Financial Management
(As per the Revised Syllabus of Semester - II 2016 Pattern of SPPU for MBA)

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PREFACE

It gives us great pleasure to present this book titled, ‘Financial Management’ to our intelligent and dynamic readers, the scholar students of different Management Courses and knowledge seekers. This book intends to cover, in detail, the entire Syllabus as per 2016 Pattern of ‘Financial Management’ of MBA Programme offered by Savitribai Phule Pune University. Apart from that, this book is also useful to the UG and PG students of other universities who have ‘Financial Management’ as a subject in their respective curriculum. This book is a sincere attempt to provide readers with latest study material in simple and lucid language. To make the topics clear to the students, various examples have been included.

Financial Management mainly covers various basic financial aspects of the business organizations. This book will help to understand the basic concepts of Business Finance, Financial Planning, Financial Management, Procurement of Funds, Allocation of Funds, Utilization of Available Resources, etc. It also provides various tools of Financial Statement Analysis, Capital Budgeting, Capital Structure, etc. which would facilitate decision making. Due to Globalization, Liberalization, and Privatization, it is essential to have basic knowledge of Finance and Financial Management for all the Entrepreneurs, Managers and Executives who are working at domestic, national and international level. For developing analytical abilities and to face the business situations, basic information and knowledge is must which is provided in this book.

Looking at the new trends and scenarios, and acknowledging necessity of studying various dimensions of Finance and Financial Management, the Savitribai Phule Pune University has included this subject in their MBA Programme.

Success can never be achieved single handedly, so it is our duty to express our gratitude towards all those who provided their help and support. We express our special thanks to Prof. Dr. V.D. Karad, Executive President and Managing Trustee of MAEER’s MIT, Prof. Rahul V. Karad – Vice President, MAEER’s MIT, Prof. Dr. Mangesh Karad – Secretary & Executive Director, MAEER’s MIT Group of Institutions for their continuous motivation in writing the said book. In addition, we wish to express our gratitude to our colleagues for their help and support. We would also like to express our sincere thanks to the Publisher of Himalya Publishing House Pvt. Ltd., Mr. S.K. Srivastava – Regional Manager, Mr. Abhijit, Ms. Archana, Ms. Lalita and all the staff members of Himalaya Publishing for their willing cooperation and support. Our words fall short to express our feelings towards our family members, colleagues and our friends who extended their whole hearted best wishes and encouraged us throughout.

Suggestions of readers are most welcome and will be acknowledged with appreciation.

With best wishes.

Authors
## SYLLABUS

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### Course Title: Financial Management (FM)

#### Course Objectives:
1. To understand various concepts related to financial management.
2. To study in detail, various tools and techniques in the area of finance.
3. To develop the analytical skills this would facilitate the decision making in business situations.

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<td>Unit – 4</td>
<td><strong>Capital Budgeting:</strong> Meaning, Definition and Types of Evaluating the Project on the Basis of Traditional Techniques and Modern Techniques (viz., Payback Period, Discounted Payback Period, NPV, ARR, IRR, PI), Time Value of Money.</td>
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**Note:**

1. Theory 30% and Numerical Problems 70%.
2. Numerical Problems will be asked on following topics only –
   - Calculation of Cost of Capital: Specific Costs – Cost of Equity/Preference/Retained Earnings and Debt, Weighted Average Cost of Capital, Leverages.
   - Problems on Ratio analysis (Computation and Interpretations of Ratios).
   - Simple Problems on Fund Flow Statement
   - Capital Budgeting: Payback Period, Discounted Payback Period, NPV, ARR, IRR, PI.
   - Problems on Estimation of Working Capital.
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Chapter 1
Business Finance

Contents
- Introduction
- Definition, Characteristics and Nature of Business Finance
- Definition of Finance and Financial Management
- Goals of Financial Management (Profit Maximization and Wealth Maximization)
- Modern Approaches to Financial Management (Investment Decision, Financing Decision and Dividend Policy Decisions)
- Finance and Other Related Disciplines
- Functions of Finance Manager
- Key Strategies of Financial Management

Introduction

Every Business Organization needs finance to meet their business activities and requirements irrespective of their nature, size and type of business. Every type of business activity depends on finance. Hence, finance is called lifeblood of a business organization. Finance may be called capital, investment, fund, etc., but each term has different meanings and unique characters. To increase the profit is the ultimate aim of any type of economic activity. Finance plays an important role in growth and development of every Business Organization because it is a starting point of every business activity.

