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The Role of the Finance Function in Organizational Processes

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Abstract
Contemporary organizations need to practice cost control if they are to survive the recessionary times. Given the fact that many top tier companies are currently mired in low growth and less activity situations, it is imperative that they control their costs as much as possible. This can happen only when the finance function in these companies is diligent and has a hawk eye towards the costs being incurred. Apart from this, companies also have to introduce efficiencies in the way their processes operate and this is another role for the finance function in modern day organizations. There must be synergies between the various processes and this is where the finance function can play a critical role. Lest one thinks that the finance function, which is essentially a support function, has to do this all by themselves, it is useful to note that, many contemporary organizations have dedicated project office teams for each division, which perform this function. In other words, whereas the finance function oversees the organizational processes at a macro level, the project office teams indulge in the same at the micro level. This is the reason why finance and project budgeting and cost control have assumed significance because after all, companies exist to make profits and finance is the lifeblood that determines whether organizations are profitable or failures.

Keywords: *Finance Function, Organizational Processes*

1.0 INTRODUCTION

The next role of the finance function is in payroll, claims processing, and acting as the repository of pension schemes and gratuity. If the US follow the 401(k) rule and the finance function manages the defined benefit and defined contribution schemes, in India it is the EPF or the Employee Provident Funds that are managed by the finance function. Of course, only large organizations have dedicated EPF trusts to take care of these aspects and the norm in most other organizations is to act as facilitators for the EPF scheme with the local or regional PF (Provident Fund) commissioner. The third aspect of the role of the finance function is to manage the taxes and their collection at source from the employees. Whereas in the US, TDS or Tax Deduction at Source works differently from other countries, in India and much of the Western world, it is mandatory for organizations to deduct tax at source from the employees commensurate with their pay and benefits. The finance function also has to coordinate with the tax authorities and hand out the annual tax statements that form the basis of the employee's tax returns. Often, this is a sensitive and critical process since the tax rules mandate very strict principles for generating the tax statements.

1.1 Payroll, Claims Processing, and Automation

I have discussed the pension fund management and the tax deduction. The other role of the finance function is to process payroll and associated benefits in time and in tune with the regulatory requirements. Claims made by the employees with respect to medical, and transport allowances have to be processed by the finance function. Often, many organizations automate this routine activity wherein the use of ERP (Enterprise Resource Planning) software and financial workflow automation software make the job and the task of claims processing easier. Having said that, it must be remembered that the finance function has to do its due diligence on the claims being submitted to ensure that bogus claims and suspicious activities are found out and stopped. This is the reason why many organizations have experienced chartered accountants and financial professionals in charge of the finance function so that these aspects can be managed professionally and in a trustworthy manner. The key aspect here is that the finance function must be headed by persons of high integrity and trust that the management reposes in them must not be misused. In conclusion, the finance function though a non-core process in many organizations has come to occupy a place of prominence because of these aspects.

Financial activities of a firm are one of the most important and complex activities of a firm. Therefore, in order to take care of these activities a financial manager performs all the requisite financial activities. A financial manager is a person who takes care of all the important financial functions of an organization. The person in charge should maintain a far sightedness in order to ensure that the funds are utilized in the most efficient manner. His actions directly affect the Profitability, growth and goodwill of the firm. Following are the main functions of a Financial Manager:

Raising of Funds: In order to meet the obligation of the business it is important to have enough cash and liquidity. A firm can raise funds by the way of equity and debt. It is the responsibility of a financial manager to decide the ratio between debt and equity. It is important to maintain a good balance between equity and debt.

