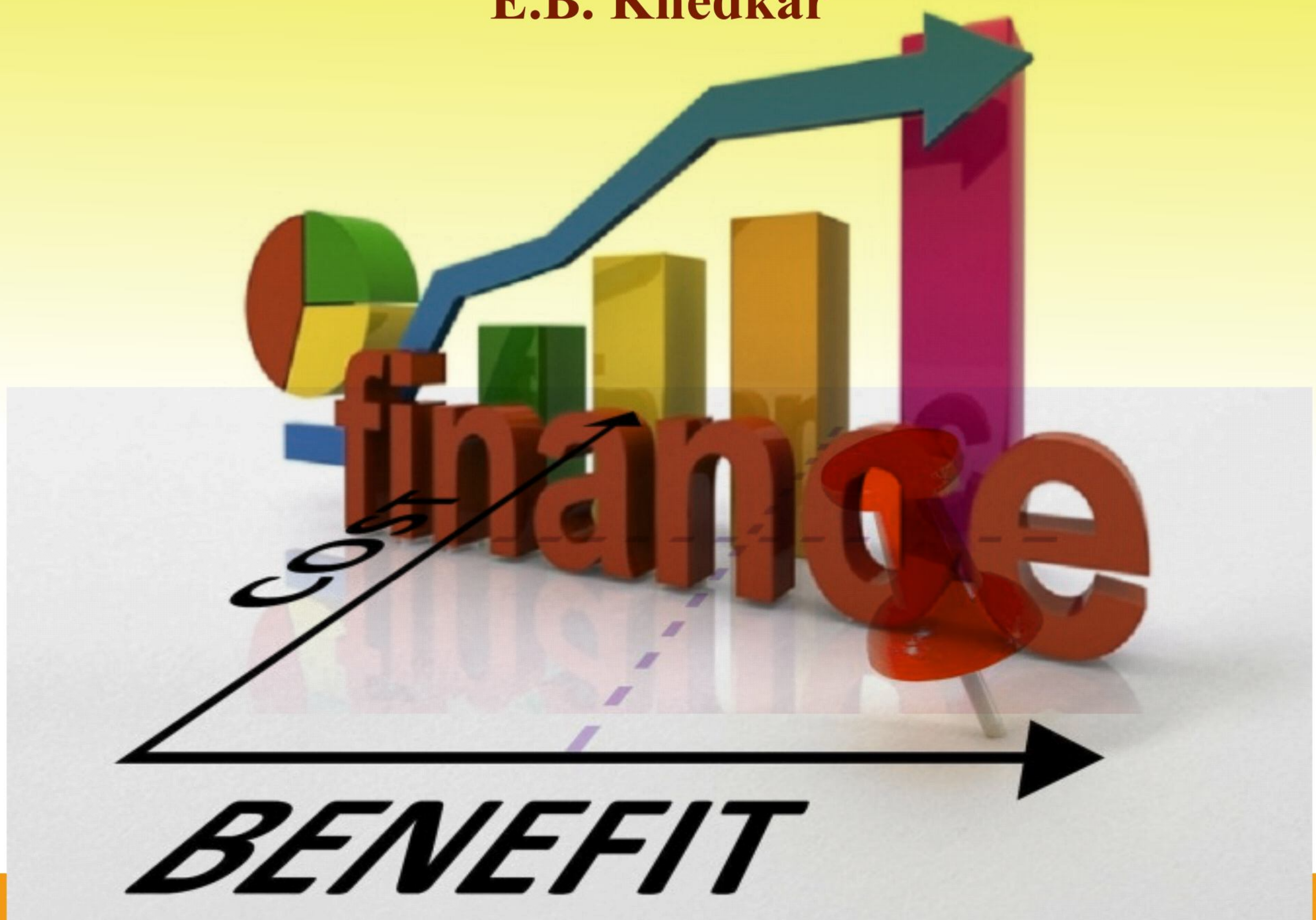
FINANCIAL MANAGEMENT

D.B. Bharati
E.B. Khedkar



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Financial Management

(Strictly as per the Choice Based Credit System and Grading System of Savitribai Phule Pune University *w.e.f.* 2016-2017)

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First Edition : 2017

Published by : Mrs. Meena Pandey for **Himalaya Publishing House Pvt. Ltd.,**
"Ramdoot", Dr. Bhalerao Marg, Girgaon, Mumbai - 400 004.
Phone: 022-23860170/23863863, Fax: 022-23877178
E-mail: himpub@vsnl.com; Website: www.himpub.com

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DTP by : Sunanda

Printed at : M/s. Charita Impressions, Hyderabad on behalf of HPH

Preface

Financial Management plays a very important role in the organization. Importance of finance cannot be overemphasized. It is indeed the key to successful business operations. Without proper administration of finance, no business enterprise can utilize its full potentials for progress and achievement.

It has now assumed an important place in the business management because the success of a business firm largely depends upon the financial policies developed by the financial management. Financial Management ensures smooth running of enterprise. Currency is to an enterprise what oil is to an engine. As business is requisite for each stage of an enterprise, i.e., promotion, development, expansion and administration of day-to-day operations, i.e., proper direction of money is very necessary to run the functions smoothly.

This book contains a good balanced combination of theory and numerical. Simple and clear language with lots of solved numerical is the USP of this book. We are grateful to the entire team of Himalaya Publishing House Pvt. Ltd. for their constant and quality support.