Definition, Characteristics and Nature of Business Finance

In simple words, Arrangement of funds is called finance. Finance word is very deep and in modern era, this word is also known as Business Finance.
Definitions of Finance:

- **According to Khan and Jain**, “Finance is the art and science of managing money”.
- **According to Oxford Dictionary**, the word ‘Finance’ denotes ‘Management of Money’.

Definitions of Business Finance:

- **According to B. O. Wheeler**, Business Finance is ‘that business activity which is concerned with the acquisition and conservation of capital funds in meeting the financial needs and overall objectives of business enterprise’.
- **According to Bonneville and Dewey**, “Business finance consists of the raising, providing, managing of all the money, capital or funds of any kind to be used in connection with the finance”.
- **According to Guthmann and Dougall**, “Business finance can be broadly defined as the activity concerned with planning, raising and administering of funds used in the business”.
- **According to Parther and Wert**, “Business finance deals primarily with raising, administering and disbursing funds by privately owned business units operating in nonfinancial fields of industry”.

Characteristics of Business Finance:

1. Business finance includes all types of funds used in business.
2. It is required in all kinds of business organizations.
3. The amount of business finances differs from firm to firms depending upon their size, nature of business. It also varies from time to time.
4. It involves estimation of funds.
5. It is concerned with raising funds from different sources as well as investment of funds for different purposes.

Nature of Business Finance:

1. Finance is concerned with cash and every business transaction involves cash directly or indirectly.
2. The financial resources are always insufficient and limited. Hence, it needs scientific planning and proper control in order to achieve the desired result.
3. Finance function is the task of procurement and utilization of funds. It covers financial planning, forecasting of cash receipt and raising of funds, use and allocation of funds and financial control.
4. Finance is an important function of every organization, as money is required to purchase raw materials, to pay wages and salaries, electricity expenses and so on. Therefore, finance must be readily available as and when required.
5. Finance is the basis of every business organization because it is life blood of every business organization.
Corporate Finance:

Corporate finance covers the tools used by financial professionals to analyze, evaluate and make financial decisions to achieve its goal of maximizing the value of the firm while taking on a minimum amount of risk. Corporate finance covers several types of financial decisions which include investment decisions, financing decisions, payout decisions and risk management decisions etc.

Meaning and Definition of Financial Management:

The term ‘Finance’ refers Management of Funds. It may be defined as planning, organizing, directing and controlling of financial activities in a business enterprise. Financial Management (FM) is responsible for estimation of financial resources, their procurement and their application in a manner in which they help, the enterprise grow according to well defined objectives. In short, FM is concerned the acquisition, financing, and management of assets with some overall goal in mind.

Definitions of Financial Management

According to –

1. Solomon Ezra and Jhon Pringle: “Financial Management is concerned with the efficient use of an important economic resource namely, capital funds”.
3. Dr. S. N. Maheshwari: “Financial management is concerned with raising financial resources and their effective utilization towards achieving the organizational goals”.
4. Richard A. Brealey: “Financial management is the process of putting the available funds to the best advantage from the long-term point of view of business objectives”.
5. Howard and Upton: “Financial management is an application of general managerial principles to the area of financial decision making”.
6. Weston and Brigham: “Financial management is an area of financial decision making, harmonizing individual motives and enterprise goals”.
7. Joshep and Massie: “Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations”.

Goals of Financial Management
(Profit Maximization and Wealth Maximization)

There are several goals of financial management. But two main goals are profit maximization and wealth maximization.

1. To earn the maximum amount profit is the main aim of every business organizations.
2. To increase the net present value of business, i.e., maximization of shareholders wealth in the form of dividend and capital gains is another important goal of financial management.
3. To ensure availability of funds.
4. To keep the cost of funds low.
5. To ensure efficient utilization of funds.
6. To ensure reasonable return and safety of funds.
7. To create and establish suitable system for maintaining financial discipline among the organization.
8. To plan a sound capital structure, i.e., combination of debt and equity capital.
9. To ensure adequate returns to the shareholders.
10. Apart from profit maximization and wealth maximization, organization should also concentrate on sales maximization, growth maximization, ROI maximization for survival.

