Financial Management

Principles and Practice

G. Sudarsana Reddy

3rd Revised Edition

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PREFACE TO THE THIRD REVISED EDITION

I am very thankful to the teachers and students community for their overwhelming response to the second edition of Financial Management – Principles and Practice. It gives me great satisfaction and privilege to place before the esteemed readers, the third revised edition of Financial Management – Principles and Practice.

Besides improving the text focus on creating shareholder’s value and the effectiveness of the conceptual presentation, the following additions have gone into the present edition:

♦ Chapter 1: Limited Liability Partnership, risk return trade-off, and new role of finance manager in the contemporary scenario.

♦ Five new chapters added keeping in mind the contemporary areas and to increase the coverage of the book:
  Chapter 3: Cash Flow Analysis
  Chapter 15: Capital Market
  Chapter 26: Corporate Value Based Management System
  Chapter 28: Financial Information System
  Chapter 29: Basics of Management Control System

I am confident that the above additions would be more useful for the readers.

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Since the days of recorded history, finance has been playing a critical role in the lives of individuals, families and organisations. Organisations got wound up, families broke up and individuals were bankrupted if they failed to manage their finances effectively. It was all roses if funds were managed wisely and effectively.

Grandma and grandfather managed finances easily. They hoarded the cash that came in and were generally frugal in spending. They were not required to open accounts, sign cheques and documents, and own plastic cards. Same was the status with organisations too. People who managed cash did not probably need lessons on management of finance.

It is a different scenario today. Management of finances of individuals and of business organisations has become too complex and challenging. One should understand and implement set principles and practices of managing finance.

‘Financial Management – Principles and Practice’ has been written keeping in mind the challenges of managing finances in different contexts.

Divided into nine parts and comprising 22 chapters, the text essentially revolves around three fundamental issues of managing finance: raising funds, investing them judiciously and dispersal of profits, including dividends to shareholders.

Part one includes the first two chapters that provide an overview to financial management including financial system; Part two has one chapter on financial planning that gives a brief idea on financial planning; Part three contains three chapters providing fundamental concepts on time value of money, risk and return, and valuation of securities; part four covers long-term investment decisions including cost of capital budgeting; and Part five focuses on financing investment and has two chapters-leverages, and capital structure.

Part six, with three chapters, contains detailed discussion on the sources of long-term finance including venture capital, and lease and hire-purchase financing; and part seven deals with working capital management. Chapter 15 explains the concepts of working capital finance respectively. Part eight, with two chapters, focuses on an overview of dividend policy and its importance in maximising value of the firm; and part nine of the book touches fundamentals of international financial management. Thus, the 22 Chapters are well–structured and the nine parts are logically sequenced.

Besides being comprehensive on the coverage of the subject, Financial Management – Principles and Practice has been following unique pedagogic aids.

1. Each chapter begins with learning objectives.
2. Numerous problems with solutions are appended to each chapter.
3. Self-taught tools comprising fill-in-the-blank statements and true/false statements with answers at the end of each chapter.
4. Skill-building exercises which help students develop skills in the subject by bridging the gap between theory and practice.

The book is free from jargons and verbose. It is written in simple conventional style. Though the book is aimed at meeting the requirements of commerce and management students at various levels, general readers too will find the book interesting and rewarding.

I have pleasure in expressing my sincere thanks to Prof. Kiran Reddy, CEO, Acharya Institute of Management & Sciences, Bangalore, for her encouragement.

I am short of words to express my deep sense of gratitude to Dr. K. Aswathappa, Former Dean, Faculty of Commerce and Management, Bangalore University and Director, Canara Bank School of Management Studies, Bangalore.
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My thanks are due to all my colleagues at AIMS for their encouragement.

I am very much beholden to my wife and my son for their wholehearted support and encouragement in completing this book.

I am very much grateful to Sri Niraj Pandey and Mr. Vijay Pandey of HPH, for having given me the opportunity to write this book.

My thanks are due to Mr. Madhu, Sri Siddhi Softteck, for his excellent DTP.

Finally, I am grateful to my parents, teachers, and the almighty without whose blessings this book would not have seen the light of the day.

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LEARNING OBJECTIVES

After reading this Chapter, you should be able to:

– Give the meaning and definition of financial management.
– Trace the evolution of financial management.
– Explain the scope of financial management.
– Give the interface of financial management with other disciplines.
– Explain the different financial decisions.
– Extract the interrelationship among financial decisions.
– Explain different forms of business ownership.
– Bring out aims of finance function.
– Elucidate the objectives of financial management.
– Illustrate risk-return trade-off.
– Give the meaning of agency problem, and ways of achieving goal congruence.
– Debate on organisation of finance function.
– New role of finance function in the contemporary scenario.
Organisation is a group of employees working together consciously towards the organisation’s goal. The goal of traditional organisations is to maximise profit. But the goal of modern organisations, which are raising funds by issue of equity shares, is to maximise shareholders’ wealth. In other words, the objective is to maximise net present worth by taking right decisions which help increase share price. Maximisation of shareholders’ wealth is possible only when the organisation is able to maximise net profits. The employees work in the organisation under different departments, viz., HR, finance, production, marketing and R&D and nowadays, IT. All the employees who are in the decision-making level have to take decisions that help maximise shareholders’ wealth.

In this book we shall study how a finance manager contributes to organisation’s profit and we exclude other departments, because they are out of the scope of the book.

Men, Money, Machines, Materials, Methods, Minutes and Management, are the 7 Ms of management.

_Money_—is one of the important vitamins required for running any organisation, it is just like blood, without which there is no human being, similarly without finance there is no organisation. Here, there is a need to know the difference between money and finance. Money is any country’s currency, which is in the hands of a person or an organisation, whereas finance is also a country’s currency, which is owned by a person or organisation, that is given to others as loan to buy an asset or to invest in investment opportunities. Put it simply, a currency as long as you have it with you is money only and when you lend it to others to buy or invest in investment avenues it becomes finance. For example, Bank, which has raised money from public through various types of deposits, when it grants the same money to others, it becomes finance. If it is granted to buy a car, it is known as car finance, if it is granted to buy a house it is called as housing finance. Organisations raise funds from public to buy assets or invest in business. Efficient management of finance helps in maximising the shareholders wealth. In other words, financial management plays a key role in maximisation of the owner’s wealth.

**MEANING AND DEFINITION OF FINANCIAL MANAGEMENT**

Many authors use business finance and corporate finance as synonym but business finance is broader than corporate finance, since it covers sole proprietorship, partnership and company business. Corporate finance is restricted to the company finance only and not the other forms of business organisations.

According to the Encyclopedia of Social Sciences, _Corporate finance_ deals with the financial problems of corporate enterprises. Problems include financial aspects of the promotion of new enterprises and their administration during early development, the accounting problems connected with the distinction between capital and income, the administrative questions created by growth and expansion and finally, the financial adjustments required for the bolstering upon rehabilitation of a corporation which has come into financial difficulties. Management of all these is financial management. _Financial management_ mainly involves raising funds and their effective utilisation with the objective of maximising shareholders’ wealth.

According to _Van Horne and Wachowicz_, “Financial Management is concerned with the acquisition, financing and management of assets with some overall goal in mind.” Financial manager has to forecast expected events in business and note their financial implications.

Financial Management is concerned with three activities: (i) anticipating financial needs, which means estimation of funds required for investment in fixed and current assets or long-term and short-term assets, (ii) acquiring financial resources – once the required amount of capital is anticipated the next task is acquiring financial resources, i.e., where and how to obtain the funds to finance the
anticipated financial needs and (iii) allocating funds in business – means allocation of available funds among the best plans of assets, which are able to maximise shareholders’ wealth. Thus, the decisions of financial management can be divided into three, viz., investment, financing and dividend decisions.

**EVOLUTION OF FINANCIAL MANAGEMENT**

Financial management has emerged as a distinct field of study, only in the early part of this century, as a result of consolidation movement and formation of large enterprises. Its evolution may be divided into three phases (some what arbitrary) – viz.,

1. The Traditional phase,
2. The Transitional phase and
3. The Modern phase.

1. The Traditional Phase: This phase lasted for about four decades. Its finest expression was shown in the scholarly work of Arthur S. Dewing, in his book titled “the Financial Policy of Corporation in 1920s.” In this phase the focus of financial management was on four selected aspects.

   (i) *It treats the entire subject of finance* from the outsider’s point of view (investment banks, lenders, other) rather than the financial decision-maker’s viewpoint in the firm.

   (ii) *It places much importance on corporation finance* and too little on the financing problems of non-corporate enterprises.

   (iii) *The sequence of treatment was on certain episodic events* like formation, issuance of capital, major expansion, merger, reorganisation and liquidation during the life cycle of an enterprise.