Prof. (Dr.) E.B. Khedkar
Prof. (Dr.) D.B. Bharati

Syllabus

Unit Number	Contents	No. of Sessions
Unit – 1	**Business Finance:** Introduction of Business Finance: Meaning, Definition of 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, Financial Planning – Principles and Steps in Financial Planning.	(Hours: 3+2)
Unit – 2	**Capital Structure:** Meaning, Factors Affecting the Capital Structure, Different Sources of Finance and its Types, Concept and Measurement of Cost of Capital, Measurement of Specific Costs WACC, Trading on Equity and its Types.	(Hours: 8+2)
Unit – 3	**Techniques of Financial Analysis:** Meaning, Nature, Objectives, Understanding of Financial Statements, Schedule VI of Companies Act, Tools of Analysis, Interpretation and Limitations of Financial Analysis, Fund Flow Statement (Working Capital Basis), Understanding Cash Flow Statement – Difference between Cash Flow and Fund Flow Statement, Ratio Analysis (Computation and Interpretations of Ratios)	(Hours: 8+2)
Unit – 4	**Capital Budgeting:** 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.	(Hours: 8+2)
Unit – 5	**Working Capital Management:** Nature and Scope, Components of Working Capital, Operating Cycle, Types of Working Capital, Sources of Working Capital Financing, Factors Affecting Working Capital, Estimation of Working Capital Requirement.	(Hours: 8+2)
Very Important Instructions for Problems	**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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Unit 1 Business Finance

Chapter Outline

1.1 Introduction to Business Finance
1.2 Meaning of Business Finance
1.3 Meaning and Definition of Financial Management
1.4 Importance of Financial Management
1.5 Goals of Financial Management
1.6 Modern Approaches to Financial Management
1.7 Finance and Other Related Disciplines
1.8 Functions of Finance Manager
1.9 Key Strategies of Financial Management
1.10 Financial Planning – Principles and Steps in Financial Planning

1.1 Introduction to Business Finance

The concept Business Finance consists of two words, one is business and other is finance. The word business is a wider concept which includes commerce, industry and service. The main objective of these three groups is making a profit. In simple words business is an activity consisting of trading, manufacturing, producing a commodity or articles with the intension of earning a profit. It also includes start-up of business unit to meet the needs of the society with the motive of making a profit. Business also consists of the industries which are providing services to the society. The word finance can be classified into three approaches: (a) According to first approach finance relates to acquisition of funds on certain terms and conditions to pay bills. (b) According to second approach, finance relates to

cash only and (c) According to third approach finance relates to acquisition or procurement of funds and their wise utilisation for productive purpose.

Business Finance is the combination of these two words. Thus, Business Finance deals with raising, administering and disbursing funds by business units operating business activities.

The term Business Finance can be defined as the process of raising, providing and managing all the money to be used in connection with business activities. Business finance can be broadly defined as the activity concerned with planning, raising, controlling and administering of funds used in the business.

In our present day economy, finance is defined as the provision of money at the time when it is required. Every enterprise, whether big, medium or small, needs finance to carry on its operations and to achieve its targets. In fact, finance is so indispensable today that it is rightly said to be the lifeblood of an enterprise. Without adequate finance, no enterprise can possibly accomplish its objectives.

The subject of finance has been traditionally classified into two classes:

(i) Public Finance; and

(ii) Private Finance.

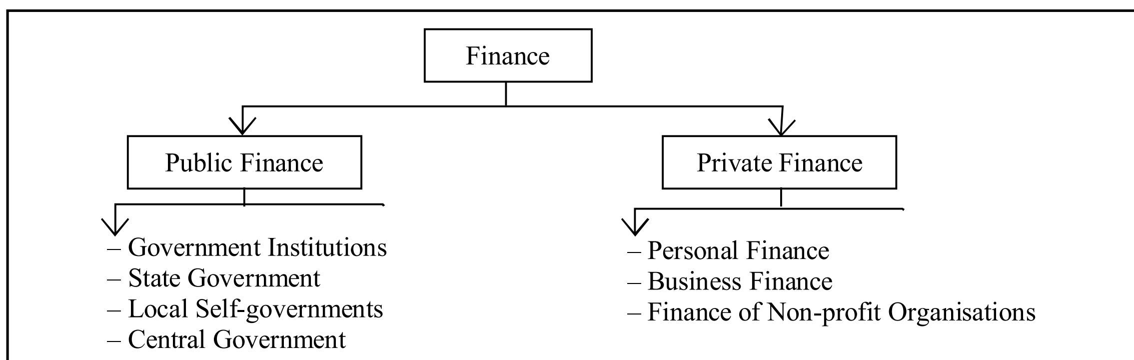
Public finance deals with the requirements, receipts and disbursements of funds in the government institutions like states, local self-governments and central government. Private finance is concerned with requirements, receipts and disbursements of funds in case of an individual, a profit seeking business organisation and a non-profit organisation.

Thus, private finance can be classified into:

(i) Personal finance;

(ii) Business finance; and

(iii) Finance of non-profit organisations.



Personal finance deals with the analysis of principles and practices involved in managing one's own daily need of funds. The study of principles, practices, procedures, and problems concerning financial management of profit making organisations engaged in the field of industry, trade, and commerce is undertaken under the discipline of business finance.

The finance of non-profit organisation is concerned with the practices, procedures and problems involved in financial management of charitable, religious, educational, social and other similar organisations.

1.2 MEANING OF BUSINESS FINANCE

Literally speaking, the term 'business finance' connotes finance of business activities. It is composed of two words: (i) Business, and (ii) Finance.

Thus, it is essential to understand the meaning of the two words, business and finance, which is the starting point to develop the whole concept and meaning of the term business finance.

The word 'business' literally means a 'state of being busy'. All creative human activities relating to the production and distribution of goods and services for satisfying human wants are known as business. It also includes all those activities which indirectly help in production and exchange of goods, such as, transport, insurance, banking and warehousing, etc. The term business consists of industry, trade and commerce.

Finance may be defined as the provision of money at the time when it is required. Finance refers to the management of flows of money through an organisation. It concerns with the application of skills in the manipulation, use and control of money. Different authorities have interpreted the term 'finance' differently.