Profit Maximization and Wealth Maximization:

Financial Management is concerned with the proper utilization of funds in such a manner that it will increase the value plus earnings of the firm. Wherever funds are involved, financial management is there. There are two supreme objectives of Financial Management, i.e., Profit Maximization and Wealth Maximization. Profit Maximization as its name signifies refers that the profit of the firm should be increased while Wealth Maximization aims at increasing the worth of the entity.

Meaning and Definition of Profit Maximization:

Profit Maximization is the ability of the firm in producing utmost output with limited input, or it uses minimum input for producing stated output. It is termed as the primary objective of the company.

It has been usually recommended that the clear motive of any business organization is to earn a profit, it is necessary for the success, survival, and growth of the company. Profit is a long-term objective, but it has a short-term perspective, i.e., one financial year.

Profit can be calculated by deducting total cost from total revenue. Through profit maximization, a firm can be able to find out the input-output levels, which gives the highest amount of profit. Therefore, the finance officer of an organization should take his decision in the direction of maximizing profit although it is not the only objective of the company.

Meaning and Definition of Wealth Maximization:

Wealth maximization is the ability of a company to increase the market value of its common stock over time. The market value of the firm is based on many factors like their Goodwill, Sales, Services, Quality of Products, etc.

It is the adaptable goal of the company and vastly recommended standard for evaluating the performance of a business organization. This will help the firm to increase their share in the market, attain leadership, maintain consumer satisfaction.

It has been commonly accepted that the fundamental goal of the business enterprise is to increase the wealth of its shareholders, as they are the owners of the undertaking, and they buy the shares of the company with the expectation that it will give some return after a period. This states that the financial decisions of the firm should be taken in such a manner that will increase the Net Present Worth of the company’s profit. The value is based on two factors namely:

1. Rate of Earning per Share
2. Capitalization Rate
Key Differences between Profit Maximization and Wealth Maximization:

The major differences between profit maximization and wealth maximization are:

1. The process through which the company is capable of increasing earning capacity known as profit maximization. On the other hand, the ability of the company in increasing the value of its stock in the market is known as wealth maximization.
2. Profit maximization is a short-term objective of the firm while the long-term objective is wealth maximization.
3. Profit maximization ignores risk and uncertainty whereas wealth maximization considers both.
4. Profit maximization avoids time value of money, but wealth maximization recognizes it.
5. Profit maximization is necessary for the survival and growth of the enterprise. Conversely, wealth maximization accelerates the growth rate of the enterprise and aims at attaining the maximum market share of the economy.

Functions of Financial Management:

Following are the important functions of financial management:

1. Estimation of capital requirement with regards to company is the main function of financial management.
2. After proper estimation the proper capital structure need to be decided.
3. Proper choice of sources of funds need to be decided in case of procurement of additional funds, i.e., issue of debentures, public deposits, loan from banks and financial institutions etc.
4. Investment of funds in profitable ventures.
5. Distribution of dividend and retention of profit in case of disposal of surplus.
7. Need to use different financial techniques for precise financial control.

Modern Approaches to Financial Management (Investment Decision, Financing Decision and Dividend Policy Decisions):

Approaches of Financial management are classified into two categories:

1. Traditional Approach
2. Modern Approach

1. Traditional Approach:

Traditional approach is the initial stage of financial management, which was followed, in the early part of during the year 1920 to 1950. This approach is based on the past experience and the traditionally accepted methods. Main part of the traditional approach is raising of funds for the business concern. Traditional approach consists of the following important area.

1. Arrangement of funds from lending body, i.e., from financial institutions.
2. Arrangement of funds through various financial instruments like shares, bonds, etc.
3. Finding out the various sources of funds.
Main Limitations of Traditional Approach:
1. Ignored routine problems.
2. Ignored working capital financing.
3. No emphasis of allocation of funds.
4. Time value of money is not considered.

2. Modern Approach:
This approach is more balanced because it says that financing is concerned with procurement of funds and wise application of funds. It gives equal weightage to both procurement of funds and utilization of funds. It is divided into four major decisions:
1. Financing Decision.
2. Investment Decision.
3. Dividend Policy Decision.
4. Funds Requirement Decision.