   (iv) *It placed heavy emphasis on long-term financing, institutions, instruments, procedures* used in capital markets and legal aspects of financial events. That is it lacks emphasis on the problems of working capital management.

   It was criticised throughout the period of its dominance, but the criticism is based on matters of treatment and emphasis. Traditional phase was only outsiders looking approach, due to its over emphasis on episodic events and lack of importance to day-to-day problems.

2. The Transition Phase: It began around the early 1940s and continued through the early 1950s. The nature of financial management in this phase is almost similar to that of earlier phase but more emphasis was given to the day-to-day (working capital) problems faced by the finance managers. Capital budgeting techniques were developed in this phase only. Much more details of this phase are given in the book titled “Essays on Business Finance”.

3. The Modern Phase: It begun in the mid 1950s. It has showed commendable development with a combination of ideas from economic and statistics that has lead financial management to be more analytical and quantitative. The main issue of this phase was rational matching of funds to their uses, which leads to the maximisation of shareholders’ wealth. This phase witnessed significant developments. The areas of advancements are: capital structure. The study says the cost of capital and capital structure are independent in nature. Dividend policy, suggests that there is the effect of dividend policy on the value of the firm. This phase has also seen one of the first applications of linear programming. For estimation of opportunity cost of funds, multiple rates of return gives way to calculate multiple rates of a project. Investment decisions under conditions of uncertainty, gives formulas for determination of expected cash inflows and variance of net present value of projects and gives how probabilistic information helps the firm to optimise investment decisions.
Financial Management

involving risk. Portfolio analysis\(^{(10)}\) gives the idea for allocation a fixed sum of money among the available investment securities. Capital Asset Pricing Model (CAPM), suggests that some of the risks in investments can be neutralised by holding diversified portfolio of securities. Arbitrage Pricing Model (APM),\(^{(11)}\) argued that the expected return must be related to risk in such a way that no single investor could create unlimited wealth through arbitrage. CAPM is still widely used in the real world, but APM is slowly gaining momentum. Agency theory\(^{(12)}\) emphasises the role of financial contracts in creating and controlling agency problems. Option Pricing Theory (OPT),\(^{(13)}\) applied Martingale pricing principle to the pricing of real estates. Cash management of models (working capital management) by Baumol Model,\(^{(14)}\) Miller\(^{(15)}\) and Orglers. Baumol models helps to determine optimum cash conversion size; Miller model reorder point and upper control points and Orglers model helps to determine optimal cash management strategy by adoption of linear programming application. Further, new means of raising finance with the introduction of new capital market instruments, such as Pads, Fads, PSBs and Capps, etc. Financial engineering that involves the design, development and implementation of innovative financial instruments and formulation of creative optional solutions to problems in finance. While the above developed areas of finance was little, which is not sufficient in the globalised era.

SCOPE OF FINANCIAL MANAGEMENT

From the above discussion it is evident that financial management as an academic discipline has undergone notable changes over the years in its scope and areas of coverage. At the same time the finance manager’s role has also undergone fundamental changes over the years. Study of the changes that have taken place over the years is known as “scope of financial management”. In order to have easy understanding and better exposition to the changes, it is necessary to divide the scope into two approaches: (1) The Traditional Approach and (2) The Modern Approach.

1. Traditional Approach

Financial management emerged as a separate field of study in the early 1900s. The role of financial management is limited to fund raising and administering needed by the corporate enterprises to meet their financial needs. Enterprise requires funds for certain episodic events like merger, formation of new firms, reorganisation, liquidation and so on. To put it simply, the scope of financial management in traditional approach was in the narrow sense. The field of financial management was interrelated with aspects, \textit{viz.},

(a) Raising of funds from financial institutions,

(b) Raising of funds through financial instruments — shares and bonds from the capital markets.

(c) The legal and accounting relationships between an enterprise and its sources of funds (creditors).

Thus, the traditional approach of financial management is only raising of funds needed by the corporation, externally that also limited the role of the finance manager. Apart from raising the funds externally, the expected functions are: preparation and preservation of financial (statements) reports on the enterprises financial status and managing cash level that is needed to pay day-to-day maturing obligations.

Traditional approach to the scope of financial management evolved during 1920 and continued to dominate academic thinking during the forties and through the early fifties. But criticism was stated on this approach in the later fifties due to the following:

\textit{Ignored Day-to-day Problems}: The traditional approach gives much importance to funds raising for episodic events that are stated in the above discussion. Put in simple words the approach is confined to the financial problems arising in the course of episodic events.
An Overview of Financial Management

**Outsider-looking-in Approach:** This approach equated the function with the issues involved in raising and administering funds. Thus, the subject of finance moved around the suppliers of funds (investors, financial institutions (banks), etc.) who are outsiders. It indicates that the approach was outsider-looking-in approach and ignored insider-looking-out approach, since it completely ignored internal decision-making.

**Ignored Working Capital Financing:** The approach gave over emphasis on long-term financing problems. It implies that it ignored working capital finance, which is in the purview of the finance function.

**Ignored Allocation of Capital:** The main function of this approach is procurement of funds from outside. It did not consider the function of allocation of capital, which is the important one.

The capital issues of financial management were outside the purview of the traditional phase, which was rightly described by Solomon.\(^{(16)}\)

(i) Should an enterprise commit capital funds to certain purposes?
(ii) Do the expected returns meet financial standards of performance?
(iii) How should these standards be set and what is the cost of capital funds to the enterprise?
(iv) How does the cost vary with the mixture of financing methods used?

Traditional approach failed to provide answers to the above questions due to narrow scope, but modern approach explained below provide answers to the questions, or it overcomes the shortcomings of traditional approach.

2. Modern Approach

Modern approach was started during mid-1950s. Its scope is wider since it covers conceptual and analytical framework for financial decision-making. In other words, it covers both procurement of funds as well as their allocation. Allocation is not just haphazard allocation, it is efficient allocation among various investments, which will help maximise shareholders’ wealth. The main contents of the new approach are:\(^{(17)}\)

(a) What is the total volume of funds an enterprise should commit?
(b) What specific assets should an enterprise acquire?
(c) How should the required funds be financed?

The above three questions are related to the three decisions of financial management: (i) Financing decision, (ii) Investment decision and (iii) Dividend decision.

The shareholders value maximisation focus continuously as we begin the 21st century. However, two other trends are gaining momentum, viz., (a) Increased use of information technology and (b) Globalisation of business. Both these trends provide companies with new opportunities to reduce risks and thereby, increase profitability. But these trends are also leading to increased competition and new tasks.

**FINANCIAL DECISIONS**

As we have read above that financial management is concerned with the acquisition, financing and management of assets with some overall goals in mind. As mentioned in the contents of modern approach the discussions of financial management can be broken down into three major decisions, viz., (1) Investment decision; (2) Financing decision; and (3) Dividend decision (See Fig. 1.1). A firm takes these decisions simultaneously and continuously in the normal course of business. Firm may
not take these decisions in a sequence, but decisions have to be taken with the objective of maximising shareholders’ wealth.

1. Investment Decision

It is more important than the other two decisions. It begins with a determination of the total amount of assets needed to be held by the firm. In other words, investment decision relates to the selection of assets, on which a firm will invest funds. The required assets fall into two groups:

(i) **Long-term Assets** (fixed assets: plant & machinery land & buildings, etc.), which involve huge investment and yield a return over a period of time in future. Investment in long-term assets is popularly known as “capital budgeting”. It may be defined as the firm’s decision to invest its current funds most efficiently in fixed assets with an expected flow of benefits over a series of years. It is discussed in detail under the Chapter Capital Budgeting.

(ii) **Short-term Assets** (current assets: raw materials, work-in-process, finished goods, debtors, cash, etc.) that can be converted into cash within a financial year without diminution in value. Investment in current assets is popularly termed as “working capital management”. It relates to the management of current assets. It is an important decision of a firm, as short-survival is the prerequisite for long-term success. Firm should not maintain more or less assets. More assets reduces return and there will be no risk, but having less assets is more risky and more profitable. Hence, the main aspects of working capital management are the trade-off between risk and return. Management of working capital involves two aspects. *One* determination of the amount required for running of business and *second* financing these assets. It is discussed in detail in the Working Capital Management Chapter.

