

## Chapter 9

### Impact of Effective Financial Management on Corporate Performance

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#### **Abstract**

All organisations are set up to achieve certain set targets and objectives. The ability of a firm to achieve their set objectives is referred to as corporate performance. A firm can only achieve its objectives if it applies effective financial management practices which involve the planning, operating and monitoring of the finance function of the organisation. Given the rapidly changing and competitive nature of the business environments in which modern organisations operate, if firms are to survive, corporate managers must appreciate the need to develop and make full use of financial management tools. Effective financial management has a direct and positive impact on corporate performance. That is, a good financial management system will lead to better and improved corporate performance, and similarly, a weak financial management system is likely to result in poor corporate performance.

**Keywords:** *Corporate performance; financial management; Budgeting; Working capital management.*

#### **Introduction**

How does effective financial management influence corporate performance? An answer to this question has relevance for organisations in all sectors of a nation including national governments. This is because, regardless of the sector in which an organisation operates, organisations are set up to pursue and achieve some objectives. Some firms are set up to maximise value for the owners through profitable and productive ventures whilst others are set up to undertake activities that promote the public interest by resolving specific societal challenges.

Whatever the rationale may be for setting up an organisation, all corporate entities must work towards the achievement of their set targets and objectives which are varied and different. It is worthy to note that regardless of the objective of an organisation, actions need to be taken to achieve those objectives. Some of the conditions necessary to achieve good corporate

performance include good corporate governance; skilful, hardworking and experienced human capital along with a good compensation scheme; and existing demand for the goods and services the organisation provides just to mention a few.

An organisation needs to put structures and processes in place to be able to undertake its business in order to achieve the set objectives. These structures include having a board of governors to lead the organisation, attracting and retaining competent employees through competitive compensation schemes and good working conditions as well as putting in place efficient operational arrangements to guide the delivery of goods and services. To do all of the above, there is the unavoidable need to secure the right amount of financial resources from the right sources, in the right mix, at the right cost, and at the right time and to effectively manage these financial resources.

The process involved in doing this is what is often referred to as financial management. This chapter analyses the impact of effective financial management on corporate performance. The chapter begins with an introduction, and then discusses corporate performance followed by a discussion of the processes of good financial management. The chapter then draws the link between effective financial management and corporate performance and concludes by drawing attention to the implications of the analysis for business executives, policy makers, and scholars and for future research.

### **What is Corporate Performance?**

A number of empirical studies have established a positive relationship between a myriad of variables and corporate performance. It has been documented that a positive relationship exists between corporate performance and good corporate governance (Klapper & Love, 2004); optimal corporate diversification (Lang & Stulz, 1993); discharge of corporate social responsibility (McGuire, Sundgren, & Schneeweis, 1988); good corporate reputation (Roberts & Dowling, 2002); good corporate social performance (Griffin & Mahon, 1997; Orlitzky, Schmidt, & Rynes, 2003; Preston & O'bannon, 1997; Waddock & Graves, 1997); equity based compensation schemes for corporate agents and employees (Mehran, 1995); good human resource management practices (Huselid, 1995); and, appropriate mix of debt to equity financing for the activities of organisations (Williamson, 1988).

Corporate performance relates to the ability of a firm to achieve its set qualitative and quantitative objectives. The business of organisations necessarily involves the carrying out of activities aimed ultimately at helping the firm achieve some objective. Organisational objectives are both quantitative and qualitative. Goals relating to the quantity of goods and services to produce and sell, the number of customers or clients to attract, the amount of sales value, target profits, cost ceilings etc. are quantitative objectives. Qualitative goals include: levels of efficiency in delivering services, the quality of products and services, quality of management etc. When an organisation is able to achieve its stated objectives, it is said to have performed well. If corporate objectives are not met; the organisation is said to be non-performing. Thus, the ability of a firm to attain its set targets reflects how well or badly it has performed. Corporate performance is thus a multidimensional construct which attempts to measure the ability of organisations to achieve their set goals and objectives (Zahra & Pearce, 1989).

Corporate performance may be measured by assessing movements in the market value of the organisation, profit levels attained by the firm, its ability to meet current and future obligations and remain sustainable, the ability of the organisation to fulfil its corporate social obligations and more generally, its ability to accomplish what it sets out to do. Corporate performance could be viewed from the perspective of financial performance, operational performance, or a firm's ability to meet different corporate social responsibility targets. It is obvious that corporate performance, no matter how it is conceived, is the core essence for the existence of the firm. A number of studies have suggested that an organisation's performance is linked to a number of factors. The question that begs for an answer is: what is the impact of effective financial management on corporate performance? To answer this question, one needs to understand the processes of effective financial management. The next section therefore explains the processes involved in effective financial management.