However, there are three main approaches to finance:

(i) The first approach views finance as to providing of funds needed by a business on most suitable terms. This approach confines finance to the raising of funds and to the study of financial institutions and instruments from where funds can be procured.

(ii) The second approach relates finance to cash.

(iii) The third approach views finance as being concerned with rising of funds and their effective utilisation.

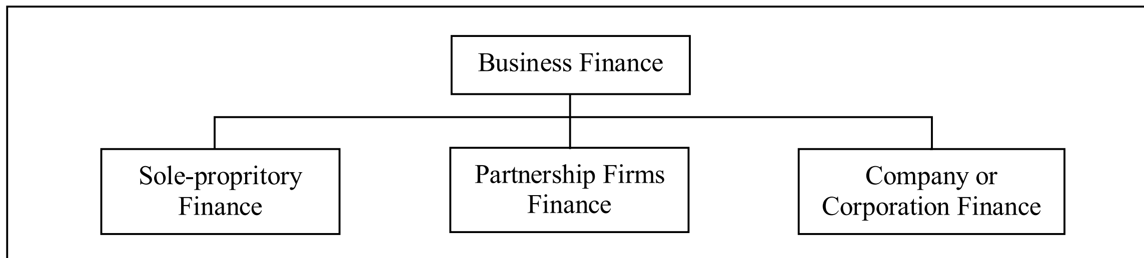
Having studied the meaning of the two terms business and finance; we can develop the meaning of the term 'business finance' as an activity or a process which is concerned with acquisition of funds, use of funds and distribution of profits by a business firm. Thus, business finance usually deals with financial planning, acquisition of funds, use and allocation of funds and financial controls.

Business finance can further be sub-classified into three categories, viz;

(i) Sole-proprietary finance,

(ii) Partnership firm finance, and

(iii) Corporation or company finance.



The above classification of business finance is based upon the three major forms of organisation for a business firm. In sole proprietorship form of organisation, a single individual promotes, finances, controls and manages the business enterprise. He also bears the whole risk of business.

A partnership, on the other hand, is an association of two or more persons to carry on as co-owners of a business and to share its profits and losses. It may come into existence either as a result of the expansion of sole-trade business or by an agreement between two or more persons.

The liability of the partners is unlimited and they collectively share the risks of the business. A joint stock company or a corporation is an association of many persons who contribute money or money's worth to a common stock and employs it in some trade or business and who share profit and loss arising therefrom.

In the words of Chief Justice Marshall, "a corporation is an artificial being, invisible, intangible and existing only in contemplation of the law. Being a mere creation of law, it possesses only the properties which the charter of its creation confers upon it either expressly or as incidental to its very existence".

Corporation is a legal entity having limited liability, perpetual succession and a common seal. A corporation is regarded as something different from its owners. The assets of the corporation are owned by it rather than its members and a corporation's liabilities are the obligations of the corporation, not the owners or the members.

1.3 Meaning and Definition of Financial Management

Definition of Financial Management: Corporation finance or broadly speaking business finance can be defined as the process of rising, providing and administering of all money/funds to be used in a corporate (business) enterprise.

Wheeler defines business finance as, "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 Guthmann and Dougall, **"Business finance can be broadly defined as the activity concerned with the planning, raising, controlling and administering the funds used in the business".**

In the words of Prather and Wert, "Business finance deals primarily with raising, administering and disbursing funds by privately owned business units operating in non-financial fields of industry."

According to the Encyclopedia of Social Sciences, "Corporation finance deals with the financial problems of corporate enterprises. These problems include the 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 up or rehabilitation of a corporation which has come into financial difficulties".

Thus, the scope of corporation finance is so wide as to cover the financial activities of a business enterprise right from its inception to its growth and expansion and in some cases to its winding up also. Corporation finance, usually, deals with financial planning, acquisition of funds, use and allocation of funds, and financial controls. To sum up in simple words, we can say that financial management as practiced by corporate (business) firms can be called corporation finance or business finance. Finance function has become so important that it has given birth to Financial Management as a separate subject.

Financial management refers to that part of the management activity which is concerned with the planning and controlling of firm's financial resources. It deals with finding out various sources for raising funds for the firm. The sources must be suitable and economical for the needs of the business. The most appropriate use of such funds also forms a part of financial management. As a separate managerial activity, it has a recent origin. This draws heavily on Economics for its theoretical concepts.

In the words of Weston and Brigham, **"Financial management is an area of financial decision-making, harmonising individual motives and enterprise goals".**

J.F. Bradley defines financial management as, "The area of the business management devoted to a judicious use of capital and a careful selection of sources of capital in order to enable a spending unit to move in the direction of reaching its goals."

According to J.L. Massie, "Financial management is the operational activity of a business that is responsible for obtaining and effectively utilising the funds necessary for efficient operations."

Howard and upon are of the opinion that financial management is the application of the planning and control functions to the finance function.

Evolution of Financial Management

Corporation finance 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 sized business undertakings. In the initial stages of the evolution of corporation finance, emphasis was placed on the study of sources and forms of financing the large sized business enterprises.

The grave economic recession of 1930s rendered difficulties in rising finance from banks and other financial institutions. Thus, emphasis was laid upon improved methods of planning and control, sound financial structure of the firm and more concern for liquidity. The ways and means of evaluating the creditworthiness of firms were developed.

The post-World War II era necessitated reorganisation of industries and the need for selecting sound financial structure. In the early 50s the emphasis shifted from the profitability to liquidity and

from institutional finance to day-to-day operations of the firm. The techniques of analysing capital investment in the form of 'capital budgeting' were also developed.

Thus, the scope of financial management widened to include the process of decision-making within the firm.

The modern phase began in mid-fifties and the discipline of corporation finance or financial management has now become more analytical and quantitative. 1960s witnessed phenomenal advances in the theory of 'portfolio analyses by Microwitz, Sharpe, Lintner etc. Capital Asset Pricing Model (CAPM) was developed in I970s.