2. Financing Decision

After estimation of the amount required and the selection of assets required to be purchased, the next financing decision comes into the picture. Financial manager is concerned with make up of the right hand side of the balance sheet. It is related to the financing mix or capital structure or leverage. Financial manager has to determine the proportion of debt and equity in capital structure. It should be on optimum finance mix, which maximises shareholders’ wealth. A proper balance will have to be struck between risk and return. Debt involves fixed cost (interest), which may help in increasing the return on equity but also increases risk. Raising of funds by issue of equity shares is one permanent source, but the shareholders will expect higher rates of earnings. The two aspects of capital structure are: *One* capital structure theories and *two* determination of optimum capital structure. Capital structure theories are out of the scope of this book, but optimal capital structure is discussed in detail under the Chapter Capital Structure.
3. Dividend Decision

This is the third financial decision, which relates to dividend policy. Dividend is a part of profits, which are available for distribution to equity shareholders. Payment of dividends should be analysed in relation to the financial decision of a firm. There are two options available in dealing with net profits of a firm, viz., distribution of profits as dividends to the ordinary shareholders where there is no need of retention of earnings or they can be retained in the firm itself if they are required for financing of any business activity. But distribution of dividends or retaining should be determined in terms of its impact on the shareholders’ wealth. Financial manager should determine the optimum dividend policy, which maximises market value of the share thereby market value of the firm. Considering the factors to be considered while determining dividends is another aspect of dividend policy.

INTERRELATION AMONG FINANCIAL DECISIONS

The three financial decisions, discussed above, are interdependent (See Fig 1.2). Investment decision determines the profitable investment avenue, financing decision determines the pattern of financing the capital required for investment, and together impact the surpluses generated by an organisation to be distributed as dividends. The underlying objective of all the three decisions remains the same: maximisation of shareholders wealth.

1. Interrelation between “Investment and Financing Decisions”: Under the investment decision, financial manager will decide what type of asset or project should be selected. The selection of a particular asset or project will help determine the amount of funds required to finance the project or asset. For example, investment on fixed assets is `10 crore and investment on current assets is `4 crore. So the total funds required to finance the total assets are `14 crore.

Once the anticipation of funds required is completed then the next decision is financing decision. Financing decision means raising the required funds by various instruments of finance.

There is an interrelation between investment decision and financing decision, without knowing the amount of funds required and types of funds (short-term and long-term) it is not possible to raise funds. To put it simply investment decisions and financing decisions cannot be independent. They are dependent on each other.

2. Interrelation between “Financing Decision and Dividend Decision”: Financing decision influences and is influenced by dividend decision, since retention of profits for financing selected assets or projects reduces the profit available to ordinary shareholders, thereby reducing dividend payout ratio. For example, in the above, we have decided the amount required to finance a project is `14 crore. If financial manager plans to raise only `7 crore from outside and the remaining by way of retained earnings. If the dividend decision is 100 per cent payout ratio then the finance manager has to depend completely on outside sources to raise the required funds. So, dividends decision influences the financing decision. Hence, there is an interrelation between financing decision and dividend decision.
3. Interrelation between “Dividend Decision and Investment Decision”: Dividend decision and investment decision are interrelated because retention of profits for financing the selected asset depends on the rate of return on proposed investment and the opportunity cost of retained profits. Profits are retained when the return on investment is higher than the opportunity cost of retained profits and *vice versa*. Hence, there is an interrelation between investment decision and dividend decision.

The above discussion says that there is an interrelationship among financial decisions. Financial manager has to take optimal joint decisions by evaluation of the decisions that will affect the wealth of the shareholders, if there is any negative effect on wealth it should be rejected and *vice versa*.

**AIMS OF FINANCE FUNCTION**

As we have seen that financial management is concerned with acquisition, financing and management of assets. And we have seen that there are three financial decisions. While making these decisions, an organisation tries to balance cash inflows and cash outflows, which is called the liquidity decision. The following points bring out the aims of finance function.

1. **Anticipation of Funds Needed**: In the series of financial decisions, investment decision takes first place, but before going to identify the investment assets or projects, there is a need to evaluate available investment assets or projects. Selection of assets or projects takes place only after proper evaluation, which is helpful to anticipate the funds required for financing the selected assets or projects. Hence, anticipation of funds required to finance assets is one aim of financial function.

2. **Acquire the Anticipated Funds**: The main aim of the finance function is to assess the required needs of a firm and then arrange the funds needed by raising from suitable sources of finance. The total required funds can be raised by different sources, viz., long-term sources and short-term sources. If the funds are needed for long-period then the funds need to be raised only from long-term sources of finance, like share capital, bonds/debenture, capital and long-term loans from financial institutions. If the organisation is an old company, which is running with profit track record, it can use profit by retaining them in business. Short-term (capital) finance needs can be raised mainly from the bank by way of short-term loans. Acquiring funds needed should be at least possible cost and it should not affect owners’ interest.

3. **Allocation or Utilisation of Funds**: Acquisition of funds needed by a firm is a prime objective of traditional finance function, but efficient allocation or utilisation of funds is the objective of modern finance function. Efficient allocations among investment avenues means investing funds on profitable projects. Profitable project means a project or asset that provides return, which is higher than the cost of funds. For example, there are three projects, X, Y and Z, which are identified as profitable in terms of ROI (%) with 10, 20 and 30 return on investment, respectively. The cost of raised funds is 20%. Here, the project ‘Z’ is only eligible to invest because its (30) return on investment (ROI) is higher than cost of funds (20), i.e., it is able to provide 10 (30 - 20) profit, but the project X’s ROI is less than cost of funds, i.e., 10 loss (10 - 20). The project Y is considerable but not preferable, its ROI is equal to cost of funds, which means there is no profit. So, project Y is not helpful to maximise shareholders’ wealth. Hence, the finance manager should allocate funds among profitable investment assets and operations that help to maximise shareholders’ wealth.

4. **Increase Profitability**: Planning and control are the twin functions of management that help to increase profits by reducing costs or minimising waste or effective utilisation of available resources. In the same way, proper planning and control of finance function aim at increasing profitability of the firm. Proper planning of anticipation of funds, selection of investment avenues, acquiring and allocations of funds helps to increase profits, by way of arranging sufficient funds at
least at right time, investing on right asset. Control of operations like cash receipts and payments also helps to increase profits. Hence, the finance function need to match the costs and returns from the funds.

5. Maximising Firm’s Value: The prime objective of any function in any organisation is to maximise firm’s value by taking right decisions so as to finance function. But maximisation of shareholders’ wealth is possible only when the firm is able to increase profits. Hence, whatever decision a financial manager takes should be with the objective of maximisation of owners’ wealth.

FORMS OF BUSINESS OWNERSHIP

Ownership of business takes either of the four popular forms: proprietorship, partnership, co-operatives and company. The three financial management decisions not equally relevant in all the four ownership patterns. Dividend decision, for example, is irrelevant in one person ownership business and in partnership. Nor investment and financing are so conspicuous in co-operatives of all the four, it is the limited companies whose management is too complex and all the three decisions are highly practiced in them. Obviously our focus in this book is on corporate financial management. Before that, it is useful to take a look at the features of the four forms of ownership.

There are three general forms of business organisations, they are sole proprietorship, partnership, limited liability partnership and corporations. But if we really observe the different forms of organising small and medium units. We come across “co-operative form” in business organisation. A brief description of each form of business organisation is in order.

1. Sole Proprietorship: A sole proprietorship is business owned by a single person. It is owned by an individual just because, it is the simple form of business to start, and least regulated by the Government. Any individual whether she/he, irrespective of the place they live can start a sole proprietorship business by just obtaining a license. We need to remember that license is necessary for those individuals who wants to run the business on a specific name. That is why every nook and corner we can see sole proprietorship. Most of the large corporations started their business as sole proprietorships.

Sole proprietorship is not treated as a separate legal entity, from the legal and tax point of view. In other words, business and owner both are same. Therefore, the individual receives all profits or losses. Owner has unlimited liability for all the debtor obligations of the business. It means creditors can look beyond business assets (covers owners asset) for the recovery of their money. In the same way, there is no difference between business and personal income, and all income from business is taxed as personal income. Hence, individual needs to show business income while filing his/her tax return.

It is difficult for a sole proprietorship to raise large, sums of capital, since it is limited to the personal wealth of the owner. Due to this business firms may not be able to grab opportunities, and no chance of growing above a certain level. It is difficult to transfer the ownership, since it needs to sell the entire business to a buyer. Sometimes when the business is not sold, the life of the business is tied up with owner’s life span.

2. Partnership: A partnership firm is owned by two or more persons. In other words, partnership is an aggregate between two or more persons to carry a business in common view of showing the profits or losses of the business. It operates as a collection of sole proprietor owners. A partnership firm comes into being with the execution of partnership agreement (deed) prepared as the Partnership Act, 1932. The Partnership Deed specifies:
1. The capital to be contributed by each partner.
2. The ratio in which profits are to be shared.
3. The rate of interest, if any, to be paid on capital before the profits are shared.
4. The rate of interest, if any, charged on partnership drawings.
5. Salaries to be paid to partners.
6. Arrangements for admission of new partner.
7. Procedures to be carried out when a partner retires or dies.