### **The Financial Management Framework**

Figure 9.1 below presents the conceptual framework of a functional financial management system and suggests that a functional financial management system should lead to improved corporate performance.

FINANCIAL MANAGEMENT FRAMEWORK



Figure 9.1: Financial Management Framework

**What is Financial Management?**

According to Horne and Wachowicz (2001) “financial management is concerned with the acquisition, financing and management of some assets with some overall goal in mind” (p.2). It can be deduced from this definition that financial management is the planning, operating and monitoring of the finance function of an organisation in order to achieve its objectives. Financial management encompasses all the processes involved in managing the finances of corporate organisations. These processes include the identification of corporate objectives through medium to long term planning; formulation of short term corporate budgets to implement the medium to long term plans; identifying funding sources and raising the funds to finance operations and projects identified in the budget; managing budget execution processes through effective working capital management; making investment decisions regarding the kind of assets to hold as an organisation that will ensure the achievement of objectives; and making decisions regarding how to distribute returns to stakeholders in the

form of dividends and other forms of compensations.

In effect, financial management is about taking deliberate and intentional actions to look after the health of an organisation, and not leaving things to chance. Financial management to a corporate organisation is like maintenance is to a vehicle. Just like a vehicle, the corporate organisation requires good quality fuel and oil and regular servicing and maintenance in order to function well. If neglected, just like a vehicle, the organisation will eventually break down and fail to reach its intended destination.

An effective financial management system ensures that the organisation has resources to achieve its objectives. An effective financial management model will necessarily involve the following phases; the planning phase, the budgeting phase, the budget execution phase which includes revenue mobilisation or fund raising, financial reporting phase, as well as the auditing, monitoring and evaluation phase. The roles of each phase in financial management are depicted in figure 9.2 and discussed in turns.

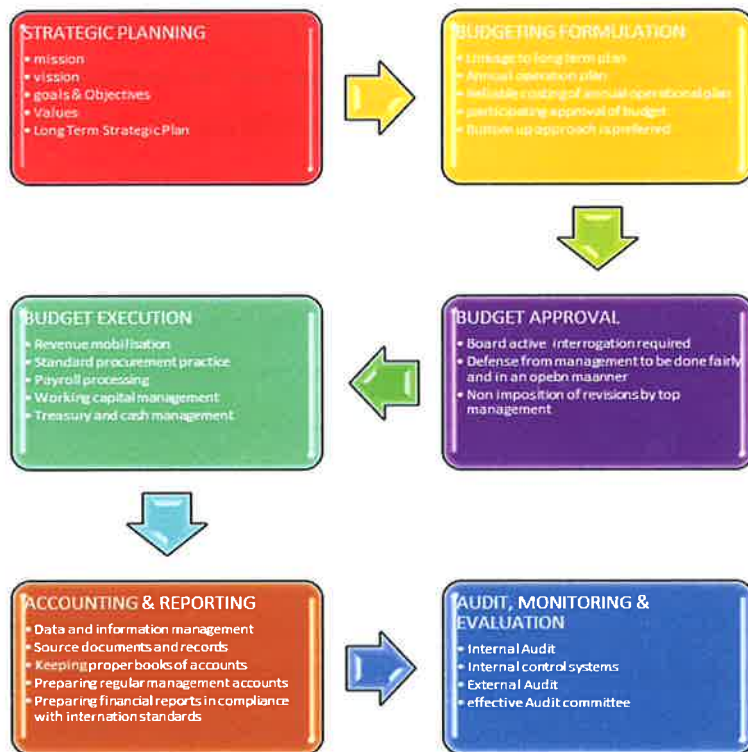


Figure 9.2: Detailed description of financial management framework

## **Planning**

A number of studies have shown that good planning within organisations has a positive association with corporate performance (Miller & Cardinal, 1994; Pearce, Robbins, & Robinson, 1987; Robinson & Pearce, 1983). Planning involves making deliberate and intentional choices regarding the future direction of an organisation. To be effective, an organisation should first identify its strategic focus by defining its vision, which represents the organisation's long term goals, and its mission which clarifies the purpose and values of the organisation. Specific objectives that will enable the organisation to achieve its mission and vision statements are then developed out of which clear strategies for the implementation of the objectives are crafted.