The CAPM suggested that some of the risks in investments can be neutralised by holding of diversified portfolio of securities. The 'Option Pricing Theory' was also developed in the form of the Binomial Model and the Black-Scholes Model during this period. The role of taxation in personal and corporate finance was emphasised in 80s.

Further, newer avenues of raising finance with the introduction of new capital market instruments such as PCDs, FCDs, PSBs and CPPs etc. were also introduced. Globalisation of markets has witnessed the emergence of 'Financial Engineering' which involves the design, development and implementation of innovative financial instruments and the formulation of creative optimal solutions to problems in finance.

The techniques of models, mathematical programming and simulations are presently being used in corporation finance and it has achieved the prime place of importance. We may conclude that financial management has evolved from a branch of economics to a distinct subject of detailed study of its own.

1.4 Importance of Financial Management

Finance is the life blood and nerve centre of a business, just as circulation of blood is essential in the human body for maintaining life, finance is very essential to smooth running of the business. It has been rightly termed as universal lubricant which keeps the enterprise dynamic. No business, whether big, medium or small can be started without an adequate amount of finance.

Right from the very beginning, i.e. conceiving an idea to business, finance is needed to promote or establish the business, acquire fixed assets, make investigations such as market surveys, etc., develop product, keep men and machine at work, encourage management to make progress and create values. Even an existing concern may require further finance for making improvements or expanding the business.

Thus, the importance of finance cannot be over-emphasised and the subject of business finance has become utmost important both to the academicians and practicing managers. The academicians find interest in the subject because the subject is still in its developing stage and the practicing managers are interested in the subject because among the most crucial decisions of a firm are those related to finance.

The importance of corporation finance (which is a constituent of business finance) has arisen because of the fact that present day business activities are predominantly carried on company or corporate form of organisation.

The advent of corporate enterprises has resulted into:

(i) The increase in size and influence of the business enterprises,

(ii) Wide distribution of corporate ownership, and

(iii) Separation of ownership and management.

The above three factors have further increased the importance of corporation finance. As the owners (shareholders) in a corporate enterprise are widely scattered and the management is separated from the ownership, the management has to ensure the maximisation of owner's economic welfare.

The success and growth of a firm depends upon adequate return on its investment. The investors or shareholders can be attracted by a firm only by maximisation of their wealth through the application of principles and procedures as laid down by Corporation Finance.

The knowledge of the discipline of Corporation Finance is important not only to the practicing managers, but also to others who deal with a corporate enterprise, such as investors, lenders, bankers, creditors, etc., as there is always a scope for the management to manipulate and 'window dress' the financial statements.

In the present day capitalistic regime, the size of the business enterprises is increasing resulting into corporate empires empowered with a lot of social and political influence. This makes corporation finance all the more important.

Further, if we refer to corporation finance as the financial management practiced by business firms, the importance of financial management can well be described as the importance of corporation finance.

Financial management is applicable to every type of organisation, irrespective of its size, kind or nature. It is as useful to a small concern as to a big unit. A trading concern gets the same utility from its application as a manufacturing unit may expect.

This subject is important and useful for all types of ownership organisations. Where there is a use of finance, financial management is helpful. Every management aims to utilise its funds in a best possible and profitable way. So this subject is acquiring a universal applicability.

Financial management is indispensable to any organisation as it helps in:

(i) Financial planning and successful promotion of an enterprise;

(ii) Acquisition of funds as and when required at the minimum possible cost;

(iii) Proper use and allocation of funds;

(iv) Taking sound financial decisions;

(v) Improving the profitability through financial controls;

(vi) Increasing the wealth of the investors and the nation; and

(vii) Promoting and mobilising individual and corporate savings.

Factors influencing Financial Decisions: There are number of various (both external as well as internal) factors that influence the financial decisions.

A list of the important external as well as internal factors influencing the decisions is given below:

External Factors: (i) State of economy; (ii) Structure of capital and money markets; (iii) Requirements of investors; (iv) Government policy; (v) Taxation policy; (vi) Lending policy of financial institutions.

Internal Factors: (i) Nature and size of business; (ii) Expected return, cost and risk; (iii) Composition of assets; (iv) Structure of ownership; (v) Trend of earnings; (vi) Age of the firm; (vii) Liquidity position; (viii) Working capital requirements; (ix) Conditions of debt agreements.

1.5 Goals of Financial Management

The main objective of financial management will differ from one business undertaking to another business undertaking. However, there are three key goals or objectives of financial management. They are:

1. Profit maximisation decision criterion
2. Wealth maximisation decision criterion and
3. Other important decision criterion

1. **Profit Maximisation Decision Criterion:** In financial management the objective of financial management states that the investment, financing and dividend policy of business undertaking should be focused to the maximisation of profits. It means that profit can be maximised through increase in production with available resources or reducing the cost of production for a particular level of production. The following are various causes for the consideration of profit maximisation objective:
   (a) Profit is a way of judging the financial and economic performance of business undertaking.
   (b) It ensures efficient use of economic resources.
   (c) It guides to financial decision making process.
   (d) It ensures efficient allocation of resources with the intension of profitability.
   (e) It ensures maximisation of total economic welfare.
   (f) This objective is widely accepted and simple.

   However, giving importance to profit maximisation only can create various problems:
   (a) Risk is inevitable part of profit maximisation. Measures should be taken to minimise the possible risks.
   (b) Social aspect is totally ignored in profit maximisation.
   (c) The word profit arises questions like whether short term profit or long term period profit as well as profit after tax or before tax. In this sense profit is a vague term.
   (d) Time pattern of return is not considered in profit maximisation.
2. **Wealth Maximisation Decision Criterion:** Financial management is an academic discipline which is concerned with decision-making. This decision is concerned with the size and

composition of assets and the level and structure of financing. In order to make right decision, it is necessary to have a clear understanding of the objectives. Such an objective provides a framework for right kind of financial decision making. The objectives are concerned with designing a method of operating the Internal Investment and financing of a firm. There are two widely applied approaches, viz. (a) Profit maximisation and (b) Wealth maximisation.