Partnership can be set up easily, it allows to raise capital from partners, it can benefit from partner’s experience and expertise, ownership can be easily transferred to other partners, these are the few advantages of a strong partnership form of business. The partnership business is no exception for limitations. They are — the partners has unlimited liability, limited life of partnership, limited capital, difficult to transfer ownership. These are the limitations when compared to company form of business organisation and not sole proprietorship. Government of India introduced new form of business organisation "The Limited Liability Partnership" in 2009. The following para covers brief details.

**Limited Liability Partnership (LLP)**

LLP is essentially a partnership constituted in corporate form which has a separate legal identity distinct from its partners. It is called LLP because partner's liability is limited (restricted) to the extent of their individual contributions. LLP is a corporate business vehicle that enables professional expertise and entrepreneurial initiative to combine and operate in feasible, innovative and official manner, providing benefits of limited liability while allowing its members the flexibility for organising their internal structure as a partnership.

**Need for LLP**

With the growth of Indian economy, the role played by entrepreneurs, technical and professional manpower has been acknowledged internationally. Government of India felt it is appropriate to combine knowledge and risk and to provide a further impetus to economic growth. This has created a need for a new corporate form that would provide an alternative to the traditional partnership, with limited liability and the statute-based governance structure to encourage innovative entrepreneurs. Therefore, LLP form of ownership is intended as an alternative business organisation for small scale industries, whether it is manufacturing or service provider (lawyers, chartered accountants, event management companies) which at present, are primarily set up as partnership in India.

The Limited Liability Partnership Bill, 2008 (the Bill) was introduced in parliament, and was published in the official Gazette of India on 9th January 2009. It has been notified with effect from 1st April 2009. The LLP 2008 consists of 14 chapters, 41 rules and four schedules. Rules 1 to 31, rules 34 to 37 and rule 41 shall come into force on the 1st day of April 2009. The remaining rules (32 and 33, and 38 to 40) shall come into force on such date as the Central Government may, by notification in the official Gazette, appoint the Act extends to the whole of India.

**The Salient Features of the LLP Act 2009 are:**

(i) The LLP shall be a body corporate and a has separate legal entity from its partners; (ii) Any two or more persons, with the idea of carrying a lawful business with a view to profit may from LLP with the Registrar of Companies no maximum limit on partners, like Partnership Act; (iii) The LLP will have perpetual succession; (iv) The mutual rights and duties of partners are governed by an agreement between partners subject to the provisions of the LLP Act, 2008; (v) No partner would be liable on account as the independent or unauthorised actions of other partners or their misconduct;
(vi) The LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. A Statement of accounts and solvency shall be filed by every LLP with the Registrar every year; (vii) The accounts of LLPs shall be audited with these rules: Provided that a LLP’s turnover does not exceed, if any financial year, ‘40 lakh, or LLP’s contribution does not exceed ‘25 lakh shall not be required to get its accounts audited; (viii) The Central Government have powers to investigate the affairs of an LLP, if required by appointment of competent Inspector for the purpose; (ix) The winding up of the LLP may be either voluntary or by the Tribunal to be established under the companies Act, 1956. Till the Tribunal is established, the power in this regard has been given to the high court; (x) The Indian Partnership Act, 1932 shall not be applicable to LLPs.

3. Co-operative Society: A co-operative society is a commercial enterprise owned by a group of customers, or workers, with the objectives of promotion of economic interests of its members, in accordance with the co-operative principles (Sec. 4 of the Co-operative Societies Act, 1912).

Features of a co-operative undertaking: (1) It is a body corporate being registered and corporate body, it enjoys certain privileges which are enjoyed by a company. (2) It is a voluntary association – the membership of the co-operative society is voluntary. Any person having a common interest can become the member of a society. (3) One member one vote — a member has only one vote irrespective of the number of shares she/he owns. (4) Service motive – As paid it is mainly set up for rendering service to its members in a particular field. (5) Profit-sharing: profits is distributed among members on the basis of capital held by them. (6) Control: the members elect the managing committee to carry on day-to-day affairs of the company. (7) Minimum and maximum members: there is no maximum limit for membership, but a minimum of 10 members are required to form a society. But co-operatives suffer from lack of capital, insufficient management, can not employ outside talent, lack of prompt decision, lack of incentives to members Company.

4. The Company Form of Business Ownership: A company is a form of business ownership set up by a group of shareholders under the Companies Act, 1956.

The following are the salient features of a company:

1. The company is a distinct legal “person” separate from its owners [equity shareholders]. Since, company has separate legal entity it can enjoy the rights, duties, and privileges of an actual individual person. For example, it can buy assets, borrow money, enter into contacts, sue and be used in its name.

2. Limited liability: the liability of the shareholders of a company is limited to the face value of the share capital paid by them. Here limited liability means, in the process of paying creditors during difficult times the shareholder loses only his/her subscribed capital and not their personal assests.

3. Double tax: the company has to pay tax on all its profits at prescribed rates, whether the profit is small or huge. At the same time, shareholder has to pay taxes when he receives dividend.

4. Complex proceduce for setting up and managing: It is difficult to setup and manage companies, because they are large and they are regulated by the Companies Act,1956.

Types of Companies

A company may be a private limited or a public limited company. The main differences are: Minimum number of shareholders:

1. Private Limited Company must have minimum two shareholders for starting business, whereas a public limited company should have seven shareholders.
2. Maximum Number of Shareholders: In case of private limited company, 50 is the maximum shareholders’ membership, where public limited company has no limit on the number of shareholders.

3. Offer of Shares to Public: Private limited company cannot offer shares to public or can not invite public people as shareholders. Whereas public limited company is allowed to offer shares to public and invite shareholders.

4. Transfer Shares: Private company may not allow shareholders to transfer shares freely, it imposes restrictions. Whereas public limited company allows shareholders to transfer his/her shares freely.

5. Name: Private companies name should end with private limited company, whereas in case of a public company, the company name should end with “ public limited company.”

6. Paid-up Share Capital: Private company (Sec. 3(1)(iii) (of the act), it means a company with a minimum paid-up capital of one lac rupees or such higher paid-up capital as may be prescribable, whereas a public company (Sec. 3(7)(iv) (of the act) with a minimum paid-up capital of five lakh rupees or such higher paid-up capital.

ABC Shipyard Ltd., ABC Paper, Bajaj Auto Ltd.; SBI, General Electric are the few public limited companies.

Intel Technology India Pvt Ltd.; Raj Television Network Pvt Ltd; Rajshree Sugars and Chemicals Pvt Ltd.; are the few examples of private companies. Table 1.1 provides comparison of different forms of business organisation.

**Government Company**

Readers should not confuse between public limited company, and government company. Government Company is defined in Sec. 17(b) of the Act, it means any company in which not less than 50 per cent of the paid-up share capital is held by the Central Government or by the State Government or Governments or partly by the Central Government and partly by one or more State Government and includes a company which is a subsidiary of a Government company as thus defined.

Appropriate form of business depends on the number of individuals interested, motive behind establishing the firm, availability and requirement of capitals, etc.

From the above we can understand that public limited company form is appropriate for individual economic development. For individuals, the risk is less, there is potential for growth, free transfer of shares. For country company helps create more employments, uses available resources, contributes to Government treasures by paying tax.