Allocation of Funds: Once the funds are raised through different channels the next important function is to allocate the funds. The funds should be allocated in such a manner that they are optimally used. In order to allocate funds in the best possible manner the following point must be considered: The size of the firm and its growth capability, Status of assets whether they are long-term or short-term, Mode by which the funds are raised. These financial decisions directly and indirectly influence other managerial activities. Hence formation of a good asset mix and proper allocation of funds is one of the most important activity

Profit Planning: Profit earning is one of the prime functions of any business organization. Profit earning is important for survival and sustenance of any organization. Profit planning refers to proper usage of the profit generated by the firm. Profit arises due to many factors such as pricing, industry competition, state of the economy, mechanism of demand and supply, cost and output. A healthy mix of variable and fixed factors of production can lead to an increase in the profitability of the firm. Fixed costs are incurred by the use of fixed factors of production such as land and machinery. In order to maintain a tandem, it is important to continuously value the depreciation cost of fixed cost of production. An opportunity cost must be calculated in order to replace those factors of production which has gone thrown wear and tear. If this is not noted, then these fixed cost can cause huge fluctuations in profit.

Understanding Capital Markets: Shares of a company are traded on stock exchange and there is a continuous sale and purchase of securities. Hence a clear understanding of capital market is an important function of a financial manager. When securities are traded on stock market there involves a huge amount of risk involved. Therefore, a financial manger understands and calculates the risk involved in this trading of shares and debentures. It's on the discretion of a financial manager as to how to distribute the profits. Many investors do not like the firm to distribute the profits amongst shareholders as dividend instead invest in the business itself to enhance growth. The practices of a financial manager directly impact the operation in capital market.

2.0 CAPITAL STRUCTURE

2.1 Meaning of Capital Structure

Capital Structure is referred to as the ratio of different kinds of securities raised by a firm as long-term finance. The capital structure involves two decisions: Type of securities to be issued are equity shares, preference shares and long term borrowings (Debentures). Relative ratio of securities can be determined by process of capital gearing. On this basis, the companies are divided into Two-Highly geared companies - Those companies whose proportion of equity capitalization is small. Low geared companies - Those companies whose equity capital dominates total capitalization. For instance - There are two companies A and B. Total capitalization amounts to be USD 200,000 in each case. The ratio of equity capital to total capitalization in company A is USD 50,000, while in company B, ratio of equity capital is USD 150,000 to total capitalization, i.e, in Company A, proportion is 25% and in company B, proportion is 75%. In such cases, company A is considered to be a highly geared company and company B is low geared company.

2.1.1 Factors Determining Capital Structure

Trading on Equity- The word "equity" denotes the ownership of the company. Trading on equity means taking advantage of equity share capital to borrowed funds on reasonable basis. It refers to additional profits that equity shareholders earn because of issuance of debentures and preference shares. It is based on the thought that if the rate of dividend on preference capital and the rate of interest on borrowed capital is lower than the general rate of company's earnings, equity shareholders are at advantage which means a company should go for a judicious blend of preference shares, equity shares as well as debentures. Trading on equity becomes more important when expectations of shareholders are high.

Degree of control- In a company, it is the directors who are so called elected representatives of equity shareholders. These members have got maximum voting rights in a concern as compared to the preference shareholders and debenture holders. Preference shareholders have reasonably less voting rights while debenture holders have no voting rights. If the company's management policies are such that they want to retain their voting rights in their hands, the capital structure consists of debenture holders and loans rather than equity shares.

Flexibility of financial plan- In an enterprise, the capital structure should be such that there is both contractions as well as relaxation in plans. Debentures and loans can be refunded back as the time requires. While equity capital cannot be refunded at any point which provides rigidity to plans. Therefore, in order to make the capital structure possible, the company should go for issue of debentures and other loans.

Choice of investors- The company's policy generally is to have different categories of investors for securities. Therefore, a capital structure should give enough choice to all kind of investors to invest. Bold and adventurous investors generally go for equity shares and loans and debentures are generally raised keeping into mind conscious investors.

Capital market condition- In the lifetime of the company, the market price of the shares has got an important influence. During the depression period, the company's capital structure generally consists of debentures and loans. While in period of boons and inflation, the company's capital should consist of share capital generally equity shares.

Period of financing- When company wants to raise finance for short period, it goes for loans from banks and other institutions; while for long period it goes for issue of shares and debentures.

Cost of financing- In a capital structure, the company has to look to the factor of cost when securities are raised. It is seen that debentures at the time of profit earning of company prove to be a cheaper source of finance as compared to equity shares where equity shareholders demand an extra share in profits.