2.1 Financing Decisions: These decisions basically deal with acquiring of funds and deployment of funds.

2.2 Investment Decisions: These decisions are related with selection of assets. Assets are classified into two types:
(a) Fixed Assets
(b) Current Assets

The decisions regarding Fixed Assets are known as Capital Budgeting Decisions.
The decisions regarding Current Assets come under Working Capital Management.

2.3 Dividend Policy Decisions: Whatever profit company earns, the owners are entitled to receive them. These decisions are related with distribution of dividends, i.e., to decide how much profit company should distribute as a dividend and how much should be retained in business.

2.4 Funds Requirement Decisions: Estimation of the financial requirement of the business concern, i.e., to estimate, how much finance is required for acquiring fixed assets, forecasting the amount needed to meet the working capital requirements in future. Funds Requirement Decisions are also called as Liquidity Decisions.

Finance and Other Related Disciplines:

Financial management is one of the significant parts of overall management, which is directly related with various functional departments like marketing, production, personnel, etc. Financial management covers broad area with multidimensional approaches. The following are the important scope of financial management.

1. Finance and Economics:

    Economic concepts like micro and macroeconomics are directly applied with the financial management approaches. Investment decisions, micro and macro-environmental factors are directly related with the functions of financial manager. Financial management also uses the economic
equations like economic ordering quantity, money value discount factor, etc. Financial economics is one of the upcoming area, which provides huge opportunities to finance, and economical areas.

2. Finance and Accounting:

Accounting records includes the financial information of the business organization. Hence, one can easily comprehend the relationship between the financial management and accounting. In the ancient periods, both financial management and accounting were treated as a same discipline and then it was merged as Management Accounting because this part is very much useful to finance manager to take several decisions. But nowadays financial management and accounting discipline are separate and interconnected.

3. Finance and Mathematics:

In today’s competitive era financial management applied large number of mathematical and statistical tools and techniques. They are also called as econometrics. Economic order quantity, ratio analysis, working capital analysis, discounting factor, time value of money, present value of money, cost of capital, capital structure theories, dividend theories are used as mathematical and statistical tools and techniques in the field of financial management.

4. Finance and Production:

Production management is the operational part of every business organization which helps to increase the money into profit. Profit of every business organization depends upon the production performance. Production performance needs finance, because production department requires machinery, raw materials, wages, operating expenses, etc. These expenditures are decided and estimated by the finance department and accordingly, the finance manager allocates the appropriate finance to the production department. The finance manager must be aware about the operational processes and essential finance required for each process of production activities.

5. Finance and Marketing:

Manufactured goods are sold in the market with innovative ideas and modern ways. For this, the marketing department also needs finance to meet their departmental requirements. The finance manager or finance department is liable to allocate adequate finance to the marketing department. Hence, marketing and finance are interconnected and depends on each other.

6. Finance and Human Resource:

Financial management is also associated with human resource department, which provides required manpower to all the functional areas of the organization. Finance manager should cautiously evaluate the requirement of manpower to each department and allocate the finance to the human resource department as wages and salaries, remunerations, commissions, bonus, pensions and other monetary benefits to the human resource department. Hence, finance is directly related with human resource management.

7. Finance and Costing:

Cost efficiency is the foremost strategic advantage to a business organization which will greatly contribute towards its profitability, competitiveness and sustainability. A finance manager has to comprehend and manage cost through suitable tools and techniques including Budgeting, Marginal Costing, Standard Costing, Activity-based Costing, Kaizen Costing, Target Costing, etc.
8. Finance and Quantitative Methods:

Financial management is also closely related with quantitative methods such as discounting techniques, present value techniques, probability, linear programming, etc., are useful in examining difficult financial management problems. Therefore, the financial manager must be familiar with several tools, techniques of quantitative methods.

9. Finance and Taxation:

All financial decisions are likely to have tax implications. Therefore, finance manager must have sound knowledge in taxation, both direct and indirect taxes.

10. Finance and Law:

Apart from taxation knowledge, finance manager should be familiar with the knowledge of Legal Environment, Business Laws, Corporate Laws, Commercial Contracts, Import Export Guidelines, International Trade and Patent Laws etc.

11. Finance and Banking:

A good knowledge of banking operations and ancillary services is required for a finance manager because banking has completely undergone a change in today’s environment.