These strategies can be framed in the form of strategic plans for the medium to long term. Activity plans are then crafted out of the strategic plan for relatively shorter time horizons to facilitate implementation. When developing strategic plans for organisations, there is the need to consider the resources available to the firm, organisational needs which are based on the strategic choices made by the organisation in terms of its areas of operation. The strategic plan helps to coordinate the allocation of organisational resources over a long term horizon, and thus, contributes to a rational and optimal use of resources. It also allows for the early anticipation of risks that may arise along the line to allow for careful and considered analysis of mitigation strategies to resolve the risks.

Planning is an essential pillar of financial management. Without it, the organisation will only be wandering in the wilderness without any benchmark against which performance can be measured. The implication is that without a plan, performance measurement will be less meaningful. Actual performance has to be measured against a plan to come to some conclusion whether or not an organisation is performing well and a good plan is an essential feature of an effective financial management system.

## **Budgeting**

Once a strategic plan has been developed, an activity plan can be crafted, and developed into an annual budget which could be further broken down into bi-annual, quarterly, monthly or weekly budgets. Merchant (1981) and Nouri and Parker (1998) found that a participatory budgeting system increases staff morale and job satisfaction, and ultimately makes a positive

impact on productivity. This implies that good budgeting and budgetary control practices in corporate organisations should lead to improved corporate performance. A budget may be defined as a predetermined detailed plan of action, developed and distributed as a tool to guide operations for the ensuing period and to serve as a partial basis for subsequent evaluation of performance.

A budget is a detailed plan which sets out, in money terms, the estimated revenue and expenditure of an organisation for a future period of time, prepared based on some agreed underlying assumptions and objectives. Operational budgets cover the recurring and routine operating activities of an organisation, whilst a capital budget covers the investment activities of an organisation such as the acquisition of long term assets used for the production of goods and services of the organisation. Ryan and Ryan (2002) show how the fortune 1000 companies are increasingly relying on the net present value method of capital budgeting to analyse the appropriateness or otherwise of critical and important capital asset investments decisions.

Among other objectives, the budget and the process of budgeting greatly facilitate planning, help in revenue mobilisation or fund raising, and serve as tools for control through comparison of budgets with actuals throughout the year so that variances are spotted and remedial actions taken to align actuals closely to the budget. Merchant (1981) explained that the budget process positively influences managerial behaviour and helps to secure positive corporate performance and budgeting as a key feature of effective financial management.

### **Budget Execution**

Once the budget is developed, there is need to raise the funds required to execute the budget. No organisation can carry on its business without having sufficient funds. Ensuring that sufficient funds are available in the right amount, at the right time from the right source and at the right cost is critical to organisational success. Funds may be raised from different sources: from the owners of the organisation, from the operations of the organisation, or from lenders. Again the funds that could be made available to an organisation could be long term, medium term or short term. Each of these different maturity terms of funding sources would have different cost implications and therefore have a bearing on corporate performance.

A major financial management function is to carefully evaluate how much funding an organisation requires, and to determine the appropriate mix of sources from which the funding should be raised to ensure that cost is minimised. Among the several factors that are often considered in deciding on the mix of funding sources for organisations are: the cost and risk associated with the particular source of funding, the tax implication of the source of funding, the timing and reliability of cash flows expected from the projects to be funded. Indeed, the point that an organisation needs to have sufficient funds at minimal cost in order to be able to carry out its activities is obvious.

Budget execution involves disbursements of allocated funds in the budget for their assigned purposes using processes that have been agreed upon. The budget execution process involves procurement of goods and services, payroll processing and payments, contracting processes etc. The payment of wages and salaries and the procurement of goods and services can only be done well when cash is available at the right time to meet committed needs. A number of empirical studies have established that effective working capital management practices have a positive relationship with corporate performance in a number of organisations in a number of countries (Padachi, 2006; Raheman, Afza, Qayyum, & Bodla, 2010; and Vishnani & Shah, 2007).

Working capital management which is a key financial management function ensures that funds are available in the right amount, at the right time, from the right source and at the right cost to meet the commitments of the organisation. Working capital management also ensures that the organisation does not run into deficits where there are no funds at particular points in time to finance the planned activities of the organisation; and also that organisations do not lock up surplus funds in cash balances that do not yield returns by ensuring that surplus funds are invested in appropriate investment instruments with the right maturity terms.