The term **'objective'** is used in the sense of an object, a goal or decision criterion. The three decisions – Investment decision, financing decision and dividend policy decision are guided by the objective. Therefore, what is relevant – is not the over-all objective but an operationally useful criterion: It should also be noted that the term objective provides a normative framework. Therefore, a firm should try to achieve and on policies which should be followed so that certain goals are to be achieved. It should be noted that the firms do not necessarily follow them.

We shall now discuss the limitations of profit maximisation objective of financial management.

1. **Ambiguity:** The term 'profit maximisation' as a criterion for financial decision is vague and ambiguous concept. It lacks precise connotation. The term 'profit' is amenable to different interpretations by different people. For example, profit may be long-term or short-term. It may be total profit or rate of profit. It may be net profit before tax or net profit after tax. It may be return on total capital employed or total assets or shareholders equity and so on.
2. **Timing of Benefits:** Another technical objection to the profit maximisation criterion is that it ignores the differences in the time pattern of the benefits received from Investment proposals or courses of action. When the profitability is worked out **the bigger the better principle** is adopted as the decision is based on the total benefits received over the working life of the asset, irrespective of when they were received. The following table can be considered to explain this limitation.
3. **Quality of Benefits:** Another important technical limitation of profit maximisation criterion is that it ignores the quality aspects of benefits which are associated with the financial course of action. The term 'quality' means the degree of certainty associated with which benefits can be expected. Therefore, the more certain the expected return, the higher the quality of benefits. As against this, the more uncertain or fluctuating the expected benefits, the lower the quality of benefits.

The profit maximisation criterion is not appropriate and suitable as an operational objective. It is unsuitable and inappropriate as an operational objective of Investment financing and dividend decisions of a firm. It is vague and ambiguous. It ignores important dimensions of financial analysis viz. risk and time value of money.

An appropriate operational decision criterion for financial management should possess the following quality.

(a) It should be precise and exact.

(b) It should be based on bigger the better principle.

(c) It should consider both quantity and quality dimensions of benefits.

(d) It should recognise time value of money.

Wealth Maximisation Decision Criterion: Wealth maximisation decision criterion is also known as Value Maximisation or Net Present-Worth maximisation. In the current academic literature value maximisation is widely accepted as an appropriate operational decision criterion for financial management decision. It removes the technical limitations of the profit maximisation criterion. It possesses the three requirements of a suitable operational objective of financial courses of action. These three features are exactness, quality of benefits and the time value of money.

(i) Exactness: The value of an asset should be determined in terms of returns it can produce. Thus, the worth of a course of action should be valued in terms of the returns less the cost of undertaking the particular course of action. Important element in computing the value of a financial course of action is the exactness in computing the benefits associated with the course of action. The wealth maximisation criterion is based on cash flows generated and not on accounting profit. The computation of cash inflows and cash outflows is precise. As against this the computation of accounting is not exact.

(ii) Quality and Quantity and Benefit and Time Value of Money: The second feature of wealth maximisation criterion is that it considers both the quality and quantity dimensions of benefits. Moreover, it also incorporates the time value of money. As stated earlier the quality of benefits refers to certainty with which benefits are received in future.

The more certain the expected cash inflows the better the quality of benefits and higher the value. On the contrary the less certain the flows the lower the quality and hence, value of benefits. It should also be noted that money has time value. It should also be noted that benefits received in earlier years should be valued highly than benefits received later.

The operational implication of the uncertainty and timing dimensions of the benefits associated with a financial decision is that adjustments need to be made in the cash flow pattern. It should be made to incorporate risk and to make an allowance for differences in the timing of benefits. Net present value maximisation is superior to the profit maximisation as an operational objective.

It involves a comparison of value of cost. The action that has a discounted value reflecting both time and risk that exceeds cost is said to create value. Such actions are to be undertaken. Contrary to this actions with less value than cost, reduce wealth should be rejected. It is for these reasons that the Net Present Value Maximisation is superior to the profit maximisation as an operational objective.

Profit Maximisation vs Wealth Maximisation: Profit maximisation is one of the basic objectives of financial management. Profit maximisation aims at improving profitability, maintaining the stability and reducing losses and inefficiencies. Profit in this context can be seen in 2 senses.

1. Profit maximisation for the owner.
2. Profit maximisation is for others.

Normally profit is linked with efficiency and so it is the test of efficiency. However, this concept has certain limitations like ambiguity i.e. the term is not clear as it is nowhere defined, it changes from person to person.

1. **Quality of profit:** Normally profit is counted in terms of rupees. Normally amount earned is called as profit but it ignores certain basic ideas like wastage, efficiency, employee skill, employee's turnover, product mix, manufacturing process, administrative setup.

2. **Timing of benefit/time value of profit:** In inflationary conditions the value of profit will decrease and hence the profits may not be comparable over a longer period span.
3. Some economists argue that profit maximisation is sometimes leads to unhealthy trends and is harmful to the society and may result into exploitation, unhealthy competition and taking undue advantage of the position.

Wealth of shareholders = Number of shares held ×Market price per share.

In order to maximise wealth, financial management must achieve the following specific objectives:

(a) To ensure availability of sufficient funds at reasonable cost (liquidity).

(b) To ensure effective utilisation of funds (financial control).

(c) To ensure safety of funds by creating reserves, re-investing profits, etc. (minimisation of risk).

(d) To ensure adequate return on investment (profitability).

(e) To generate and build-up surplus for expansion and growth (growth).

(f) To minimise cost of capital by developing a sound and economical combination of corporate securities (economy).