12. Finance and Treasury Management:

Every business organization including banks treasury has become an important function and discipline. Therefore, every finance manager should be well versed in treasury operations.

13. Finance and Insurance:

Identify and evaluate the commercial insurance requirements, choice of products and available reliable insurers in the market, analyze the applicability according to needs, cost effectiveness, techniques ensuring appropriate and optimum coverage, handling of claims, etc., fall within the area of finance manager’s scope.

14. Finance and Information Technology:

A finance manager must know how to incorporate finance and costing operations through software packages including ERP, SAP, etc. The finance manager must take active part in evaluation of various available options, identifying the best one in the implementation of such packages in the business organization for smooth functioning and prompt reporting.

Functions of Finance Manager:

For carrying out its different functions effectively and efficiently management requires different financial information and data in simple and more analytical form. This is provided by finance manager. A person who deals with finance-related activities is called a finance manager. Finance manager is considered to be the eye and brain of the management as far as finance and financial matter is concerned.
Finance Manager's Role:

1. Forecasting financial requirements of business organization.
2. Acquiring necessary capital/raising of funds for business organization.
3. Allocation of funds to the different departments of the business organization.
4. Take appropriate investment decisions.
5. Proper cash management.
6. Constantly coordinate with other departments.
7. Profit planning for dividend distribution and profit retention.
8. Understanding capital markets according to environment.

Functions/Duties of Finance Manager:

1. Finance Manager should take decisions related to Capital Budgeting.
2. Finance Manager is responsible for proper Working Capital Management.
3. Finance Manager should formulate the appropriate Dividend Policy according to the objectives of the organization.
4. Finance Manager is liable for Investment Decisions, Wealth Maximization and Finance Control in the organization.
5. Finance Manager is responsible for Profit Maximization (Profit After Tax)
6. Finance Manager is accountable for Assets Management and Allocation of Income.
7. Finance Manager is answerable for Corporate Taxation.
8. Finance Manager is liable for Performance Evaluation of the business organization.
9. Finance Manager should always try for Maximizing Earnings Per Share.
10. Finance Manager is responsible for Shareholder’s Wealth Maximization

Key Strategies of Financial Management

The areas of key strategies are identified by financial management to achieve the desired goals and objectives of an organization. The key strategies of financial management are as follows:

1. **Determining Financial Needs:** The financial manager should ensure availability of sufficient financing according to the requirement of business organization from time to time.
2. **Determining Sources of Funds:** The financial manager has to select different sources of funds according to the situation for short-term or long-term requirement.
3. **Optimal Capital Structure:** The finance manager has to set up an ideal capital structure and make sure the highest rate of return on investment.
4. **Profit Planning and Control:** Profit planning and control has immense importance in the financial activities of today’s business era.
5. **Project Planning and Evaluation:** A sizeable portion of the initial capital must be invested in long-term assets of a firm. Also the inaccuracy of judgment in project planning and evaluation should be minimized.
6. **Capital Budgeting:** Capital budgeting decisions are most crucial and they have long-term implications. Therefore, they should relate to sensible allocation of capital.

7. **Financial Analysis:** It is the evaluation and explanation of a firm’s financial position and operations which involves a comparative study of accounting data.

8. **Cost-Volume-Profit Analysis:** This is popularly known as the ‘CVP relationship’. For this purpose, fixed costs, variable costs and semi-variable costs have to be analyzed.

9. **Fixed Assets Management:** Land, building, machinery and equipment, furniture are the firm’s fixed assets and intangibles assets such as patents, copyrights, goodwill, and so on. The acquisition of any fixed assets involves capital expenditure decisions and long-term commitments of funds.

10. **Working Capital Management:** Working capital is a financial lubricant which keeps business operations going. It is the life-blood of a business operation.

11. **Dividend Policies:** Decisions related to formulation of dividend policies and distribution of dividend is always crucial for the management. Considering future plans of expansion and need of working capital, the Management takes decisions related to distribution of dividend.

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**Financial Planning – Principles and Steps in Financial Planning**

**Meaning of Financial Planning:**

*According to Business Dictionary,* “Financial Planning means long-term profit planning aimed at generating greater return on assets, growth in market share, and at solving foreseeable problems”.