Stability of sales- An established business which has a growing market and high sales turnover, the company is in position to meet fixed commitments. Interest on debentures has to be paid regardless of profit. Therefore, when sales are high, thereby the profits are high and company is in better position to meet such fixed commitments like interest on debentures and dividends on preference shares. If company is having unstable sales, then the company is not in position to meet fixed obligations. So, equity capital proves to be safe in such cases.

Sizes of a company- Small size business firm's capital structure generally consists of loans from banks and retained profits. While on the other hand, big companies having goodwill, stability and an established profit can easily go for issuance of shares and debentures as well as loans and borrowings from financial institutions. The bigger the size, the wider is total capitalization.

3.0 CAPITALIZATION IN FINANCE

Capitalization comprises of share capital, debentures, loans, free reserves,etc. Capitalization represents permanent investment in companies excluding long-term loans. Capitalization can be distinguished from capital structure. Capital structure is a broad term and it deals with qualitative aspect of finance. While capitalization is a narrow term and it deals with the quantitative aspect. Capitalization is generally found to be of following types-

- Normal
- Over
- Under

3.1 Overcapitalization

Overcapitalization is a situation in which actual profits of a company are not sufficient enough to pay interest on debentures, on loans and pay dividends on shares over a period of time. This situation arises when the company raises more capital than required. A part of capital always remains idle. With a result, the rate of return shows a declining trend. The causes can be-

1. **High promotion cost-** When a company goes for high promotional expenditure, i.e., making contracts, canvassing, underwriting commission, drafting of documents, etc. and the actual returns are not adequate in proportion to high expenses, the company is over-capitalized in such cases.
2. **Purchase of assets at higher prices-** When a company purchases assets at an inflated rate, the result is that the book value of assets is more than the actual returns. This situation gives rise to over-capitalization of company.
3. **A company's floatation n boom period-** At times company has to secure its solvency and thereby float in boom periods. That is the time when rate of returns is less as compared to capital employed. This results in actual earnings lowering down and earnings per share declining.
4. **Inadequate provision for depreciation-** If the finance manager is unable to provide an adequate rate of depreciation, the result is that inadequate funds are available when the assets have to be replaced or when they become obsolete. New assets have to be purchased at high prices which prove to be expensive.
5. **Liberal dividend policy-** When the directors of a company liberally divide the dividends into the shareholders, the result is inadequate retained profits which are very essential for high earnings of the

company. The result is deficiency in company. To fill up the deficiency, fresh capital is raised which proves to be a costlier affair and leaves the company to be over- capitalized.

6. **Over-estimation of earnings-** When the promoters of the company overestimate the earnings due to inadequate financial planning, the result is that company goes for borrowings which cannot be easily met and capital is not profitably invested. This results in consequent decrease in earnings per share.

3.2 Effects of Overcapitalization

1. **On Shareholders-** The over capitalized companies have following disadvantages to shareholders:
   a. Since the profitability decreases, the rate of earning of shareholders also decreases.
   b. The market price of shares goes down because of low profitability.
   c. The profitability going down has an effect on the shareholders. Their earnings become uncertain.
   d. With the decline in goodwill of the company, share prices decline. As a result, shares cannot be marketed in capital market.

2. **On Company-**
   a. Because of low profitability, reputation of company is lowered.
   b. The company's shares cannot be easily marketed.
   c. With the decline of earnings of company, goodwill of the company declines and the result is fresh borrowings are difficult to be made because of loss of credibility.
   d. In order to retain the company's image, the company indulges in malpractices like manipulation of accounts to show high earnings.
   e. The company cuts down it's expenditure on maintainance, replacement of assets, adequate depreciation, etc.

3. **On Public-** An overcapitalized company has got many adverse effects on the public:
   a. In order to cover up their earning capacity, the management indulges in tactics like increase in prices or decrease in quality.
   b. Return on capital employed is low. This gives an impression to the public that their financial resources are not utilized properly.
   c. Low earnings of the company affect the credibility of the company as the company is not able to pay its creditors on time.
   d. It also has an effect on working conditions and payment of wages and salaries also lessen.

