Managing Financial Principles and Techniques

Subject: Finance

Institute: Maldives National University

Introduction

Generally, organisational success is significantly determined by the financial aspects of an organization. This implies that adequate fund availability is a major necessity that facilitates the overall operational ability of any organization. As such, in light of the mercurial nature of the business environment, there is a need for the application of effective methods of financial management with the aim of improving the chances of organisational success. Consequently, the achievement of organisational success may occur through the examination and utilization of a number of appropriate financial techniques and principles.

Over the years, various experts in the field of finance have worked to develop an array of techniques and theories to enhance organisational financial function based on a number of differentiating factors. These factors serve as guidelines for the selection of the most effective financial strategies on the basis of business type, environment and financial needs. In this light, this paper provides a detailed description of the principles and techniques of financial management with a focus on costs, funding and budget creation. Ultimately, this description is aimed at improving the overall comprehension of the importance and application of financial management techniques for the sake of organisational success.

Techniques of Financial Management

Vernimmen et al. (2022) reiterate that the concept of financial management revolves around a total of eight main techniques, whose applicability is solely dependent on unique organisational needs. More specifically, these techniques revolve around the utilization of trend ratios, common size statements, capital structure, analysis of fund flow, techniques of capital budgeting, working capital management, analysis of cash flow, and ratio analysis.

The use of financial statements that are common-size involves the percentage conversion of reported figures based on a common base. More specifically, income statements and balance sheets that are common-size are often prepared for the purpose of facilitating vertical interpretation and analysis (Vernimmen et al., 2022). Consequently, this analysis allows for the identification of organisational changes, which have developed slowly over a long period of time. Essentially, a common base is often used as a foundation to obtain comparisons between item-to-total item ratios or percentages of individual items with respect to the total number of items within financial statement presentations.

Alternatively, financial management may also be conducted through the use of trend ratios, which involve the creation of numerical records for financial figure movement indexes over the course of multiple accounting periods (Shapiro & Hanouna, 2019). This technique allows for projected financial statement preparation, as well as behavioral analysis for financial items, through an examination of trends. During trend ratio preparation, 100 is used as the value for the index number which is allocated to the financial figures contained within a base accounting period. This allows for subsequent accounting period trend calculations, with the aim of identifying potential areas of change for the facilitation of financial success.

Fund flow analysis is an alternative financial management technique, which allows for the identification of financial position changes through the analysis of potential areas of interest within multiple balance sheets (Shapiro & Hanouna, 2019). This technique analyses organisational working capital changes through an examination of fund flow and the subsequent preparation of a statement detailing the identified changes. This statement enhances the working capital utilisation effectiveness, thus facilitating long-term planning, particularly in cases where the vitality of liquid resource projection is clear.

In contrast to other techniques, the analysis of cash flow is a mandatory financial management technique, which features the preparation of a statement that details cash net changes, payments and receipts resulting from organisational financing, investing and operating activities (Gitman et al., 2015). This statement revolves around reconciliation of reported closing and opening balances within a specified accounting period. Consequently, this reconciliation yields a detailed report on the net outflow or inflow of cash on the basis of organisational operations. The analysis of cash flow can be used in collaboration with the analysis of financial ratios, which expresses the relationship between figures that are mutually independent. This in turn aids the identification of organisational weaknesses and strengths, through the comparison of future and past financial ratios.

The management of working capital is a technique of financial management which involves the analysis of capital budgeting and investment. Essentially, this details the organisational expenditure on non-current assets and provides solutions to improve the overall profitability of decisions linked to capital investment. According to Bhattacharya (2021), the four main methods used for the appraisal of investment profitability include IRR (Internal Rate of Return), NPV (Net Present Value), ROR (Rate of Return), and PP (Payback Period). Whereas ROR and PP are applied for short-term investments (up to five years) due to their ease of application, IRR and NPV are applied for investments such as technology and supply chain, which are long-term. Nevertheless, these methods should be combined for enhanced success in capital investment.

