AN OVERVIEW ON FINANCIAL MANAGEMENT TECHNIQUES FOR ORGANIZATION EFFECTIVENESS

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ABSTRACT
Financial management is highly concerned with maximizing the wealth of equity shareholders. Though profit is the main motto of any business financial management concerns more on the distribution of profit to the equity shareholders. Financial Management means planning, controlling, organizing and directing the monetary resources of the firm. The challenge of any finance manager is to have a deep knowledge regarding the procurement, allocation and management of funds of the business. The success behind any organization depends on the efficient management of finance. In this study, the researcher has concentrated on the various management techniques in finance. The data is collected from secondary information and data. The paper enriches the quality of information in financial management and enables the reader to clearly understand the major concepts and techniques in the subject.

Key words: Finance, procurement, management, efficient, organization, knowledge, wealth.

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1. INTRODUCTION
Finance is the life-blood of any business. In the early times every entrepreneur’s motive was to earn profit and expand the business. But in the present scenario, the survival of any business depends highly on the growth of the firm’s stakeholder’s. The satisfaction of each and every member associated with the business makes it survive in the long run. Thus the importance of Financial management is increasing in the recent years. Finance managers are highly trained and equipped with the latest techniques and methods to be adopted in the financial activities of the firm. The various financial management techniques/methods used in this study enables the financial managers to take right decision in proper utilisation of firm’s funds.

2. OBJECTIVES OF THE STUDY
The study has focused on the following objectives;

- To know the objectives of financial management in business
- To understand the major functions of a financial manager
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- To study the various methods/techniques used in financial management

3. RESEARCH METHODOLOGY
The study is based on secondary data and information. The paper includes the importance of financial management, objectives, various financial management techniques used for business decisions, etc.

4. NEED FOR STUDY
As said earlier the success of an enterprise depends on the efficient utilisation of fund. At present, banks and various financial institutions have come forward with various schemes to lend money to business entrepreneurs. Apart from banks various other institutions like angel investors, venture capitalist firms, etc., has also emerged to meet the requirements of entrepreneurs. This has led the businessmen to generate funds easily. Hence rather than procuring fund management of this fund is a challenge to all the finance mangers. Thus the study of financial management helps and guides the finance managers to make right decision in generating fund, making right investment, earning good return and sharing the profit to the shareholders.

5. CONCEPT OF FINANCIAL MANAGEMENT
Financial Management means planning, organizing, directing and controlling the financial resources of the firm. It includes activities like procurement and deployment of funds of the venture. It means applying general management principles and methods to financial resources of the project and evaluates the value of the project return. A financial Management technique helps the firm to clearly monitor the future cash flows and helps to achieve business goals. Managerial finance is an interdisciplinary approach that takes the views and ideas from both managerial accounting and corporate finance. Financial Management is a branch of economics that includes- Managerial Finance, Corporate Finance and Financial Management for IT services. Managerial Finance is a branch of finance that connects with managerial importance of finance techniques and methods. The Corporate Finance deals with financial decisions that the business enterprises make and analysis used for making such decisions. Financial Management for IT Services deals with the financial management of IT assets and resources. The important objectives of the financial management are to create wealth for the business, generate income and create sufficient return on investment.

6. FINANCIAL MANAGEMENT TECHNIQUES
Three major decisions which every Finance manager has to take into consideration are:

- Investment decision
- Financing decision
- Dividend decision

7. INVESTMENT DECISION (CAPITAL BUDGETING)
Investment decision is also known as Capital Budgeting decision. It is the process of estimating the required fund for the firm. The finance manager has to assess the value of various projects before making any investments.

Capital budgeting is the process of making investment decisions in capital expenditure. These are expenditures, the benefits of which are expected to be received over a long period of time exceeding one year. The finance manager has to assess the profitability of various projects before committing the funds.

Some of the major traditional techniques used in capital budgeting are as follows: 1. Payback period 2. Accounting Rate of Return method 3. Net present value method 4. Internal Rate of Return Method 5. Profitability index.
7.1. Payback Period
The payback (or payout) period is the most popularly and commonly used method. This method explains the number of years required to recover the invested amount (original cash outlay) invested in the project. It is one of the easiest traditional method that derives the years taken for the firm to take back its invested amount for a project. If the project generates constant annual cash inflows, the payback period can be computed by dividing cash outlay by the annual cash inflow.

\[
\text{Payback period} = \frac{\text{Cash outlay (investment)}}{\text{Annual cash inflow}} = \frac{C}{A}
\]

7.2. Accounting Rate of Return Method
The Accounting rate of return (ARR) method used to find the average income derived from average investment. It simply means the earnings obtained out of the investment made. It uses accounting information, as revealed by financial statements, to measure the profit abilities of the investment proposals. The accounting rate of return is calculated by dividing the average income after taxes by the average investment.

\[
\text{ARR} = \frac{\text{Average income}}{\text{Average Investment}}
\]

7.3. Net Present Value Method
The net present value (NPV) method is a popular method in the capital budgeting techniques. It is the process of calculating the present value of cash flows (inflows and outflows) of an investment proposal, using the cost of capital as the appropriate discounting rate. It enables the firm to easily understand whether the project (investment) needs to be accepted or rejected with a simple substitute of future cash flows.

