Financial Management

(Text & Cases)

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FINANCIAL MANAGEMENT

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Preface

We have great pleasure in presenting First edition *"Financial Management"* written for students of PG courses. The related matters are written in a simple and easily understandable language with sufficient support from real business information.

This volume is an attempt to provide the students with thorough understanding of financial management concepts, methods and techniques. We have presented the subject matter in a systematic manner with liberal use of charts and diagrams where ever necessary so as to make it interesting and sustain students' interest. We thank almighty for showering his substantial blessings and giving us the determination in preparing this book.

In writing this book we have benefited immensely from the studies of a number of books and the articles written by scholars spread over various books, journals and magazine. We are grateful to them.

We are sure this book will prove extremely useful to students and teachers alike. This book would not have seen the light, but for the grace of God and the blessings and support of our family members and friends.

We are quite confident, though, that the book can also be adopted and used successfully. We believe that the book is even suited for self-study. This book will provide an up-to-date first foundation for informed discussion of today's national and global issues.

We offer our gratitude to Himalaya Publishing House Pvt. Ltd., who is leader in Commerce and Management publications. Our sincere regards to Mr. Niraj Pandey, and Mr. Vijay Pandey for interest shown and for the best effort put forth by the matter of publication of this book.

Finally, we express our sincere thank to *SPS*, Bengaluru for their excellent computer typesetting work and the printing.

We respectfully acknowledge that the critical comments and constructive suggestions for the improvement of this book are most welcome and will be greatly appreciated.

Ahmedabad Authors
March., 2018

Syllabus

Module - 1:

Overview of Financial Management - Meaning, Objectives, Scope and Functions of Financial Management (Financial Decisions), Finance and Related Disciplines, Financial Goal: Profit Maximization versus Shareholders' Wealth Maximization, Role of the Financial Manager;

Time value of Money - Concepts, Compounding, Discounting, Annuities; Valuation of Bonds and Shares;

Sources of Long-Term Finance- Equity Shares, Preference Shares and Debentures

Module - 2:

Understanding Investment Decisions (Capital Budgeting Decisions) – Meaning, Features, Types and Importance of Investment Decisions; Discounted Cash Flow (DCF) and Non-discounted Cash Flow Techniques;

Cost of Capital – Significance, Concept of the Opportunity Cost of Capital, Weighted Average Cost of Capital (WACC), Component Costs of Capital - Cost of Debt, Preference Capital and Equity Capital, Capital Asset Pricing Model (CAPM), Risk Diversification: Systematic and Unsystematic Risk, Risk-Return Trade-off

Module - 3:

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Understanding Financing Decisions (Capital Structure Decisions) - NI Approach, NOI Approach, Traditional Approach, MM Theory with and without Taxes;

Understanding Leverage, Financing and Dividend Decision - Issues, Objectives and Determinants of Dividend Policy, Forms of Dividend, Dividend Theory- Dividend Relevance - Walter's Model and Gordon's Model, MM Theory of Dividend Irrelevance

Module - 4:

Working Capital Management- Concepts of Working Capital, Operating Cycle, Determinants of Working Capital, Issues in Working Capital Management, Estimating Working Capital Needs. Working Capital Finance Policies;

Inventory Management –Significance and Objectives, Costs associated with Inventory, Inventory Management Techniques (EOQ), ABC Inventory Control System;

Cash Management – Need, Cash Management Cycle, Cash Forecasting, Determining the Optimum Cash Balance under Certainty (Baumol's Model) and Uncertainty (The Miller-Orr Model);

Receivable Management- Nature and Goals of Credit Policy, Optimum Credit Policy, Credit Policy Variables

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Module - 1

Overview of Financial Management & Time Value of Money

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- Compounding, Discounting
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- Valuation of Bonds and Shares
- Sources of Long-Term Finance
- Equity Shares, Preference Shares and Debentures