(g) To coordinate the activities of the finance department with the activities of other departments of the firm (cooperation).

Profit Maximisation: Very often maximisation of profits is considered to be the main objective of financial management. Profitability is an operational concept that signifies economic efficiency. Some writers on finance believe that it leads to efficient allocation of resources and optimum use of capital.

It is said that profit maximisation is a simple and straightforward objective. It also ensures the survival and growth of a business firm. But modern authors on financial management have criticised the goal of profit maximisation.

Ezra Solomon has raised the following objections against the profit maximisation objective:

Objections against the Profit Maximisation Objectives

(i) The concept is ambiguous or vague. It is amenable to different interpretations, e.g., long run profits, short run profits, volume of profits, rate of profit, etc.

(ii) It ignores the timing of returns. It is based on the assumption of bigger the better and does not take into account the time value of money. The value of benefits received today and those received a year later are not the same.

(iii) It ignores the quality of the expected benefits or the risk involved in prospective earnings stream. The streams of benefits may have varying degrees of uncertainty. Two projects may have same total expected earnings but if the earnings of one fluctuate less widely than those of the other it will be less risky and more preferable. More uncertain or fluctuating the expected earnings, lower is their quality.

(iv) It does not consider the effect of dividend policy on the market price of the share. The goal of profit maximisation implies maximising earnings per share which is not necessarily the same

as maximising market-price share. According to Solomon, "to the extent payment of dividends can affect the market price of "the stock (or share), the maximisation of earnings per share will not be a satisfactory objective by itself."

(v) Profit maximisation objective does not take into consideration the social responsibilities of business. It ignores the interests of workers, consumers, government and the public in general. The exclusive attention on profit maximisation may misguide managers to the point where they may endanger the survival of the firm by ignoring research, executive development and other intangible investments.

Wealth maximisation is more operationally viable and valid criterion because of the following reasons:

(a) It is a precise and unambiguous concept. The wealth maximisation means maximising the market value of shares.

(b) It takes into account both the quantity and quality of the expected steam of future benefits. Adjustments are made for risk (uncertainty of expected returns) and timing (time value of money) by discounting the cash flows,

(c) As a decision criterion, wealth maximisation involves a comparison of value of cost. It is a long-term strategy emphasising the use of resources to yield economic values higher than joint values of inputs.

(d) Wealth maximisation is not in conflict with the other motives like maximisation of sales or market share. It rather helps in the achievement of these other objectives. In fact, achievement of wealth maximisation also maximises the achievement of the other objectives. Therefore, maximisation of wealth is the operating objective by which financial decisions should be guided.

The above description reveals that wealth maximisation is more useful if objective than profit maximisation. It views profits from the long-term perspective. The true index of the value of a firm is the market price of its shares as it reflects the influence of all such factors as earnings per share, timing of earnings, risk involved, etc.

Thus, the wealth maximisation objective implies that the objective of financial management should be to maximise the market price of the company's shares in the long-term. It is a true indicator of the company's progress and the shareholder's wealth.

However, "profit maximisation can be part of a wealth maximisation strategy. Quite often the two objectives can be pursued simultaneously but the maximisation of profits should never be permitted to overshadow the broader objectives of wealth maximisation.

1.6 Modern Approaches to Financial Management

The scope and functions of financial management is classified into two groups:

(a) Traditional view of financial management and

(b) Modern view of financial management

(a) Traditional view of financial management: The old or traditional view of financial management is mainly focused on obtaining funds and utilisation of funds in business undertaking. This traditional approach includes the following:

(i) To raise and collect short-term, medium-term and long-term funds from various sources.

(ii) To raise funds by issue of equity shares, preference shares, debentures and bonds.

(iii) To redistribute income and assets among these resources.

(iv) To assess the legal and accounting relationship between a firm and its sources of funds.

(b) Modern approach of financial management: According to this approach, finance relates not only to raising of funds but its administration also. According to this approach, finance includes the following:

(i) Investment Decisions: Investment decisions deals with utilisation of funds in one activity or the other. It includes the following:

1. To determine the total investment employed in the business undertakings.
2. To decide about the financial performance of each activity.
3. To decide the size of investment in permanent assets.
4. To determine allocation of funds to each investment proposals.
5. To assess investments in relation to their risk and return.
6. To determine the optimum capital structure.
7. To estimate firms investment opportunities regarding merger and amalgamation with other companies.

(ii) Financing Decision: Financial decisions deals with how the total funds required by business will be made available through issue of shares and debentures or raising of loans or retained earnings. It also covers the following:

1. To decide the borrowing policy of business.
2. To decide the best finance mix or capital structure of business.
3. To negotiate for finances.
4. To determine cost of financing, risk and repayment schedule.
5. To fix the optimum proportion of equity capital and debt capital.
6. To decide allocation of funds to each investment proposals.

(iii) Dividend Policy Decisions: Dividend decisions relate to the part of profits that will be given to shareholders in the form of cash dividend and also to decide the amount that will be kept back in business for utilisation. It covers the following:

1. To frame and formulate dividend policy.
2. To determine allocation of profits among the shareholders.
3. To decide the amount of profit to be distributed as dividend to shareholders.
4. To frame retention policy of profit.

5. To examine behaviour of share prices and stock market quotations.
6. To estimate and judge shareholders desire about return and their tax rates.

1.7 Finance and Other Related Disciplines

Finance in Relation to Other Allied Disciplines: The finance function cannot work effectively unless it draws on the disciplines which are closely associated with it. Management is heavily dependent on accounting for operating facts. Accounting has been described by Richard M. Lynch and Robert W. Williamson as the measurement and communication of financial and economical data. In fact, accounting information relates to the production, sales, expenses, investments, losses and gains of the business. Accounting has three branches namely, financial accounting, cost accounting and management accounting.