Net Present Value (NPV) is the difference between the present value of cash inflows and the present value of cash outflows. NPV is used in capital budgeting to analyze the profitability of a projected investment or project.

The following is the formula for calculating NPV:

\[
\text{NPV} = \sum_{t=1}^{T} \frac{C_t}{(1+r)^t} - C_0
\]

Where:
- \(C_t\) = net cash inflow during the period \(t\)
- \(C_0\) = total initial investment costs
- \(r\) = discount rate, and
- \(t\) = number of time periods

A positive net present value indicates that the projected earnings generated by a project or investment exceeds the anticipated costs. Generally, an investment with a positive NPV will be a profitable one and one with a negative NPV will result in a net loss. This concept is the basis for the Net Present Value Rule, which dictates that the only investments that should be made are those with positive NPV values.

Apart from the formula itself, net present value can often be calculated using tables, spreadsheets such as Microsoft Excel or Investopedia’s own NPV calculator.

8. INTERNAL RATE OF RETURN METHOD
The Internal Rate of Return (IRR) equates the present value cash inflows with the present value of cash outflows of an investment. It is called internal rate because it depends solely on the outlay and proceeds
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associated with the project and it does determine any rate outside the investment. IRR is the minimum discount rate used by the management to identify whether the future capital investment yield an acceptable return. It is the rate that equates NPV of future cash flows from the project to zero. Formula for calculating IRR is as follows;

\[
R_1 + \frac{NPV1 \times (R2 - R1)}{(NPV1 - NPV2)}
\]

Where:

- \( R1 \) = Lower discount rate
- \( R2 \) = Higher discount rate
- \( NPV1 \) = Higher Net Present Value (derived from R1)
- \( NPV2 \) = Lower Net Present Value (derived from R2)

9. PROFITABILITY INDEX

It is the ratio of the present value of future cash benefits, at the required rate of return to the initial cash outflow of the investment. It may be gross or net, net being simply gross minus one. The formula to calculate profitability index (PI) or benefit cost (BC) ratio is as follows.

\[
PI = \frac{PV \text{ cash inflows}}{Initial \text{ cash outlay A}} \quad \text{(or)}
\]

\[
PI = \frac{PV \text{ cash inflows}}{Initial \text{ Investment}}.
\]

10. FINANCING DECISION (CAPITAL STRUCTURE)

Financing decision is also called Capital Structure. Once the required fund for investment has been decided (Capital Budgeting) the next step is to raise the amount for making the investment. Now the challenge of the finance manager is to prepare a structure on the proportion of all types of capital viz. equity, debt, preference etc. It is synonymously used as financial leverage or financing mix. Capital structure is also referred as the degree of debts in the financing or capital of a business firm. It is believed that with the change in capital structure, the value of a firm can be influenced. There are four approaches to this, viz. net income, net operating income, traditional and M&M approach.

Important theories or approaches to financial leverage or capital structure or financing mix are as follows:

- **Net Income Approach:** This approach was developed by Durand and he was in the favour of financial leverage decision. According to him, change in financial leverage would lead to a change in the cost of capital. In short, if the ratio of debt in the capital structure increases, the weighted average cost of capital decreases and hence the value of the firm.

- **Net Operating Income Approach:** This approach is also provided by Durand but it is totally opposite to the Net Income Approach. It says that the weighted average cost of capital remains constant. It believes in the fact that the market analyses firm as a whole which discounts at a particular rate which is not related to debt-equity ratio.

- **Traditional Approach:** This approach is not defined hard and fast facts but it says that cost of capital is a function of the capital structure. The special thing about this approach is that it believes an optimal capital structure. Optimal capital structure implies that at a particular ratio of debt and equity, the cost of capital is minimum and the value of the firm is maximum.

- **Modigliani and Miller Approach (MM Approach):** It is a capital structure theory named after Franco Modigliani and Merton Miller. MM theory proposed two propositions.

- **Proposition I:** It says that the capital structure is irrelevant to the value of a firm. The value of two identical firms would be same and it would not be affected by the mode of finance adopted to finance the assets. The value of a firm is dependent on the expected future earnings.
• Proposition II: It says that the financial leverage boosts the expected earnings but it does not increase the value of the firm because the increase in earnings is compensated by the change in the required rate of return.