Overview of Financial Management

INTRODUCTION

Every business enterprise whether small, medium or big needs finance to carry out its operations and accomplish its targets. Finance is the study of how investors allocate their financial resources over time under conditions of certainty and uncertainty. It is judicious way of managing funds. Earlier the concept of finance focussed on raising funds by the enterprise. Now the domain of finance has expanded. It focuses not only on raising of funds by the business enterprise but also its optimum usage

An enterprise need finance to meet its requirements in the economic world. For smooth functioning of a business activity, proper flow of fund is required of time to ensure maximum profit. So it is necessary to understand the need of finance, which plays a vital role in business. In the modern economy all the business operations are taking new shape as per the changing demands in the business world. It further becomes essential for finance managers, academicians, practicing managers and all people who are connected to the finance world to understand the wider aspects of financial management.

All the business operations are concerned with maximizing profits. A finance manager should be able to integrate with other departments for improving the efficiency of business process by proper utilization of finance. To do integrate the financial manager has to consider the other functional activities like marketing, production, human resources, research and development, technology etc., which requires adequate finance to achieve functional goals and in turn the overall goals of an organization. All type of organizations whether small, medium or large scale corporation requires finance for the above said functions without which the smooth functioning of business cannot be accomplished. In short, finance plays a key role in the business.

The term financial management can be defined as the management of the flow of funds in a firm and it deals with financial decision making. The financial Management as practiced by corporate firms can be called as corporate 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 planning and controlling of the firm's financial resources. It encompasses the procurement of funds in the most economic and prudent manner and employment of these funds in the most optimum way to maximize the return to the owner. The financial management has got a place of prime relevance as a functional area because raising of funds and their best utilization is a key to the success of any business organisation. All business decisions have financial implications and therefore financial management is inevitably related to almost every aspect of business operations.

Meaning of Finance

The term finance is derived from the Latin word 'finis' which means end/finish. Finance can also be interpreted in many ways such as fund, money, investment, capital, amount etc. Finance act as a medium for business which involves the acquisition and usage of funds in various departments such as production department, purchase department, research and development etc.

Finance is the life blood of business. Finance is provision of money at the time when it is required. Finance is an art and science of managing money. Finance is the set of activities dealing with the management of funds. More specifically, it is the decision of collection and use of funds.

Finance also refers to the science that describes the management, creation and study of money, banking, credit, investments, assets and liabilities. Finance consists of financial systems, which include public, private and government bodies and the study of finance and financial instruments, which can relate to countless assets and liabilities.

For instance, when a manager has to buy machineries for a production process, he requires fund in order to procure it for further process. Fund is also required in human resource department for providing training to their employees. In a nut shell it can be stated that every department needs finance for their business operations.

Hence, Finance has been rightly termed as universal lubricant which keeps the enterprise dynamic.

Definitions of Finance

According to ***Paul G Hasings,*** "Finance is the management of the monetary affairs of a company."

Financing is the process of organising the flow of funds so that a business firm can carry out its objectives in the most efficient manner and meet its obligations as they fall due. ***- Kenneth Midgley and Ronald Burns***

According to ***Simon Andrade,*** "Finance is the area of economic activity in which money is the basis of various embodiments, whether stock market investments, real estate, industrial, construction, agricultural development and so on".

According to ***Bodie and Merton,*** "Finance is the study of how scarce resources are allocated over time".

According to ***Ivan Thompson,*** "The term finance comes from the Latin word "finis" which means end or finish. It is a term whose implications affect both individuals and business, organizations and states what it has to do with obtaining and using money or money management".

According to ***O. Ferrel C. and Geoffrey Hirt,*** "The term finance refers to "all activities related to obtaining money and its effective use".

According to ***Henry Ford,*** "Finance or money is an arm or leg which one can either use it or lose it".

Webster's Ninth New Collegiate Dictionary defines finance as "The Science on study of the management of funds and the management of fund as the system that includes the circulation of money, the granting of credit, the making of investments and the provision of banking facilities".