Financial Accounting: It is concerned with the preparation of reports which provide information to users outside the firm. The most common reports are the financial statements included in the annual reports of stockholders and potential investors. The main objective of these reports is to inform stockholders, creditors and other investors how assets are controlled by a firm. In the light of the financial statements and certain other information, the accountant prepares funds film statement, cash flow statement and budgets. A master plan (Budget) of the organisation includes and coordinates the plans of every department in financial terms. According to Guthmann and Dougall, "Problems of finance are intimately connected while problems of purchasing, production and marketing".

Cost Accounting: It deals primarily with cost data. It is the process of classifying, recording, allocating and reporting the various costs incurred in the operation of an enterprise. It includes a detailed system of control for material, labour and overheads. Budgetary control and standard costing are integral part of Primary Disciplines:

1. Accounting
2. Economics
3. Taxation

Other Disciplines:

1. Operations Research
2. Production

The purpose of cost accounting is to provide information to the management for decision making, planning and control. It facilitates cost reduction and cost control. It involves reporting of cost data to the management.

Management Accounting: It refers to accounting for the management. It provides necessary information to assist the management in the creation of policy and in the day-to-day operations. It enables the management to discharge all its functions, namely, planning, organising, staffing, direction and control efficiently with the help of accounting information. Functions of management accounting include all activities connected with collecting, processing, interpreting and presenting information to the management. According to J. Batty, 'management accounting' is the term used to describe the accounting methods, systems and technique which coupled with special knowledge and ability, assist

management in its task of maximising profits or minimising losses. Management accounting is related to the establishment of cost centres, preparation of budgets, and preparation of cost control accounts and fixing of responsibility for different functions.

1.8 Functions of Finance Manager

Finance Manager is an integral and vital part of corporate management of business undertakings. With his professional experience, expertise knowledge and competence he has to play a key role in optimum utilisation of financial resources of the business undertaking. In large business undertakings, the finance manager is a top management executive who participates in various decision making functions. The finance manager should possess and update his knowledge with regard to foreign direct investment, foreign portfolio investments, mergers, amalgamations, acquisitions, corporate restructuring, performance management, risk management, corporate governance, investor relations, working capital, investor education and investor protection etc.

1. **Forecasting of Cash Flow:** This is necessary for the successful day-to-day operations of the business so that it can discharge their obligation as and when occurs. In fact, it involves matching of cash inflows against outflows and the manager must forecast the sources and timing of inflows from customers and use them to pay the liability.
2. **Raising Funds:** The Financial Manager has to plan for mobilising funds from different sources so that the requisite amount of funds are made available to the business enterprise to meet its requirements for short term, medium term and long term.
3. **Managing the Flow of Internal Funds:** Here the Manager has to keep a track of the surplus in various bank accounts of the organisation and ensure that they are properly utilised to meet the requirements of the business. This will ensure that liquidity position of the company is maintained intact with the minimum amount of external borrowings.
4. **To Facilitate Cost Control:** The Financial Manager is generally the first person to recognise when the costs for the supplies or production processes are exceeding the standard costs/budgeted figures. Consequently, he can make recommendations to the top management for controlling the costs.
5. **To Facilitate Pricing of Product, Product Lines and Services:** The Financial Manager can supply important information about cost changes and cost at varying levels of production and the profit margins needed to carry on the business successfully. In fact, financial manager provides tools of analysis of information in pricing decisions and contribute to the formulation of pricing policies jointly with the marketing manager.
6. **Forecasting Profits:** The Financial Manager is usually responsible for collecting the relevant data to make forecasts of profit levels in future.
7. **Measuring Required Return:** The acceptance or rejection of an investment proposal depends on whether the expected return from the proposed investment is equal to or more than the required return. An investment project is accepted if the expected return is equal or more than the required return. Determination of required rate of return is the responsibility of the financial manager and is a part of the financing decision.

8. **Managing Assets:** The function of asset management focuses on the decision-making role of the financial manager. Finance personnel meet with other officers of the firm and participate in making decisions affecting the current and future utilisation of the firm's resources. As an example, managers may discuss the total amount of assets needed by the firm to carry out its operations. They will determine the composition or a mix of assets that will help the firm best achieve its goals. They will identify ways to use existing assets more effectively and reduce waste and unwarranted expenses. The decision-making role crosses liquidity and profitability lines. Converting the idle equipment into cash improves liquidity. Reducing costs improves profitability.
9. **Managing Funds:** In the management of funds, the financial manager acts as a specialised staff officer to the Chief Executive of the company. The manager is responsible for having sufficient funds for the firm to conduct its business and to pay its bills. Money must be located to finance receivables and inventories, to make arrangements for the purchase of assets, and to identify the sources of long-term financing. Cash must be available to pay dividends declared by the board of directors. The management of funds has therefore, both liquidity and profitability aspects.

1.9 Key Strategies of Financial Management

For the smooth functioning and efficient operation of a business undertaking, obtaining and utilisation of funds in effective and productive way needs proper attention. Financial management has to locate and identify the areas of key strategies to fulfil the target of business undertakings. The key strategies of financial management are given below:

(a) Investment Strategies: This strategy relates to the following:

Capital budgeting, Demand and Sales revenues, Level of cash inflows and outflows, Types of investment, Investment planning and forecasting, financial relation with institutions and corporate sectors, disinvestments, emphasis on growth and development of a concern and inflation rates and stock of inventory.

(b) Conduct of financial operation Strategies: It deals with the following: Utilisation of assets, Market selection, Competitive position, Pricing strategy, Cost effectiveness, Operating leverage, Liquidity and General inflation.

(c) Disposition of Profit Strategies: It relates to the following: Dividend to the owners; Interest to lenders; Payment to taxes; Reinvestment of profits; Match revenues and expenses.

(d) Financing Strategies: This relates to types of equity, types of debt, financial leverages, financial changes, achievement of financial objectives and equilibrium in the capital.