Good working capital management requires that organisations keep optimal levels of inventories and manage their financial relations with both debtors and creditors to avoid situations where clients keep substantial amounts of the organisation's funds for unduly long periods of time and at the same time ensure that the organisation takes advantage of optimal credit terms from its suppliers and lenders. It also requires that the organisation applies



competitive procurement processes so that the organisation obtains value for money in the procurement of goods and services. Kaynak (2003) established that there is a positive relationship between total quality management which involves efficient procurement processes and firm performance. The importance of efficient procurement in ensuring good procurement cannot be overemphasised.

### **Financial Reporting**

Financial management does not end with the disbursements of allocated funds. There is the need to ensure that a set of financial statements are prepared to report the financial transactions of the organisation. Financial reports generated from the financial management system are critical tools for enhancing corporate performance. Cunningham and Harris (2005) and Kluvers and Tippetts (2010) pointed out that relevant and understandable financial reports have the ability to clearly communicate organisational performance to stakeholders. Barton (2005) suggested that for financial reporting systems to be useful, they must possess the characteristics of: relevance, reliability, comparability, and understandability. Chan (2003) explained that financial reports are used to: evaluate an organisation's ability to meet obligations, induce others to offer resources to the organisation, and monitor the performance of the organisation. Having good financial reports helps to provide information about the organisation to allow for stakeholders to make informed decisions.

Effective financial management systems support organisations to generate financial statements that are prepared in accordance with established accounting standards to capture the material financial transactions of the organisation accurately and reliably to show the financial performance of the organisation during the reporting period, the financial position of the organisation as at the end of the reporting period and the cash flows of the organisation during the reporting period. Such information generated from the financial reporting system should allow the different stakeholders to be in a position to properly evaluate performance and make informed decisions based on this evaluation.

### **Auditing, Monitoring and Evaluation**

Organisations are often run by trained management teams who are often different from the owners and tend to have interests which differ from that of the owners. The divergence in

interest between owners and managers create what has come to be known as the agency problem. The agency problem makes it necessary for the owners to engage independent auditors to review the financial statements prepared by management and to provide assurance to the owners through their independent professional opinion as to whether or not the financial statements prepared by management reflect a true and fair view of the operations of the organisation during the reporting period and whether the assets and liabilities as at the end of the reporting period reasonably reflects the true state of financial position of the organisation.

Before the independent external auditors examine the records to provide their independent opinion, it is good financial management practice to have internal auditors, who work as part of the management team, to continuously monitor and evaluate the policies and procedures put in place by management, to assess the adequacy or otherwise of those policies in helping management achieve its set objectives. Both internal and external audit processes help to provide recommendations on the operational and financial policies and practices of the organisation which when acted upon will help to improve corporate performance (Klein, 2002).

From the above analysis on what represents a good financial management system, the question is what is the relationship between good financial management and corporate performance? The next section seeks to establish this link.

### **Linking Effective Financial Management and Corporate Performance**

It has already been said in an earlier section that corporate performance is about the ability of organisations to achieve their set objectives whether operational or financial. For an organisation to be able to achieve its objectives, in the first place, those objectives must be properly developed through a careful and deliberate planning process which is an integral part of an effective financial management system. Without a good planning process, there will be no good objectives to meet. Once plans have been developed, they will remain plans on the shelves unless and until they are reduced to actionable activities and resources allocated to ensure that these activities are actually carried out through the budgeting and budget execution process. The fund raising function of financial management ensures that financial resources are raised at the right cost to finance the activities of the organisation.

Working capital management processes ensure that adequate cash is available at all times to ensure that the wheel of the organisation does not grind to a halt. If working capital is not properly managed, the organisation may run out of cash at critical times when it will need to carry out some activities. The consequence is that some activities may not be carried out, and this may lead to poor corporate performance.

The availability of financial information through effective financial reporting processes makes it possible for evidenced based decisions to be made by management of organisations. The absence of good information will result in a situation where decisions will simply be based on guess work and not informed by data. The point that financial decisions guided by cost benefit analysis based on financial information generated by the financial management system will more likely lead to better corporate performance as compared decisions not informed by cost benefit analysis cannot be over emphasised. The opportunity presented by the auditing, monitoring and evaluation process of the financial management system to ensure value for money, and identification of risks and weaknesses in organisational processes for redress, should have a direct and positive impact on corporate performance.