NATURE OF FINANCE

1. Finance management is one of the important education which has been realized word wide. Now a day's people are undergoing through various specialization courses of financial management.
2. The nature of financial management is never a separate entity. Even as an operational manager or functional manager one has to take responsibility of financial management.
3. Finance is a foundation of economic activities. The person who manages finance is called as financial manager. Important role of financial manager is to control finance and implement the plans.
4. Nature of financial management is multi-disciplinary. Financial management depends upon various other factors like: accounting, banking, inflation, economy etc. for the better utilization of finances.
5. Approach of financial management is not limited to business functions but it is a backbone of commerce, economic and industry.

FINANCIAL MANAGEMENT

As stated earlier finance plays a key role in business, hence it is imperative to understand financial management. It is an integral part of overall management which has close relationship with economics, accounting and other areas of management. It covers the broader area of decision making at all levels of management.

Financial management is the managerial activity which is related to planning, organizing, and controlling the firm's financial resources and it is an essential part of the management. As it is integrated with other departments, proper management should be at place for smooth operations of business.

Financial Management is basically the application of general management principles to the areas of financial decision-making related to investment, dividend, working capital etc., with a view to maximize the wealth of the company and also shareholders.

In simple financial management deals with financial planning, acquisition of funds, use and allocation of funds and financial controls.

Definitions

According to ***S.C. Kuchal*** "Financial Management deals with procurement of funds and their effective utilization in the business".

According to ***Soloman,*** "Financial Management is concerned with the efficient use of an important economic resource viz., Capital Funds"

Financial management is an area of financial decision making, harmonizing individual motives and enterprise goals. - ***Weston and Brigham***

Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations.

- Joseph and Massie

According to ***J. F. Bradley*** "Financial management is the area of business management devoted to a judicious use of capital and a careful selection of sources of capital in order to enable a business firm to move in the direction of reaching its goals".

Financial management is an application of general managerial principles to the area of financial decision-making. ***- Howard and Upton***

SCOPE OF FINANCIAL MANAGEMENT

Financial management is mainly concerned with acquisition and use of funds by an organization. Earlier the scope of financial management was limited to procurement of funds.

But in current scenario, there is enormous change in the business decision making process especially in the areas of financing, investment and dividend. The key objective of financial management is to organize funds for meeting short term and long term needs of an organization. The funds procured should be at minimum costs to ensure profitability of the business. Finance manager should formulate strategies for the growth of firm. Given below is the list of activities to be performed in order to meet the needs of an organization.

1. Evaluation of financial requirement

The first and foremost task of a finance manager is to estimate long term and short term financial requirements. The evaluation should be based on sound financial plan so that purchasing fixed assets and funds required for working capital will be ascertained in a right manner. The financial plan should estimate the funds accurately as excess funds may tempt the organization to indulge in unnecessary expenditure. On the contrary, inadequacy of funds may adversely affect the operations of the business and idle cash may not fetch any returns to the business.

2. Formation of capital structure

After deciding the quantum of funds to be raised for the business, the task of the finance manager remains in framing the capital structure. Capital structure refers to the kind and proportion of different securities for raising such funds. A decision about various sources of funds should be linked to the cost of raising funds. A proper blend of equity and debt should be made up in the business to finance long and short term requirement.

3. Sources of finance

An appropriate source of finance is selected after the formation of capital structure. Various sources from which finance may be raised, include share capital, debentures, financial institutions, commercial banks, public deposits etc. Finance required for short-term include banks, financial institutions and public deposits. Whereas in long-term, share capital, debentures and borrowing from financial institutions can be selected.

4. Choice of Investment plans

After procuring the required funds decision about the use of funds is to be made. i.e., a decision about the proper allocation of funds in fixed assets and working capital has to be made. While allocating funds, those assets which are appropriate to the business are to be selected so that it can provide higher returns to the enterprise. To choose the best option, various techniques may be employed such as capital budgeting, cost volume profit analysis etc. in making decisions about capital expenditures.