**Hybrid form of ownership**

Sole proprietorship partnership, and company forms are the basic types of organising (starting) businesses. Nowadays, few hybrid forms of business organisations prevails. Limited Liability Partnership (LLP), is one of the hybrid forms of business organisation. In this type of business organisation, liability of a partner is limited to the amount of their investment instead of unlimited liability.
<table>
<thead>
<tr>
<th>Points of Difference</th>
<th>Sole Proprietorship</th>
<th>Partnership</th>
<th>Limited Liability Partnership</th>
<th>Co-operative Society</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Registration</td>
<td>Not Necessary</td>
<td>Not Compulsory in registered firms will not have ability to sue</td>
<td>Compulsory. (With Registrar of companies)</td>
<td>Necessary</td>
<td>Compulsory</td>
</tr>
<tr>
<td>2. Name</td>
<td>No guidelines</td>
<td>No guidelines</td>
<td>No guidelines</td>
<td>It should end with the word “Limited” for Private Co., “Pvt. Ltd.”</td>
<td>It should end with the word “society”</td>
</tr>
<tr>
<td>5. Legal Status</td>
<td>No separate entity from owner</td>
<td>Not a separate legal entity</td>
<td>Is separate legal entity</td>
<td>Not a separate legal entity</td>
<td>Is a separate legal entity</td>
</tr>
<tr>
<td>6. Liability</td>
<td>Unlimited can extend to the personal assets of the owner</td>
<td>Unlimited</td>
<td>Limited</td>
<td>Limited to paid up capital</td>
<td>Limited to the extent of unpaid capital</td>
</tr>
<tr>
<td>7. Tax Liability</td>
<td>Personal Income</td>
<td>Partnership + Personal Income</td>
<td>Partnership + Personal Income</td>
<td>Personal + society</td>
<td>Co-operative</td>
</tr>
<tr>
<td>8. Dissolution</td>
<td>No Procedure</td>
<td>Simple and related procedure</td>
<td>Just like company procedure</td>
<td>Simple and related procedure</td>
<td>Lengthy procedure involved</td>
</tr>
</tbody>
</table>
GOALS OF FINANCIAL MANAGEMENT

Equity shareholders are the owners’ of a company. Any person becomes the owner of any company by purchasing (in primary market or secondary market) stocks and he/she expects financial return in the form of dividends and increase in stock price (capital gain). Shareholders elect directors, who then hire managers to run the company on day-to-day basis. Financial manager requires the existence of some objectives or goals without which judgment as to whether or not a financial decision is efficient must be made in the light of some standard. In other words, the goals provide a framework for optimum financial decision-making. Although various goals or objectives are possible, we assume in this book that the management’s prime goal is stockholders wealth maximisation, since the managers are working on behalf of the shareholders. This objective translates into maximising the price of the firm’s equity stock. Maximisation of shareholders’ wealth is possible only when the decisions of the managers’ are helpful to increase profit. Therefore, Financial manager is always guided by two objectives (1) Profit maximisation and (2) Wealth maximisation. A brief look at the twin objectives is in order.

1. Profit Maximisation: Profit is a primary motivating force for any economic activity. Firm is essentially being an economic organisation, it has to maximise the interest of its stakeholders. To this the firm has to earn profit from its operations. In fact, profits are an useful intermediate beacon towards which a firm’s capital should be directed. McAlpine rightly remarked that profit cannot be ignored since it is both a measure of the success of business and the means of its survival and growth. Profit is the positive and fruitful difference between revenues and expenses of a business enterprise over a period of time. If an enterprise fails to make profit, capital invested is eroded and if this situation prolongs, the enterprise ultimately ceases to exist. The overall objective of business enterprise is to earn at least satisfactory returns on the funds invested, consistent with maintaining a sound financial position.

Limitations: The goal of profit maximisation has, however, been criticised in recent times because of the following reasons:

(a) Vague: The term “profit” is vague and it does not clarify what exactly does it mean. It has different interpretations for different people. Does it mean short-term or long-term; total profit or net profit; profit before tax (PBT) or profit after tax (PAT); return on capital employed (ROCE). Profit maximisation is taken as objective, the question arises which of the about concepts of profit should an enterprise try to maximise. Apparently, the vague expression like profit can form the standard of efficiency of financial management.

(b) Ignores Time Value of Money: Time value of money refers a rupee receivable today is more valuable than a rupee, which is going to be receivable in future period. The profit maximisation goal does not help in distinguishing between the returns receivable in different periods. It gives equal importance to all earnings through the receivable in different periods. Hence, it ignores time value of money.

(c) Ignores Quality of Benefits: Quality refers to the degree of certainty with which benefits can be expected. The more certain expected benefits, the higher are the quality of the benefits and vice versa. Two firms may have same expected earnings available to shareholders, but if the earnings of one firm shows variations considerably when compared to the other firm, it will be more risky.

Profit maximisation objective leads to exploiting employees and consumers. It also leads to colossal inequalities and lowers human values that are an essential part of ideal social systems. It assumes perfect competition and in the existence of imperfect competition, it cannot be a legitimate objective of any firm. It is suitable for self-financing, private property and single owner firms. A company is financed by shareholders, creditors and financial institutions and is managed and controlled
by professional managers. Apart from these people, there are some others who are interested towards company; they are: employees, government, customers and society. Hence, one has to take into consideration all these parties’ interests, which is not possible under the objective of profit maximisation. Wealth maximisation objective is the alternative of profit maximisation.

2. Shareholders’ Wealth Maximisation: On account of the above-discussed limitations of profit maximisations shareholders wealth maximisation is an appropriate goal for financial decision-making. Finance theory rests on the proposition that the goal of a firm should be to maximise shareholders’ wealth. It is operationally feasible since it satisfies all the three requirements of a suitable operational objective of financial courses of action, namely exactness, quality of benefits and the time value of money. It provides an unambiguous measure of what financial management should seek to maximise in making investment and financing decisions on behalf of the owners. Firms do, of course, have other goals – in particular, the managers’ decisions are interested in their own personal satisfaction, in their employees’ welfare, and in the good of the community and society at large. Still stock price maximisation is the most important goal for the majority of the companies.

Shareholders’ wealth maximisation means maximising net present value (or wealth) of a course of action to shareholders. NPV can be derived more explicitly by using the following formula:

\[ W = \frac{CIF_1}{(1+r)^1} + \frac{CIF_2}{(1+r)^2} + \frac{CIF_3}{(1+r)^3} + \frac{CIF_n}{(1+r)^n} + \ldots - IC_0 \]

where \( W \) = Net present worth

\( CIF_1, CIF_2, CIF_3, \ldots, CIF_n \) represent the stream of cash inflows (benefits) expected to occur from a course of action that is adopted.

\( IC_0 \) = Initial cash outflow to buy the asset.

\( r \) = Expected rate of return or appropriate rate of discount.

A financial decision that has a positive NPV creates wealth for ordinary shareholders and therefore preferable and vice versa. The wealth will be maximised if this criterion is followed in making financial decisions. From shareholders’ point of view, the wealth created by a corporation through financial decisions or any decision is reflected in the market value of the company shares. For example, take Infosys Co., whose share price is increasing year by year, even by issue of bonus shares, and the company is trying to put its shares at popular trading level. Therefore, the wealth maximisation principle implies that the fundamental objective of a firm is to maximise market value of its shares. In other words, the market value of the firm is represented by its market price, which in turn is a reflection of a firm’s financial decisions. Hence, market price acts as a firm’s performance indicator. A shareholders’ wealth at a period of time can be computed by the following formula:

\[ SW_t = NS \times MP_t \]

where \( SW_t \) = Shareholders wealth at ‘t’ period

\( NS \) = No. of equity shares (outstanding) owned

\( MP \) = Market price of share at ‘t’ period

3. Alternative Goals: Apart from the above-discussed goals, there are several alternative goals, which will again help to maximise value of the firm or market price per share. They are:

- Maximisation of return on equity (ROE),
- Maximisation of earnings per share (EPS),
- Management of reserves for growth and expansion.
RISK-RETURN TRADE-OFF

Risk is present in every decision, whether it is corporate decision or personal decision. When we say risk, most of us think in the negative sense. For example, driving a two wheeler too fast is risky, because it may lead to accident, which in turn may take life of the people sitting on the vehicle and people moving on the road. A student planning to take slips with him/her for examination and trying to copy form them. It is risky when he/she is caught by the room supervisor or squad. According to the Business dictionary risk refers, 'threat or damage injury or liability or loss of other negative occurrence caused by external or internal vulnerabilities'. But, from business point of view risk is the variability in an expected return. In other words, business people see the risk in broader perspective. They see risk in the business when they realize less return than expected. Actual return may be less than the expected, because of risks like, business risk, financial risk, default risk, delivery risk, interest rate risk, exchange rate risk, liquidity risk, investment risk, and political risk. For example, selection of an asset for production department, or developing a new product, or financial decisions like — developing capital structure, working capital management, and dividend decision. Therefore, the decision-makers have to assess risk and return of investing on an asset before taking any financial decision (See Fig. 1.3).

There is a relation between the risk and return. Any decision that involves more risk generally we can expect more returns from taking that decision, and vice versa (See Fig. 1.4). In some decisions we do not assume any risk or assume zero risk, but we get some return. Return on this type of investment/decision is known as risk-free return ($R_f$). For example, investing in a bank fixed deposits, because the bank account is insured by Central Bank — Reserve Bank of India (RBI).

Return determined on the basis of total assets. There are a good number of techniques available for measuring risk like range, standard deviation, and coefficient of variation, but generally risk is measured with the help of standard deviation. Less standard deviation indicates less risk and vice versa. From the figure 1.4 we can understand that higher the risk and higher the expected return and vice versa, but we can earn five per cent return ($R_f$) without assuming any risk. In other words, we can earn risk-free return. Any one who assumes higher risk may expect higher return, and lower risk lower return. When the risk increases from 0.5 to 2.0, the expected return also increased from 5 per cent to 20 per cent. But one thing we need to understand is that there is no equal proportion of
increase in the expected return. For example, when the standard deviation increased from zero to 0.5, the return is increased by only three per cent.