11. DIVIDEND DECISION
Some of the major different theories of dividend in financial management are as follows: 1. Walter’s model 2. Gordon’s model 3. Modigliani and Miller’s hypothesis. On the relationship between dividend and the value of the firm different theories have been advanced.

11.1. Walter’s Model
Professor James E. Walter argues that the choice of dividend policies almost always affects the value of the enterprise. His model shows clearly the importance of the relationship between the firm’s internal rate of return (r) and its cost of capital (k) in determining the dividend policy that will maximise the wealth of shareholders.

Walter's model supports the principle that dividends are relevant. The investment policy of a firm cannot be separated from its dividend policy and both are inter-related. The choice of an appropriate dividend policy affects the value of an enterprise.

11.1.1. Relation of Dividend Decision and Value of a Firm
According to Walter’s theory, the dividend payout in relation to (Internal Rate of Return) ‘r’ and (Cost of Capital) ‘k’ will impact the value of the firm in the following ways:

<table>
<thead>
<tr>
<th>Relationship between r and k</th>
<th>Increase in Dividend Payout</th>
<th>Decrease in Dividend Payout</th>
</tr>
</thead>
<tbody>
<tr>
<td>r&gt;k</td>
<td>Value of the firm decreases</td>
<td>Value of the firm increases</td>
</tr>
<tr>
<td>r&lt;k</td>
<td>Value of the firm increases</td>
<td>Value of the firm decreases</td>
</tr>
<tr>
<td>r=k</td>
<td>No change in the value of the firm</td>
<td>No change in the value of the firm</td>
</tr>
</tbody>
</table>

11.1.2. Valuation Formula and its Denotations

\[
P = \frac{D + r/k_e (E-D)}{k_e}
\]

Where: \( D = \) Dividend per share, \( K_e = \) Equity Capitalization rate

\( E = \) Earnings per share, \( r = \) rate of return

11.2. Gordon’s Model
One very popular model explicitly relating the market value of the firm to dividend policy is developed by Myron Gordon. The determinants of the market value of the share are the perpetual stream of future dividends to be paid, the cost of capital and the expected annual growth rate of the company.

11.2.1. Relation of Dividend Decision and Value of a Firm
The Gordon’s theory on dividend policy states that the company’s dividend payout policy and the relationship between its rate of return (r) and the cost of capital (k) influence the market price per share of the company.
### 11.2.2. Valuation Formula and its Denotations

Gordon’s formula to calculate the market price per share ($P$) is

$$P = \frac{EPS \times (1-b)}{k-g}$$

Where,
- $P$ = market price per share
- $EPS$ = Earnings Per Share
- $b$= retention ratio of the firm
- $(1-b) =$ payout ratio of the firm
- $k =$ cost of capital of the firm
- $g =$ growth rate of the firm $= b \times r$

### 11.3. Modigliani and Miller’s Hypothesis

According to Modigliani and Miller (M-M), dividend policy of a firm is irrelevant as it does not affect the wealth of the shareholders. They argue that the value of the firm depends on the firm’s earnings which result from its investment policy. M – M’s hypothesis of irrelevance is based on the following assumptions.

- The firm operates in perfect capital market
- Taxes do not exist
- The firm has a fixed investment policy
- Risk of uncertainty does not exist. That is, investors are able to forecast future prices and dividends with certainty and one discount rate is appropriate for all securities and at all time periods. Thus, $r = K = K_t$ for all $t$.

Under M – M assumptions, $r$ will be equal to the discount rate and identical for all shares. As a result, the price of each share must adjust so that the rate of return, which is composed of the rate of dividends and capital gains, on every share will be equal to the discount rate and be identical for all shares.

#### 11.3.1. Valuation Formula and its Denotations

Modigliani – Miller’s valuation model is based on the assumption of same discount rate / rate of return applicable to all the stocks.

$$P_1 = P_0 \times (1 + k) – D$$

Where,
- $P_1 =$ market price of the share at the end of a period
- $P_0 =$ market price of the share at the beginning of a period
- $k =$ cost of capital
- $D =$ dividends received at the end of a period
12. CONCLUSION
The success of any business organization depends on the efficient utilization of monetary resources. The study of financial management guides the financial manager to take the right decision in matters related to capital requirement, investment proposals, working capital management, dividend distribution etc. Every business entrepreneur plans and executes the business activities for earning profit. Profit is the tonic for the growth, sustainability and successful operation of the business organization. The finance manager plays a decisive role in the success of the organization. His important duties are raising funds, allocation of resources, dealing in capital market, planning of profit, etc. The above said financial management techniques helps the organization managers to take right decision in managing the financial resources of the firm and thereby help in attaining the organisational goals effectively.

REFERENCE