5. Cash Management

Cash is one of the important aspects of financial management. Cash is a liquid asset which has to be maintained appropriately so as to cater to the various needs of the business on time. For example, cash may be required to purchase raw materials, make payments to creditors, pay rent, bills etc. To provide timely payment, there should be regular inflow of cash. Some of the sources of inflow are cash sales, collection of debts and short term arrangement with banks etc. There should be proper trade off between cash inflow and outflow for efficient operations in business.

6. Implementation of financial controls

After allocating the funds, the task of the finance manager will not end. Proper control is essential for efficient system of financial management. Various control devices such as return on investment, budgetary control, break even analysis etc. can be used as a measure to analyze the performance. Further it helps him to make corrective measures whenever needed.

7. Usage of surpluses

The scope of the finance manager implies on the effective and efficient utilization of the profits or the surpluses in the business. The surplus gained in the business may boon the expansion and diversification in the business relatively increasing the confidence in the minds of the share holders, consistently increasing the market value of shares which lead to wealth maximization. But a proper balance has to be made in using funds for paying dividend and retaining earnings for future plans in the business.

FINANCE FUNCTION

Finance function is the vital part of a business system. The need for money is perpetual. Hence it is not possible to separate this entity from business. The firm requires fund for its survival of business and future expansion. Finance manager should manage to raise funds from various sources and effectively utilize in order to meet the objectives of an organization.

The term finance function can be defined as "Procurement of funds and their effective utilization in the business".

Finance function may be broadly classified into two types:

1. Managerial finance functions

a) ***Investment decision*** involves the type and volume of assets to be acquired.

b) ***Financial decision*** involves the decision about the various sources and the extent of funds to be obtained.

c) ***Dividend decision*** involves the extent of profit to be allocated and the extent of profit to be retained.

2. Routine finance functions

a) Supervision of cash receipts and payments and safeguarding of cash balances.

b) Custody and safeguarding of securities, policies and other valuable documents.

c) Record keeping of financial transactions and reporting.

In modern day enterprises, the managerial finance functions are managed by the Chief Financial Officer (CFO) and the routine finance functions are managed by people at the operation levels.

AIMS OF FINANCE FUNCTION

1. ***Acquiring adequate funds:*** The main aim of finance function is to judge the financial requirements of an enterprise and then finding out appropriate sources for raising them. If funds are required for longer periods then long-term sources like; equity, preference share capital, debenture, term loans may be explored. If funds are wanted for shorter periods then short-term sources like; short term loans from financial intuitions, bank loans, overdraft, cash credit etc. may be explored.