The following illustration (working capital decision/policy) we can understand the relationship between risk and return.

**Illustration:**

The following information, comment on the risk and return by calculating current ratio and return on total assets.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Case 1</th>
<th>Present Position</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed assets</td>
<td>60,00,000</td>
<td>60,00,000</td>
<td>60,00,000</td>
</tr>
<tr>
<td>Current assets</td>
<td>10,00,000</td>
<td>20,00,000</td>
<td>30,00,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>10,00,000</td>
<td>10,00,000</td>
<td>10,00,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>70,00,000</td>
<td>80,00,000</td>
<td>90,00,000</td>
</tr>
<tr>
<td>Net Profit</td>
<td>15,00,000</td>
<td>15,00,000</td>
<td>15,00,000</td>
</tr>
</tbody>
</table>

**Solution:**

Current ratio helps study the short-term position or risk, and return on total assets indicates the return.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Case 1</th>
<th>Present Position</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Ratio (times): Current Assets/Currents Liabilities</td>
<td>1.0</td>
<td>2.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Return on Total Assets (%): EBIT/ Total Assets</td>
<td>21.43</td>
<td>18.75</td>
<td>16.67</td>
</tr>
</tbody>
</table>

Current ratio tells the short-term liquidity position of firm. Risk is measured by calculating current ratio, high current ratio indicates strong liquidity position (less risk) when compared to standard and the current policy is less risky and *vice versa*. Return is measured by calculating return on total assets. From the above calculation we can observe that current ratio increased when current ratio is two and it is increased (by one time) when current assets increased and decreased (by one time) when current assets are decreased. In other words, Case 1 (decreasing current assets is risky), and Case 2 (increasing current assets) is less risky when compared to the present position. Return on total assets increased in Case 1 and decreased in Case 2, because of increased risk and decreased risk respectively. Put in simple words, in Case 1, decreasing current assets increases risk but provides
higher return, and in Case 2, increasing current assets reduces risk and return. There is a positive
correlation between risk and return. The same way increasing liabilities increases risk and return;
and decrease in current liabilities reduces risk and return.

**AGENCY PROBLEM**

Before studying the agency problem, there is a need to understand the role of shareholders and
managers. In company (public ltd.) form of business ownership, shareholders (equity) are the owners
of the company. They may be in crores and they are spread throughout the country (or some cases
through the world). One unique feature about the company form of ownership is the separation
between ownership and management. Due to this they cannot control or manage the company. They
elect board of directors (BoDs) as their representatives or agents and assign the responsibility of the
management. Once BoDs are elected the actual power of shareholders is restricted, except in
certain companies where the shareholders are also the directors. If they want to know the future
prospects of their company they can collect from the annual report, accounts, stock brokers, journals,
and daily newspapers. In this circumstances the management (BoDs) will act in the interest of the
shareholders or they may try to achieve their personal goals at the cost of the shareholders.

Obviously there is agency relationship between the director and the shareholders.

Here shareholder is ‘principal’ who hires agents (BoDs) to represent his/her interests. Under
agency relationships, the day-to-day running of a company is the responsibility of ‘agent’ (BoDs).
The directors should always manage business affairs on behalf of the shareholders. Managers may
not work in the interest of maximisation of shareholders’ wealth. For example, when a company’s
EPS is `300 but BoDs declare `30 as dividend per share, and the remaining `270 is retained in the
company without specifying the reason for such decisions. If managers hold very nominal percentage
of shares or none in the company they work for, they may not work efficiently with the objective of
maximising shareholders’ wealth and take high salary or perks. In the process of discharging the day-
to-day responsibilities there is a possibility of arising conflict between shareholder (principal) and the
BoDs (agent). This is known as “Agency problem” or “Agency conflict”.

Take a very simple example, in your college where you are studying. Owners of the college
appoint Principal or Director and assign the day-to-day activities – like admissions, monitoring classes,
solving student problems, etc., with the objective of building the college name. When a Director or
Principal discharges his/her duties abnormally or inefficiently, conflict arises. Abnormal way of
discharging responsibilities are — speaking against management ideas, collecting fees beyond owner’s
decision and using for personal purpose, collecting money from students for solving their problems,
which are supposed to be discharged free of cost.

When agency problem arises, what should shareholders do? Do they need to resolve the problem
through negotiation? or remove BoDs? or take steps to avoid agency problem as a precautionary
measure? Shareholder (Principal) has the power to remove the Directors from office but they have
spread out through the world, and they need to take initiative to do this. But in many companies the
shareholders lack energy to take such steps. Most of the shareholders do not participate in accepting
reports, accounts and taking decisions on final dividend, for which approval of the shareholders’ in
the annual general meeting is necessary.

Any problem/conflict can be definitely resolved through negotiations, which will benefit both
the parties (principal and agent) or a single party who is the actual beneficiary. But it is better to have
a system that prevents “agency problem”. If there is proper system it may lead to agency cost.
Agency cost refers to the cost of conflict of interests between shareholders and BoDs. The cost
may be direct or indirect. Loss of profitable opportunity is the indirect cost. For example, a company
did not get order due to the manager’s personal lobby. Direct agency cost comes in two forms – one company expenditure that benefits agents (management) but costs the shareholders. High perks to managers is a cost to shareholders and benefit to the managers. Second, monitoring cost of BoDs actions — it is an expense that arises from the need to monitor manager’s action. Appointing supervisor to supervise, consulting outside auditor to evaluate financial performance of the company are the two examples of direct agency cost. Agency conflict will arise when there is no congruence between agents’ goal and owners’ goal. Goal congruence can be achieved when managers act according to the shareholder’s interests, which is possible by offering rewards (incentives) for good performance and punish them for poor performance. The following are the few examples of rewards or incentives:

- **Connecting pay to the profit earned:** Managerial remuneration should be paid based on the level of performance (profit). It motivates managers to do well in the given responsibility. Sometimes, it may lead to creative account whereby management will distort the actual performance in the service of the manager’s own ends. The best example is Satyam Computers, the books locked up.

- **Rewarding managers with shares:** Generally, any person discharges the assigned duties well when he/she has some stake in the business. Therefore, companies can give stock option to employees or invite managers to subscribe for shares at an attractive offer price. This will definitely help improve company performance.

- **Direct intervention by owners:** There is a sea change in the pattern of shareholding and control. Shareholders moved from passive private investors to expensive institutional investors by checking performance of the company. These aggressive shareholders have direct influence on the performance of the company. They can take very quick decisions when they feel that managers performance is poor.

- **Threat of firing:** Sometimes, threatening managers with dismissal if they put their personal interests above that of maximising the value of the firm. Nowadays increase in institutional investors has improved shareholders powers to dismiss directors as they are able to dominate but also lobby other shareholders in decision-making. Even some cases of “proxy fight” is used to replace the existing management. Proxy fight is the authority to vote for someone else’s stock.

- **Threat of takeover:** This is another way that managers replaced companies that are poorly managed, are more attractive targets for takeover or acquisition because greater profit potential exists. Generally, managers would do everything possible to frustrate takeovers, as they are aware that they are going to lose their job.

**Corporate Governance**

Corporate Governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation is directly administered or controlled. It also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. The purpose of corporate governance is to ensure the accountability of certain individuals in an organisation through mechanisms that try to reduce or eliminate the principal-agent problem. At the same time, corporate governance systems focuses on economic efficiency, with a strong emphasis on shareholders’ welfare. This is possible because BODs are supposed to meet regularly, with clear accepted responsibilities. Corporate Governance aims at bringing the directors to be accountable to all their activities and ensure that the interests of shareholders are safeguarded.

**ORGANISATION OF FINANCE FUNCTION**

Finance function is key to the success of any business to make the function more effective, a sound organisation structure is essential. A sound structure defines who is who, who reports to whom
and functions and responsibilities of each individual. The structure also facilitates allocation of resources
to carry on the financial activities. It may be pointed out that, unlike others, finance function cannot
be outsourced. This has significant on the organisation the finance function.

There is no tailor-made structure of finance function. The structure of the organisation of
financial management vary from firm to firm depending on the factors like the size of the firm, nature
of business transactions; type of financing operations; capabilities of financial executives and the
philosophy of finance function of the firm. The designation (titles) of financial officer also differs
from one organisation to another organisation. The different designations are, financial manager,
while in others, Chief Financial Officer (CFO) or the Director of Finance; or Vice-President Finance
and financial controller. He/she reports to the top management (President). The financial Vice-
President’s key subordinates are the Treasurer and the Controller; who may be appointed under the
supervision (Consent) of Vice-President (finance). In big firms, with modern management there may
be Vice-President (finance) or Director (finance) usually with both Treasurer and Controller reporting
to him. Figure 1.3 discloses the organisation of finance function.