3.3 Undercapitalization

An undercapitalized company is one which incurs exceptionally high profits as compared to industry. An undercapitalized company situation arises when the estimated earnings are very low as compared to actual profits. This gives rise to additional funds, additional profits, high goodwill, high earnings and thus the return on capital shows an increasing trend. The causes can be-

1. Low promotion costs
2. Purchase of assets at deflated rates
3. Conservative dividend policy
4. Floatation of company in depression stage
5. High efficiency of directors
6. Adequate provision of depreciation
7. Large secret reserves are maintained.

3.4 Effects of Under Capitalization

1. **On Shareholders**
   a. Company's profitability increases. As a result, rate of earnings go up.
   b. Market value of share rises.
   c. Financial reputation also increases.
   d. Shareholders can expect a high dividend.

2. **On company**
   a. With greater earnings, reputation becomes strong.
   b. Higher rate of earnings attract competition in market.

c. Demand of workers may rise because of high profits.
d. The high profitability situation affects consumer interest as they think that the company is overcharging on products.

3. **On Society**
   a. With high earnings, high profitability, high market price of shares, there can be unhealthy speculation in stock market.
   b. 'Restlessness in general public is developed as they link high profits with high prices of product.
   c. Secret reserves are maintained by the company which can result in paying lower taxes to government.
   d. The general public inculcates high expectations of these companies as these companies can import innovations, high technology and thereby best quality of product.

4.0 CONCLUSION

. Given the fact that many top tier companies are currently mired in low growth and less activity situations, it is imperative that they control their costs as much as possible. This can happen only when the finance function in these companies is diligent and has a hawk eye towards the costs being incurred. Apart from this, companies also have to introduce efficiencies in the way their processes operate and this is another role for the finance function in modern day organizations. There must be synergies between the various processes and this is where the finance function can play a critical role

Many economists have argued that profit maximization has brought about many disparities among consumers and manufacturers. In case of perfect competition, it may appear as a legitimate and a reward for efforts but in case of imperfect competition a firm's prime objective should not be profit maximization. In olden times when there was not too much of competition selling and manufacturing goods were primarily for mutual benefit. Manufacturers didn't produce to earn profits rather produced for mutual benefit and social welfare. The aim of the single producer was to retain his position in the market and sustain growth, thereby earning some profit which would help him in maintaining his position. On the other hand, in today's time the production system is dominant by two tier system of ownership and management. Ownership aims at maximizing profit and management aims at managing the system of production thereby indirectly increasing the income of the business.

These services are used by customers who in turn are forced to pay a higher price due to formation of cartels and monopoly. Not only have the customers suffered but also the employees. Employees are forced to work more than their capacity. they are made to pay in extra hours so that production can increase. Many times manufacturers tend to produce goods which are of no use to the society and create an artificial demand for the product by rigorous marketing and advertising. They tend to make the product so tempting by packaging and labeling that it's difficult for the consumer to resist. These happen mainly with products which aim to target kids and teenagers. Ad commercials and print ads tend to provide with wrong information to artificially hike the expectation of the product.

In case of oligopoly where the nature of the product is more or less same exploit the customer to the max. Since they form cartels and manipulate prices by giving very less flexibility to the consumer to negotiate or choose from the products available. In such a scenario it is the consumer who becomes prey of these activities. Profit maximization motive is continuously aiming at increasing the firm's revenue and is concentrating less on the social welfare.

Government plays a very important role in curbing this practice of charging extraordinary high prices at the cost of service or product. In fact, a market which experiences a high degree of competition is likely to exploit the customer in the name of profit maximization, and on the other hand where the production of a particular product or service is limited there is a possibility to charge higher prices is greater. There are few things which need a greater clarification as far as maximization of profit is concerned

Profit maximization objective is a little vague in terms of returns achieved by a firm in different time period. The time value of money is often ignored when measuring profit. It leads to uncertainty of returns. Two firms which use same technology and same factors of production may eventually earn different returns. It is due to the profit margin. It may not be legitimate if seen from a different stand point.

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