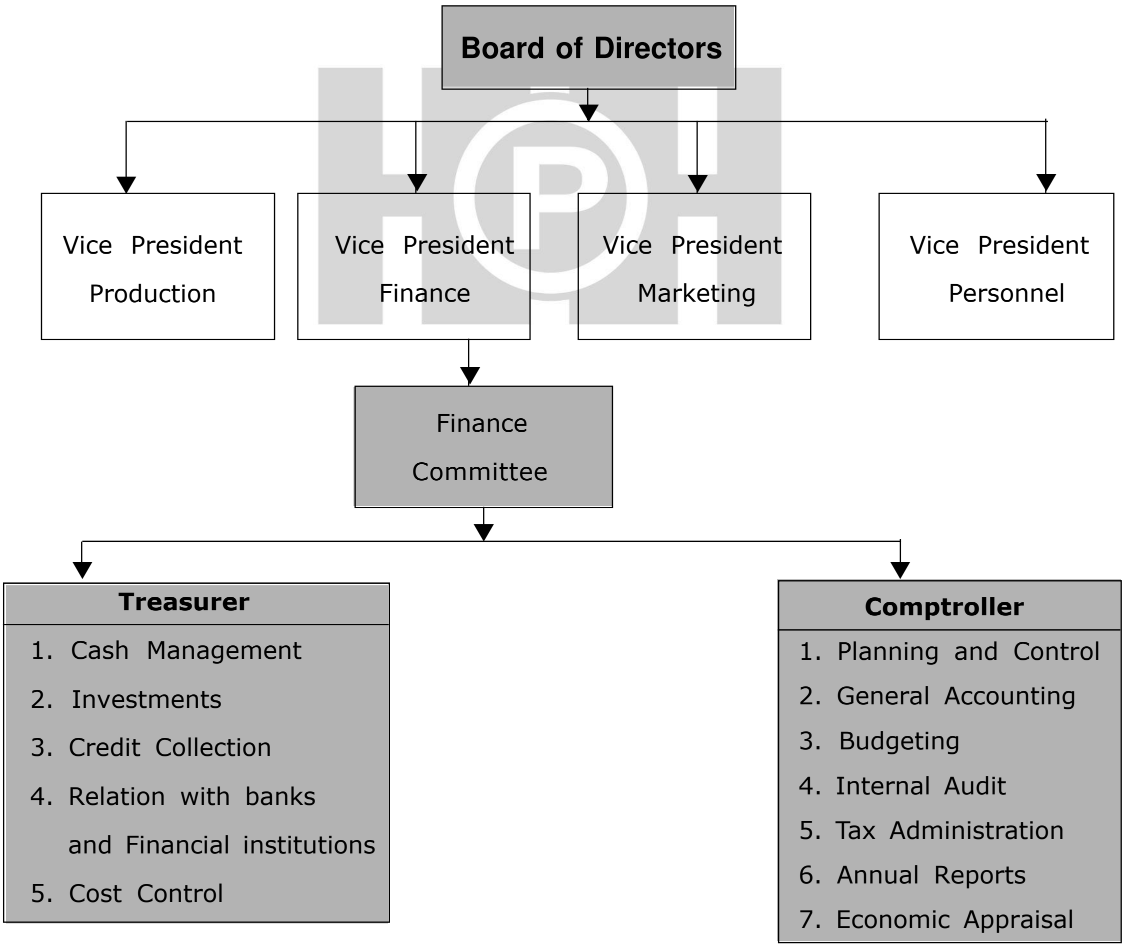
2. ***Proper deployment of funds:*** Though raising of funds is important but their effective use is more important. The funds should be used in such a way that utmost benefit is derived from them. The returns from their use should be more than their cost. It should be ensured that funds do not remain idle at any point of time. The fund devoted to various operations should be effectively utilized.

3. ***Escalating profitability:*** The planning and control of fiancé function aims at increasing profitability of the concern. It is true that money generates money. To increase profitability, sufficient funds will have to be invested in right opportunities.

4. ***Maximizing firm's value:*** Finance function also aims at maximizing the value of the firm. It is generally said that a concern's value is linked with its profitability. Besides profits, the type of sources used for raising funds, the cost of funds, the conditions of money market, the demand for products are some other factors which also influence a firm's value.

ORGANIZATION STRUCTURE OF FINANCIAL MANAGEMENT

Organisation of finance function is not standardized. It differs from an enterprise to enterprise depending upon its size, nature and other requirements. In a small firm, the operations are simple and there is little delegation of authority, thus no separate executive is appointed to handle finance function. It is the owner who performs all required functions. In case of medium and large scale operations a separate department exists to organize all financial activities which may be created at top level under the direct supervision of board of directors. All the important financial decisions are taken by the committee or the executive but routine decisions are left to the operation levels of management.



Besides this, the finance committee keeps the board of directors informed about all phases of business activity including economic, social and political developments affecting the business operations.

The financial decisions are crucial for the survival of the company. Wrong decision on financial aspects will adversely affect the reputation of the company. The finance committee also furnishes information about the financial status of the company by reviewing it from time to time. The finance functions although is controlled by the top management there will be a separate team to look after these activities and this function will be sub divided according to the needs of the business. A common structure of the finance department cannot be evolved as the size of the firm and nature of business differ from an enterprise to enterprise.

The finance function can be broadly divided into two parts:

1. Routine functions like custody of cash and bank accounts, collection of loans, payments of cash etc. are looked after by the treasurer.
2. Special financial functions like planning, budgeting, investment decisions, cost control, internal audit etc. are managed by the comptroller of finance.