In large firms, a separate finance department may be created at the top level under the direct
supervision of Board of Directors (BODs). The department may be headed by a key person called
Vice-President (Finance) or Director (Finance) or Chief Finance Office (CFO), who is directly
concerned with planning and control. He/she is also associated with policy formulation and decision-
making of the firm. He/she exercises his/her functions through his/her two subordinates known as
(1) Treasurer and (2) Controller. (See Fig. 1.5)

1. **Treasurer:** The main concern of the treasurer is mainly financing activities and investment
activities, including cash management; relationship management with commercial and
investment bankers; credit management; portfolio management; inventory management;
insurance/risk management; investors relations; dividend disbursement.

2. **Controller:** On the other hand, the functions of controller are related to the management
and control of assets. The main functions include, cost accounting, financial accounting,
internal audit, financial statement preparation; preparation of budgets, taxation, general
ledger (payroll) and data processing.

**Treasurer’s and Controller’s Functions in the Indian Context**

The terms ‘treasurer’ and ‘controller’ are used by the American Financial Executives (USA),
of a corporation. In USA, the functions of financial management or functions of financial officer’s
are divided into two, viz., treasurership and controllership functions. However, these terms are not
used in India. In India more corporations, have given the designation of the financial controller or
controller, who performs the functions of a Chief Accountant or Management Accountant. In India,
in majority corporations, the term General Manager Finance or Chief Finance Manager is given as
the designation. Government reporting, insurance coverage are the few functions of Treasurer and
Controller, which are taken care of by the company secretary. In India, in many corporations financial
managers are appointed to perform the duties of treasurer and controller both. Financial manager
should realise the importance of his/her duties and they require extraordinary skills. Hence, he/she
should ensure the optimum use of scarce financial resources, for maximising shareholders wealth.
An Overview of Financial Management

INTERFACE OF FINANCIAL MANAGEMENT WITH OTHER DISCIPLINES

As all of us know that organisation is a group of people (employees) working together consciously towards organisation’s goal. The employees are divided based on their specialisation and are put under different departments. Generally, there are departments — Human Resource, Finance, Production, Marketing, R&D and MIS. All these departments are integrated. There is no single department that works independently.

Financial management has relationship with almost all functional departments. But it has close relationship with economics and accounting.
Relationship to Economics

The relationship between finance and economics can be studied under two prime areas of economics. They are macroeconomics, and microeconomics. Macroeconomics is the environment in which an industry operates, which is not controllable. The macroeconomic factors include, economy growth rate, domestic savings rate, structure and growth of financial system, fiscal policies, monetary policies, and so on. It is important for financial managers to understand changes in macroeconomics and their impact on the firm’s operating performance. External environment analysis helps in identifying opportunities and threats.

Microeconomics is the firm’s specific environment, and also controllable one. It is concerned with the determination of optimum operational strategies. In other words, financial managers uses economic theories as guidelines for efficient business operations. Supply and demand relationship, profit maximisation; pricing strategies; risk and return determination; marginal analysis are the few examples of relevant economic theories used in financial management. Marginal analysis is the prime principle used in financial decision-making. That is all financial decisions of a firm are made on the basis of marginal cost, and marginal revenue. Therefore, it is necessary to understand the relationship between finance and economics.

Relationship to Accounting

If you observe the Figure 1.3, you can find the relationship between finance and accounting. Finance (Treasurer) and Accounting (Controller) are the two prime domains of Chief Finance Manager (Vice-President Finance). Finance and accounting are not separable and generally, considered as overlapping activities of the Chief Finance Officer (CFO).

However, it is important for the student to know the relationship and difference between finance and accounting. The following discussion reveals that these are the differences and relationship between finance and accounting.

1. **Objective:** Financial accounting is concerned with developing and reporting data for measuring performance of the firm whereas finance is concerned with the maximisation of value of the firm, by selecting and executing feasible projects.

2. **Method:** Finance accounting prepares records on the accrual basis whereas the financial manager takes decisions on the basis of cash flows (inflows and outflows).

3. **Data:** Financial accounting deals with past data (certainty) whereas finance deals with future data (uncertainty).

Relationship to HR

HR activities include recruitment, training, development, fixing compensation, incentives, promotion, and providing other benefits. All these activities need finance. Therefore, before going to take any of these decisions HR manager needs to consult finance manager. Finance manager takes decisions after studying the impact of HR activity on organisations. Therefore, there is a relation to HR function.

Relationship to Production

Production department is another functional area that involves huge investment on fixed assets (machines and tools). For example, production of new products requires new machinery, which involves capital investment. Before going to select a machinery, he/she needs to evaluate the machine or equipment and select some cases changing manufacturing process. Improper evaluation involves huge consequences on the firm. The production manager and finance manager needs to work closely for effective investment (optimum investment) on plant and machinery.
Relationship to Marketing

Marketing functions involve selection of distribution channels and promotion policies. These two are the primary activities of the marketing department and involve huge cash outflows. Therefore, finance and marketing managers need to work with co-ordination to maximise value of the firm.

Relationship to R&D

Innovation of products and process is the only way to survive in the competitive market. Innovation needs to invest funds in R&D. But R&D department does not give a guarantee of development. Therefore, it does not mean that financial manager should not provide funds or cut funds heavily to R&D. It should be given importance and try to make a balance.

NEW ROLE OF FINANCE FUNCTION IN THE CONTEMPORARY SCENARIO

Today's highly dynamic business environment is driven by opening and expanding global markets; multiple corporate governance requirements; pressure on improving efficiency, cost cutting, demand for higher return on investment; greater stress on timely valuable information; rapid changes in technology and increased use of technology; sharp focus on aligning the companies towards the customer needs and increasing focus on core unpredictable activities. It indicates that the business environment is diverse multi-faced and unpredictable. Not only the business environment at the same time, we have seen major accounting scandals around the world — Enron, Parmalat, WorldCom, Qwest Communications, Tyco International, Health South Corporation, Adelphia, Peregrine Systems, WorldCom, AIG and Satyam Computer Services. These scandals have occurred due to the misdeeds like overstating revenues, understating expenses, overstating the value of assets, underreporting the liabilities, misuse or misdirecting funds, some cases with the billions of dollars due to the collapsed share prices, shook public confidence in the global security markets. Therefore, today's business environment place extraordinary demands on corporate executives and particularly the burden of finance function is accelerated without limit. As a result, in recent years, executive roles have been forced to evolve and in some instances, change dramatically and companies restructured their traditional models to become leaner, faster, and more responsive. Finance function plays a pivotal role in restructuring traditional models and it has become core of business operations, reporting and ensuring financial integration than ever before.

The role of finance (manager) is no longer confined to accounting; number crunching, financial reporting and risk management and finance manager, once considered as an executive with proficiency in figures, is no longer confined to the game of numbers. Having undergone changes over the period of time, they now play a major role in driving the business for their organisation by acting as a strategic business partner of the chief executive officer (CEO). Put in simple words, the role and responsibilities of finance manager have become complex and demanding and require constant reinvention of the role. The following are the new functions of finance (manager):

- Continuous focus on margins and ensure that the organisation stays committed to value creation.
- Work across the functional divide of the company and exhibit leadership skills.
- Understand what's driving the numbers and provide operation insights, including a sense of external market issues and internal operating trends, and become key strategy player.
- Aware and use the highly innovative financial instruments.
- Know the emergence of capital market as central stage for raising money.
- Adding more value to the business through innovations in impacting human capital.
Must balance the need to cut overhead with the need to create a finance organisation able to meet long-term goals by — designing financial processes, systems and organisation that can support the business in the future and initiating cost reductions that further cut organisational fat, but not operational muscle.

Liaison to the financial community, investors and regulators (rating agencies, investment and commercial bankers and peers), which are valuable information sources for strategic and tactical decisions.

Assess probable acquisitions, contemplating initial negotiation, carrying out due diligence, communicating to employees and investors about the horizontal integration.

Deal with the post-merger integration in the light of people issues.

Deal with the new legislation (New Companies Bill, Limited Liability Partnership), and regulations merely add more formality and, to an extent, bureaucracy, to what most already subscribe to as best practices in financial reporting.

Be one of the undisputed arbiter in matters of financial ethics, with the backing of legislation and stiff penalties.

Finance managers are central to changes in audit and control practices. Corporate governance is a key issue that must be continuously monitored and he/she should not push the limit of the P&L and growth.