### **The Impact of Sound Financial Management on the Economy**

Financial management at the national level also has an impact on the performance of government. Financial management of public funds has come to be known as Public Financial Management. According to Andrews *et al* (2014) Public Financial Management (PFM) refers to the way governments manage public resources (both revenue and expenditure) and the immediate, medium, as well as long term effects of such resources on the economy or society. This implies that PFM involves the processes of managing financial resources and the outcome or results achieved from those processes. PFM processes involve: planning, controlling, implementation and monitoring of fiscal policies and activities, including the reporting, audit and the exercise of oversight responsibilities on the management of public funds.

The PFM cycle encompasses the phases of budget formulation, budget approval, budget execution, accounting and reporting, monitoring and oversight activities (Kan-Dapaah, 2015; Andrews et al., 2014). The impact of a good PFM system on effective resource management

at the national level cannot be overemphasised. Cangiano, Curristine and Lazare (2013) and Allen (2013) suggest that an effective PFM system promotes efficient allocation of scarce resources to activities, projects and programmes in an economy thus ensuring that scarce resources are deployed to their optimal use; leads to effective delivery of public goods and services to the citizenry at optimal prices; and helps to achieve a sustainable fiscal position for the entire economy, thus enabling economic development.

Effective PFM systems also deliver stewardship and accountability over public funds in a transparent manner. This brings about good economic governance. Good governance is a virtue that all civilised societies are trying to embrace to help improve the wellbeing of members of the society. Good governance calls for national economies to be governed and led in a manner as to ensure that resources are well utilised in meeting the needs of all stakeholders in the national economy. According to Cheema and Maguire (2001) good governance involves governance practices infused with the principles of equity, participation, rule of law, transparency and accountability. Cheema and Maguire assert further that there are three dimensions of governance: political governance, economic governance and social governance, and that all three are linked to each other and provide the platform for the effective delivery of public service. An effective PFM system ensures good economic governance.

Grindle (2004) states that “indeed, it is all too clear that when governments perform poorly, resources are wasted, services go undelivered, and citizens – especially the poor – are denied social, legal, and economic protection. For many in the development community, good governance has become as imperative to poverty reduction as it has become to development more generally” (p. 525). Cheema and Maguire (2001) find that there is a positive correlation between the practice of good economic governance and human development. Patra (2012) finds that failure of government to exhibit good PFM governance principles leads to massive scams and corruption which deprive societies of much needed resources for development and consequently lead to low levels of human development.

### **Conclusions and Recommendations**

Today’s organisations operate within rapidly changing and competitive environments. For a firm operating in the current marketplace to survive in their challenging business

environments, corporate managers must appreciate the need to develop and make full use of financial management tools. In all organisations, financial management should be given a high priority. Financial management plays a pivotal role in the performance of corporate organisations. Effective financial management helps business executives to make effective and efficient use of resources to achieve corporate objectives and fulfill commitments to stakeholders, and assists corporate organisations to be more accountable to donors and other stakeholders. Sound financial management helps corporate organisations to gain the respect and confidence of funding agencies, partners and beneficiaries and therefore is able to attract more funding; it gives corporate organisations competitive advantage over their peers in the mobilisation and use of scarce resources; and assists corporate organisations to prepare themselves for long-term financial sustainability.

These reasons make it imperative and persuasive for organisations to put in place effective financial management systems. An effective financial management system should ensure consistency in the operations of the organisation, accountability over the resources of the organisation, transparency in the management of resources of the organisation, integrity of the system to preserve resources of the organisation, stewardship by managers to owners of the organisation, and use of best standards in carrying out all the different activities of the organisation, and viability of the business of the organisation.

It can therefore be concluded that effective financial management has a direct and positive impact on corporate performance. That is to say a good financial management system will lead to better and improved corporate performance and similarly a weak financial management system should lead to poor corporate performance. This has implications for business executives, policy makers, and a scholar as far as future research is concerned.

The implication for business executives is that they should ensure that their organisations do maintain effective financial management systems to guide their operations as this will ensure better corporate performance for their business organisations. Business executives should therefore endeavour to make appropriate investments towards putting in place effective financial management systems within their businesses and should also allow the financial management systems once developed to function without impediments.

Policy makers at the national level should realise the critical role of effective financial management in the realisation of all policies that they develop. They should therefore ensure that there is an effective financial management system at the national level to facilitate the smooth implementation of all policies. If this is not done, policies will only remain pieces of documents on the shelves of the policy makers. For purposes of future research, scholars should address their attention to empirically testing the conclusions made in this chapter by using data to examine the relationship between effective financial management and corporate performance for different types of organisations in order to reinforce the assertions.

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