***The functions of the treasurer comprises of*:**

1. Formulate capital structure for the organization in accordance to the business goals and implement the same.
2. Management of liquid assets which includes cash.
3. Acts as a cashier.
4. Role of an authorized signatory on payment cheques including the authority to approve such cheques.
5. Reconciliation of bank accounts.
6. Overall management of the credit function of the firm.
7. Authority to utilize surplus cash of the company in short term beneficial investments.
8. Establishes relationship with bankers and investors.

All of the above mentioned functions are implemented by the treasurer with the cooperation of the cash manager, finance manager and the credit manager.

Comptroller does the following functions:

1. Records all the transactions in the general ledger such as the accounts receivables, transaction with respect to fixed assets such as depreciation, inventory control etc.,
2. Looks into the aspects of taxes and insurance.
3. Acts as the planning director.
4. Reports information to the management.
5. Performs the function of budgeting and internal audit.

In recent trends the finance manager can be designated in various forms such as Directors, President, Vice President Finance or CFO etc. The usage of the term comptroller and the treasurer designations are very popular in United States of America for financial executives in a firm.

However, it may be noted that many a times the functions of treasurer and comptroller overlap with each other. In India, controller is generally termed as financial comptroller or the management accountant. But the designation of treasurer has not become popular and some of his functions are performed by company secretary. A large number of companies in India appoints finance managers to discharge the duties of the treasurer or both of the comptroller and treasurer. Some large companies even appoint the Chief Financial Officer (CFO) to supervise the functions of these financial executives.

ORGANIZATION STRUCTURE OF FINANCE FUNCTION

The finance function is very crucial for every type of business enterprise. There is a strong need of a sound organization to manage the finance function. However, organization of finance function is not standardized one. It varies from enterprise to enterprise depending upon its nature, size and other requirements. In case of small business the finance function is looked after by the owner itself. In case of medium sized business it is taken care by a separate department created at top level under the direct supervision of Board of Directors. But in large organization it is taken care by the Controller and Treasurer. The following structure will indicate clearly the overview of finance function.

