $132,000**.** Time value of money is required to be considered. Money in hand is worth more than the equal amount of money receivable in future.

This is just a glimpse of what kind of issues are involved in the investment decisions. The function of investment and the manner of taking these decisions are is covered in detail in Section D of this Study Text.

1.4 Financing Decisions

Once the decision to invest has been made, the financial manager must consider how the investment is going to be funded. Companies in general have two major sources of finance:

- **Equity finance** consisting of ordinary shares. Companies may wish to issue new shares or use reserves.
- **Debt finance** consisting of fixed interest finance e.g. debentures, loans.

Before deciding the mix of funding the financial manager will consider the company's ability to tap certain sources e.g. utilising reserves may not be possible if the company has not been in existence long enough to have built up its retained earnings, or loan finance may be denied in the absence of security. The cost of each source must also be considered keeping in mind the need to maximise shareholders' wealth.

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Example

A company earns 12% return on the funds invested and pays 8% on debt finance. Ignoring the effect of taxation, the 4% saving (12 - 8) goes towards increasing shareholders' wealth.

The above simple example illustrates the issues considered. Sources of finance and financing decisions are covered in detail in Section E of this Study Text.

1.5 Dividend decisions

When shareholders invest in companies they undertake the risk of the success or failure of the business, and thus usually require a return commensurate with the level of risk. Their return can take two forms: dividends and/or capital gains (where the share price increases).

Funds generated from operations can either be retained in the business for re-investment or distributed to the shareholders as dividends. The proportion of dividends to net profits is called the **dividend payout ratio,** and it is the financial manager who will advise the board on an acceptable ratio. The decision considers:

- the required rate of return to the shareholders and
- the future investment policy of the company.

Dividend decisions are discussed in detail in Study Guide E4 of this Study Text.

1.6 Working capital management

From your previous studies you would recall that working capital is equal to current assets (inventories, accounts receivable and cash) net of current liabilities; in effect, it is equal to the amount of current assets funded through long term finance. The financial manager must decide on the following:

- the optimal level of working capital
- the form the working capital should take
- how the working capital should be funded

The financial manager has to strike a balance between the conflicting objectives of profitability and liquidity when managing working capital. The company needs to keep sufficient current assets to ensure liquidity i.e. the company's ability to pay off debts as and when they fall due. However, having too high a level of cash tied up in idle assets incurs an opportunity cost of lost investment opportunities.

Example

On 1 January 20X8 a business had a trade creditor of $500,000 payable on 1 March 20X8 and had a policy of holding cash equal to short term debts. Thus its cash balance on 1 January 20X8 was $500,000. By 1 March 20X8 the company's trade creditors increased to $760,000, and so too its cash balance.

1. Will the company be able to pay off the debt on the first of March?

Yes. It has sufficient cash to cover all its debts.

2. Would this policy ensure profitability?

No. Cash on hand earns no interest; cash in a current account earns minimal interest. The sum of $500,000 would have been idle for two months i.e. January to March. The company would have been better off if it had invested the money for two months and liquidated the investment when the payment was due. This would have ensured maximum return on the money for the two month period.

Working Capital Management is covered in detail in Section C of this Study Text.

1.7 Interdependence of the decisions

All the decisions discussed so far are interdependent.

- If a company decides to reinvest the profits earned, lower profits will be available for dividend distribution. Similarly, there is less need for external financing.
- If a company decides to pay a higher dividend, then lower internal resources will be available. The company will have to look for outside sources. If the sources are not available, then investment proposals may have to be cut down.
- If finance obtained is at a higher cost, the investment proposals have to show high potential returns to justify the investment. If sufficient attractive investment options are not available, then the company's profits and dividends in the future are likely to be lower.

1.8 Financial analysis

In order to take the decisions mentioned above, the financial manager needs an analysis of the information contained in the financial accounts as well as information collected from other sources. This analysis is provided by financial and management accounting. We will discuss this in the next section.

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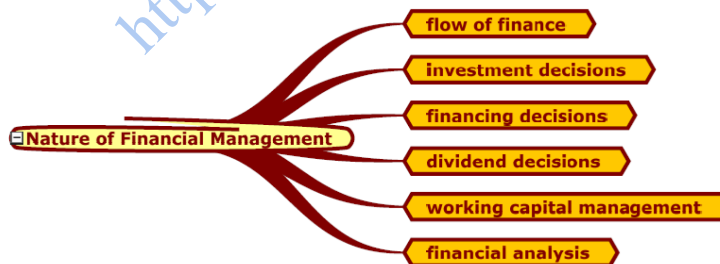
SUMMARY



Test Yourself 1

What are the main functions of a financial manager?