Be aware of the proposed changes in financial reporting systems such as International Financial Reporting Standards (IFRS), Goods and Services Tax (GST), Direct Tax Code (DTC) and Extensible Business Reporting Language (XBRL). Adapting and optimising within changing tax reforms would become imperative for them and their organisations.

Research reports reveal that, today, companies want to see how they collaborate with and influence the CEO and board of directors; how they can go beyond books of accounts and contribute to the business with a better understanding of customer needs and issues; understand why a particular market is important; why a business tie-up is necessary; why sales are not happening; how a company can motivate and retain people; how to rightsizing; and how take strategic decisions related to supply chains, pricing and production. Therefore, finance function should have to face lightening changes taking place in business environment and coping with such changes is critical for any finance manager to ensure that the business and function remain contemporary and socially relevant.

**SUMMARY**

Business may be sole proprietary, partnership or company. *Sole proprietorship* is a small organisation, which is owned and managed by a single individual. *Partnership* is an association of two or more people joining to own and managing to share profits and losses. *Corporation* is an association of many persons who contribute money or money’s worth to a common stock and employs it in business, and who share profit and loss arising from business equally.

Financial Management is concerned with the acquisition, financing and management of assets with some overall goal in mind. The main activities of financial manager are (1) anticipating financial needs, (2) acquiring financial resources, and (3) allocating funds in business.

The scope of financial management can be studied under two approaches. (1) The traditional approach and (2) The modern approach. In the traditional approach, the role of financial management is limited to fund raising and administering, needed by the corporate enterprises to meet their financial needs. It ignored day-to-day problems, outsider-looking-in approach, ignored working capital financing, and also allocation of capital.
An Overview of Financial Management

Modern approach to Financial Management covers both procurement of funds as well as their allocation. The main contents of the new approach covers the decisions: (i) Financing decision, (ii) Investment decision and (iii) Dividend decision.

Investment decision relates to the selection of assets, that a firm will invest funds. The required assets fall into two groups, long-term assets (fixed assets), and short-term assets (current assets).

Financing decision is related to the financing mix or capital structure. Here the financial manager has to determine the optimum proportion of debt and equity.

Dividend decision relates to dividend policy. Payment of dividends should be analysed in relation to the financial decision of a firm.

Financial decisions are different kinds of financial management decisions, but these decisions are interrelated due to which the underlying objective of all the three decisions is (same) maximisation of shareholders’ wealth.

Business can be organised in four forms (1) Sole Proprietorship, (2) Partnership, (3) Co-operative Society, (4) Company.

The aim of finance function covers (1) Anticipation of funds needed, (2) Acquire the anticipated funds at low cost, (3) efficient allocation and utilisation of funds, (4) increase profitability, and (5) maximising firm’s value.

There are two widely accepted goals of financial management, viz., (1) Profit maximisation and (2) Wealth maximisation. The goal of profit maximisation has been criticised due to it is vague, it ignores time value of money, and quality of benefits. Shareholders’ wealth maximisation means maximising net present value (or wealth) of a course of action to shareholders.

There is a principal agency relationship between shareholders and BoDs. It arises due to lack of congruence. Goal congruence minimises agency problem. It can be achieved by (1) connecting pay to the profit earned, (2) Rewarding managers with shares, (3) Direct intervention by owners, (4) Threat of firing and (5) Threat of takeover.

The structure of the organisation of financial management vary from firm to firm depending on the factors like the size of the firm, nature of business transactions; type of financing operations; capabilities of financial executives and the philosophy of finance function of the firm. The designation (titles) of financial officer also differs from one organisation to another organisation. Finance manager exercises his functions through his two subordinates known as (1) Treasurer and (2) Controller.

TEST QUESTIONS

Objective Type Questions

1. Fill in the blanks with appropriate word(s):

(a) Scope of Business Finance is wider than the scope of ____________ Finance.

(b) ____________finance deals the company form of organisation.

(c) Modern financial management is concerned with proper ____________, ____________, and ____________ of funds effectively.

(d) 6As of financial management are ______, ______, ______, ______, ______ and ______.

(e) Maximisation of __________ is the main goal of financial management.

(f) ______ and ______ maximisation are the goals of financial management.

(g) Profit maximisation ignores ________________.

(h) Equity shareholders’ expected return is equal to risk-free rate plus ________.

(i) __________ is a conflict of interest between agent and the owner.

(j) Social responsibility means taking decision beyond the ________ activity.

[Answers: (a) Corporate, (b) Corporate, (c) anticipation; acquiring and allocation, (d) anticipation; acquiring; allocation; administering; analysis and accounting, (e) Shareholders wealth, (f) Profit; Wealth, (g) Time value of money, (h) Risk premium, (i) Agency conflict, (j) Economic.]
2. State whether each of the following statement is True or False:

(a) Men, Money, Machine, Materials, Methods, Minutes and Management are the 7 Ms of Management.
(b) Traditional concept of finance was limited to acquisition of funds.
(c) Investment decision, financing decision, dividend decision are the decisions of finance.
(d) There is no relation among finance decisions.
(e) Profit maximisation is suitable for sole proprietorship concerns.
(f) A rupee receivable today is less valuable than a rupee receivable in future.
(g) Having basic knowledge of economics is necessary to a financial manager.
(h) Job of financial manager is confined for raising and effective utilisation of funds.
(i) There is risk involvement in financial decisions.
(j) Principles of corporate finance can be applied to every type of organisation.

[Answers: (a) True, (b) True, (c) True, (d) False, (e) True, (f) False, (g) True, (h) True, (i) True, (j) True.]

REVIEW QUESTIONS

Objective Type

1. List out the 7 Ms of Management.
2. Name the 6 As of financial management.
3. Define financial management.
4. Write a note on traditional approach of finance.
5. Write a note on profit maximisation approach.
6. What do you understand by shareholders’ wealth?
7. What is finance function?
8. List out the three limitations of profit maximisation.
9. What is meant by time value of money?
10. How do you compute shareholders’ wealth?
11. What is financing decision?
12. What do you mean by dividend decision?
13. Write a note on investment decision.
14. What is LLP?

Analytical Type

1. Write a note on evolution of finance function.
2. Contrast the salient features of traditional and modern approaches to financial management.
3. Discuss in detail the scope of financial management.
4. State the objectives of financial management.
5. What do you mean by wealth maximisation and profit maximisation? Which one do you suggest? Why?
6. Explain in brief the functions of financial management.
7. Comment on profit maximisation and wealth maximisation.
8. Explain briefly the concept ‘profit maximisation’ with its limitations.
9. “Investment, financing and dividend decisions are all interrelated”. Comment.
10. What is agency conflict? How can they be mitigated?
11. Discuss in brief the aims of finance function.
12. Write a note on organisation of finance function.
13. What are the major differences between finance and accounting?
14. Discuss the risk-return trade-off in financial decisions.
15. Comment on the emerging role of finance manager in India.
An Overview of Financial Management

16. Discuss the general relationship between finance and economics.
17. Bring out the new rate of finance function in contemporary scenario.
18. Briefly explain the risk-return trade-off.
19. Briefly explain the features of LLP.

Essay Type

1. What do you mean by financial management? Discuss the approaches to finance function.
2. What do you mean by business finance? Should the goal of financial decision-making be profit maximisation or wealth maximisation? Discuss.
3. In what respect is the objective of wealth maximisation superior to the profit maximisation?
5. What are the main functions of the modern finance manager? How do they differ from those of the traditional finance manager?
6. What are the basic financial decisions? How did they involve risk-return trade-off?
7. “Finance functions of a business is closely related to its other functions.” Discuss.
8. Assuming wealth maximisation to be the objective of the financial management, show how the financing, investment and dividend decisions of a company can help to attain this objective.
9. Explain what is meant by agency relationships and agency costs? How can the agency costs be mitigated?
10. “……… Finance has changed ……. from a field that was concerned primarily with the procurement of funds to one that includes the management assets, the allocation of capital and valuation of the firm.” Elucidate.

SKILL-BUILDING EXERCISES

1. Bring out the emerging role of financial manager in the era of changing business environment.
2. Select a public limited company of your choice, collect recent annual report, recent (last working day) closing price of equity stock and compute the value of the firm.
3. As we read in the last section of this chapter, that different companies are calling financial managers with different designations. Select five companies from different industry, and find how many of the select companies are calling their financial managers as CFO/Director Finance/VP Finance and Finance Controller.
4. Select one company from the following industry and explain the structure of finance departments. (a) IT, (b) Manufacturing.
5. Identify few LLP firms operating in India.

REFERENCES

17. Ibid., p. 8.