Financial planning is an important part of financial management. It is the process of determining the objectives; policies, procedures, programmes and budgets to deal with the financial activities of an enterprise.

Financial planning reflects the needs of the business and is integrated with the overall business planning. Proper financial planning is essential to permit the business enterprise to have right amount of capital to continue its operations effectively and efficiently. It involves certain important decisions so that funds are continuously available to the company and are used efficiently. These decisions highlight the scope of financial planning.

**Principles:**

1. Set measurable and achievable goals.
2. Understand the consequences of financial decisions on other financial issues.
3. Re-evaluate the financial plan periodically.
4. Start financial planning on the basis of available resources.
5. Consider total picture of an organization while doing financial planning.
6. Don’t confuse financial planning with investing.
7. Don’t imagine impractical returns on investments.
8. Don’t wait until a financial crisis to start planning.
**Steps in Financial Planning:**

(i) **Determination of Financial Objectives:** For effective financial planning, it is essential to clearly lay down the financial objectives wanted to be achieved. The financial objectives should be based on the overall objectives of the company. The objectives of financial management may be set up in the areas, namely, investment, profit planning, financing and dividend.

(ii) **Estimation of Capital Requirements:** Capital is mandatory for various needs of the business. Separate assessment is to be made of the requirements of fixed and working capital. Fixed capital is needed for acquiring fixed assets such as land and building, plant and machinery, furniture, etc. It is blocked for a long time. Working capital is essential for holding current assets like stock, bills receivable, etc. and cash for meeting day to day expenses for running the business.

(iii) **Determination of the Kinds of Securities to be Issued:** A company can issue equity shares, preference shares and debentures to raise long-term funds. The types and proportion of securities to be issued should be properly determined. In short, company needs to decide its capital structure.

(iv) **Formulation of Financial Policies:** Financial planning leads to formulation of policies relating to borrowing and lending, cash control and other financial activities. Such policies will help in taking vital decisions for the administration of capital and achieving coordination in financial activities.

**The important benefits of financial planning to a business are discussed below:**

1. Financial planning provides policies and procedures for the sound administration of the finance function.
2. Financial planning results in preparation of proper plans for the future. Thus, new projects could be undertaken easily.
3. It ensures required funds from different sources for the smooth conduct of business.
4. Uncertainty about the availability of funds is reduced and ensures stability of business operations.
5. Financial planning attempts to achieve a balance between the inflow and outflow of funds. Adequate liquidity is ensured throughout the year. This will increase the goodwill of the company.
6. Cost of financing is kept to the minimum possible and scarce financial resources are used wisely.
7. Financial planning serves as the basis of financial control. The management attempts to ensure proper utilization of funds in tune with the financial plans.

Finance is the life-blood of business. So financial planning is an integral part of the corporate planning of the business. All business plans depend upon the soundness of financial planning.
Review Questions

1. “From the point of view of a corporate unit, Financial Management is related not only to fund-raising but encompasses the wider perspective of managing the finances for the company efficiently”. Elucidate.

2. “Financial Management is nothing but managerial decision making on asset mix, capital mix and profit allocation”. Explain.

3. “The Financial Manager’s primary task is to plan for acquisition and use of funds so as to maximize the value of the firm”. Do you agree? Comment.

4. “Liquidity and Profitability are competing goals for the Finance Manager”. Comment.

5. “The responsibilities of the Financial Managers are linked to the goal of ensuring liquidity, profitability or both and are also related to the management of assets and funds of any business enterprise”. Comment.

6. “Financial Management is something more than an art of accounting and bookkeeping”. Explain.

7. Write detail note on ‘Interrelationship between investment, financing and dividend decisions’.

8. “It is advantageous to decentralize Accounting function while Finance function should be centralized”. Comment.

9. “It has traditionally been argued that the objective of a company is to earn profit, hence the objective of Financial Management is also profit maximization”. Comment.

10. ‘A Finance Manager is a person who is responsible in a significant way to carry out the finance functions’. Justify.

11. ‘Wealth maximization is superior to the profit maximization’. Do you agree with this statement?


13. Explain in detail how finance is associated with other disciplines.

14. Elucidate the concept of Financial Planning. Discuss the Principles and Steps involved in Financial Planning

References:

1. http://keydifferences.com

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