Finally, effective financial management can be also achieved through the application of effective capital structure techniques for optimal returns for shareholders. Some of these techniques include the analysis of financial and operational leverages, break-even financial point determination, capital component cost examination, and the analysis of indifferent points. Bhattacharya (2021) states that these techniques can be used in collaboration with techniques of capital budgeting which are based on long-term asset investment. In turn, this would enable the production of financial proposals for capital outlays, thus facilitating long-term planning.

Costing

Although effective financial management can be achieved through the techniques described in the sections above, Labro (2019) highlights that costing is a significant consideration for the achievement of overall financial success. Generally, costs can be defined as resources which have been forgone for the fulfilment of the final goal of product creation. Consequently, the presence of costs introduces the need for maximization of profit. In many organisations, the examination of major sunk, differential and opportunity costs is a significant requirement for profit maximization (Labro, 2019). This consideration extends to costs which are variable (change with response to the volume of acquired goods) and fixed (those whose values do not change in response to the output of production).

Costing is a factor which plays a major role in the development of strategies for pricing, as a result of its direct association with the profit margin (Shim et al., 2015). In this light, the pricing strategy may involve the adoption of effective techniques of promotion to achieve balanced demand, and allocating product costs that are affordable for the creation of a competitive edge. Effective promotion techniques are heavily reliant on the conduction of sales positioning and targeting, as well as the analysis of the target market, for the determination of a favourable price range. Similarly, costing design involves the consideration of various factors in product marketing, in addition to the analysis of the effectiveness of different costing systems within the target market.

Some of the systems utilised for costing include the process costing, job costing, marginal cost and the ABC (Activity Based Costing) system. Generally, the ABC system seeks to improve the accuracy of analysis for organisational activities such as tooling costs, product planning, dispatch and inspection, which have a direct impact on final product cost (Mahal & Hossain, 2015). In contrast, the marginal cost system seeks to develop a high level of differentiation between the classification of variable and fixed costs in areas such as direct expenses, material, and labour, as well as variable overhead costs. Comparatively, while the job costing system revolves around the assignment of costs to different tasks whose resource consumption is aimed at facilitating product supply to the market, the process costing system seeks to assign specific prices to products on the basis of the cost of mass production (Shim et al., 2015).

According to Mahal & Hossain (2015) the necessity of these costing systems can be linked to the importance of costing as a facilitator of organisational success through effective product price determination. Consequently, the establishment of functional systems of costing within the modern era enhances organisational financial success, through the supply chain and virtual enterprise performance improvement.

Budgeting

In addition to costing, budgeting has also been described as one of the main determinants of organisational success due to its enhancement of activities which involve the evaluation, implementation and development of plans for capital asset and service provision (Asogwa & Etim, 2017). With reference to financial management, budgeting is centred around outcomes and results that promote effective communication on available budgets with stakeholders. Moreover, budgeting allows for effective management of tax and bonus allocations to employees and the government. In this light, budgetary monitoring and flexibility are the two main factors which are necessary for the assurance of success in financial management.

Asogwa & Etim (2017) describe budgetary monitoring as a process with a continuous nature, which is aimed at ensuring target objective achievement with reference to income and expenditure. This allows for the identification of potential issues within budgets, and the development of corrective measures to minimise or prevent financial losses resulting from variances in recorded tax, expense and sales income values. Essentially, variances occur due to the differences in the projected and actual values of costs and revenues recorded. More specifically, these differences are caused by changes in the variable costs, prices of sales units and fixed costs per unit within the planned budget, as compared to the actual expenditure. Budgetary monitoring seeks to identify and resolve potential budgetary issues and variations in order to prevent additional costs.

In addition to budgetary monitoring, the creation of flexible budgets enhances the process of financial planning with reference to sales level variations. While fixed budgets may be assigned to departments whose operations are not linked to sales, budgetary flexibility should be a widely applicable trait in areas such as production and marketing so as to allow for necessary allowances for adjustments in financial allocations.

Conclusion

Ultimately, it is evident that financial management is an issue of importance in the determination of organisational success. The effectiveness of financial management is reliant on a number of guiding principles and techniques which serve to enhance business performance. Consequently, it can thus be concluded that business accomplishment in the modern era is linked to the creation of a sufficient level of comprehension for the guiding principles and effective techniques in finance.

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