1.10 Financial Planning – Principles and Steps in Financial Planning

Definition of Financial Planning: The key function of financial manager is financial planning. Financial planning relates to procurement of funds economically and profitability application of funds. It is a continuous process in the day-to-day working of business undertakings. The success or failure

of production and distribution functions of business undertakings largely depends on the manner in which the finance function is performed. Hence each financial act is carefully planned before any action is taken. Financial planning is one of the most important aspects of the financial manager's job. The financial plan of business undertaking should be formulated considering not only present situation but of future development as well. Financial Planning is the process of estimating the capital required and determining its competition. It is the process of framing financial policies in relation to procurement, investment and administration of funds of an enterprise.

Objectives of Financial Planning: Financial Planning has got many objectives to look forward to:

(a) Determining capital requirements: This will depend upon factors like cost of current and fixed assets, promotional expenses and long-range planning. Capital requirements have to be looked with both aspects: short-term and long-term requirements.

(b) Determining capital structure: The capital structure is the composition of capital, i.e., the relative kind and proportion of capital required in the business. This includes decisions of debt-equity ratio both short-term and long-term.

(c) Framing financial policies with regards to cash control, lending, borrowings, etc.

A finance manager **ensures that the scarce financial resources are maximally utilised in the best possible manner** at least cost in order to get maximum returns on investment.

Importance of Financial Planning: Financial Planning is process of framing objectives, policies, procedures, programmes and budgets regarding the financial activities of a concern. This ensures effective and adequate financial and investment policies. The importance can be outlined as-

1. Adequate funds have to be ensured.
2. Financial Planning helps in ensuring a reasonable balance between outflow and inflow of funds so that stability is maintained.
3. Financial Planning ensures that the suppliers of funds are easily investing in companies which exercise financial planning.
4. Financial Planning helps in making growth and expansion programmes which helps in long-run survival of the company.
5. Financial Planning reduces uncertainties with regards to changing market trends which can be faced easily through enough funds.
6. Financial Planning helps in reducing the uncertainties which can be a hindrance to growth of the company. This helps in ensuring stability and profitability in concern.

Steps in Financial Planning: There are four steps in financial planning. They are:

(a) Establishing Objectives

(b) Policy Formulation

(c) Forecasting and

(d) Formulation of procedures

There are six stages to the process of doing a financial plan.

The beginning step is determining your objectives for the plan. You do this by: 1. Quantifying specific dollar goals within definite time frame and clarify any financial goals within those parameters; 2. You will rank your objectives according to your priorities; 3. Together, we will examine these objectives in respect to a client's available resources and other limitations. Our key role at this stage is to assist our clients in the establishment of their financial objectives.

The second step of the financial planning process is gathering data. With our help, our clients will complete a data survey form or questionnaire. We hope your confidence will grow as we do these initial interviews with a conversational approach with basic data and planning questions. Before the next meeting the information will be reviewed to insure accurate figures have been used. This interview or questionnaire will provide both quantitative and qualitative information for our client

- Qualitative provides general information concerning a family's goals and objectives, lifestyle, health, and investment-risk tolerance level.
- Quantitative provide basic but specific identifying information concerning details of family's financial status. Examples include info about investments, cash flow, insurance coverage's, and present liabilities or other obligations.

The third step is processing and analysing the information gathered. We will undertake a review of the following: Our client's financial position and current cash flow statement; a review of existing insurance policies and other legal papers such as wills, trust agreements, and buy-sell agreements; analyse the information to determine the strengths and weaknesses in the client's finances; evaluate our client's objectives in view of available resources, and economic conditions as they relate to future resources and cash flow for the client. It is our planning role to examine the viable options for achieving the determined objectives. We begin here to look at the products and strategies that may be selected for implementing the final plan. The end result will be a fully developed set of recommendations to meet the goals.

The fourth step is the actual recommendation of a comprehensive financial plan for our client. This is a time for our clients to speak up and ask questions about each strategy or product as it relates to solutions for achieving their goals and dreams. Recommendations can change during this process or at the least, be reviewed and altered based on client input.

A **fifth step** in the financial planning process is implementing the plan. Our client may need help in obtaining products and in pursuing strategies identified in step four. Use of products and services through our office is separate from the design fees and those costs and commissions will be disclosed appropriately. Also, if need be, we will work closely with other professionals to carry out the financial plan designed for the client. Often clients have competent accountants and legal advisors with whom we coordinate the use of strategies and products.

The final step is monitoring the plan. Periodically we should review your plan to evaluate the significance of any changes in federal tax, economic conditions, and available investment techniques. If you choose to use our investment advisory services you will be encouraged to have quarterly meetings related to your assets under management. Beyond this we, will schedule times on a bi-annual basis to examine our mutual progress toward achieving objectives. Changes can be made in the financial plan as may be determined by personal, business or family circumstances.

QUESTIONS

1. Discuss the meaning of 'finance'.
2. Explain the importance of finance.
3. Define the term financial management.
4. State and explain the goals of financial management.
5. Discuss the modern approaches to financial management.
6. Briefly state finance and other related disciplines to finance.
7. Role of finance manager in an organisation is vital – Discuss.
8. What do you mean by financial planning?
9. Explain the steps in financial planning.
10. Discuss the key strategies of financial management.

    Write short notes on the following:

    (a) Scope of financial management

    (b) Importance of financial management

    (c) Financing decisions.

Long Questions

1. What are the two main aspects of the finance function?
2. What are three main considerations in procuring funds?
3. Explain Wealth maximisation and profit maximisation.
4. What are the objectives of financial management?
5. Explain the key strategies of financial management.
6. Differentiate between the profit maximisation and wealth maximisation.
7. Write in detail the goals of financial management.
8. What is financial planning? What are the various steps involved in financial planning.
9. What are the various approaches of financial management?
10. Explain the functions of finance manager.