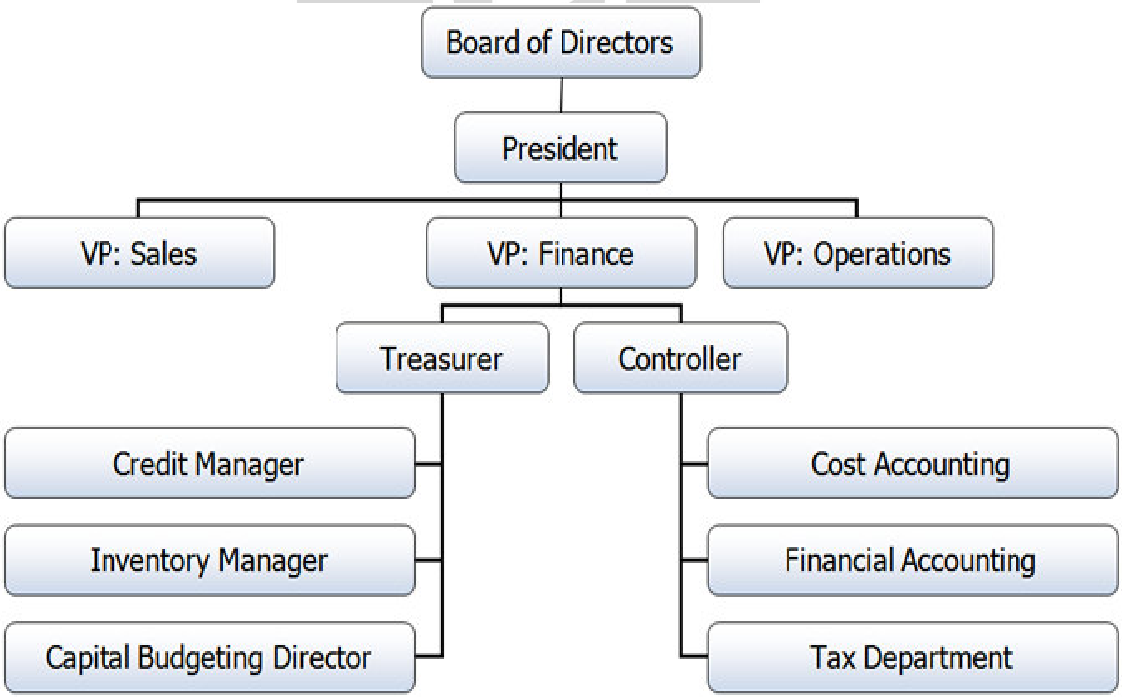


Fig: *Organisation Structure of Finance Function*

From the chart it is clear that treasurer and financial controller work under VP finance . VP finance is responsible to the president for his actions.

Treasurer performs the functions of procurement of essential funds, their utilization, investment, banking, cash management credit management, dividend distribution, pension, management etc. Financial, controller is responsible for general accounting, cost accounting, auditing, budget, reporting and preparing financial statement etc.

Functions of a Controller

1. Formulation of accounting and costing policies, standards and procedures.
2. Preparation of financial statements.
3. Preparation and interpretation of financial reports.
4. Maintenance of books of accounts.
5. Internal audit.
6. Preparation of budgets.
7. Inventory control.
8. Safeguarding company's assets.
9. Controlling cash receipts and cash payments.
10. Preparation of payrolls.

Functions of a Treasurer

1. Cash Management Functions

a) Opening accounts and depositing fund in banks.

b) Payment of company obligations through proper disbursements.

c) Maintaining records of cash transactions.

d) Management of petty cash and cash balance.

2. Credit Management Functions

a) Determination of customers' credit standards.

b) Orderly handling of collections from debtors.

c) Cash discounts to encourage prompt payment from debtors.

d) Determination customers credit risks.

3. Financial Planning Functions

a) Reporting financial results to the top level management.

b) Forecasting future financial requirements.

c) Forecasting cash receipts and payments.

d) Planning the various avenues for investment of company's surplus funds.

e) Advice on dividend payments.

4. Security floatation functions

a) Taking decisions on the type of securities a company has to float to raise the funds from the public.

b) Compliance with government regulations.

c) Maintaining good relationships with the stock holders.

d) Disbursements of dividends.

e) Redemption of bonds.

FINANCE AND RELATED DISCIPLINES

Finance is the basis of different economic activities like production, human resources, marketing and research and development etc. It is mandatory in every organization whether small, big, public sector, government organizations, finance becomes central focus of an organization backing other departments by utilizing proper financial tools and techniques resulting in effective functioning of an organization. The figure given below shows the relation of finance with other areas of management.

Relationship with Economics

Traditionally finance was considered as a part of economics. However, with the evolution of modern finance theory, finance evolved as an independent discipline and separated itself from economics. But even after separation both are related to each other deeply. For example, if finance manager wants to take investment decision then he shall analyse variables such as general economic environment, inflation rate, recession, boom, tax structure prevailing in the economy, etc. These variables are the products of macro economics. Similarly if finance function wants to make financing decision then he shall be concerned with the structure of banking system, money and capital markets, fiscal and economic policies, etc. These all things come under the purview of macro economics.

Relationship with Mathematics, Statistics and Quantitative techniques

In modern finance theory, some advance tools of mathematics, statistics and quantitative techniques are used in analyzing financial theories. For example , theory on valuation of options, derivatives, Capital Asset Pricing Model, Risk analysis, etc. are based on advance mathematical, statistical and quantitative tools.

Relationship with HR Department

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

Relationship with Production Department

Production department is another functional area that involves huge investment on fixed assets (machines and tools). *For example,* production of new product requires new machinery, which involves capital investment. Before going to select 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. Thus production manager and finance manager need to work closely for effective investment (optimum investment) on plant and machinery.

Relationship with Marketing Department

Marketing functions involves selection of distribution channel and promotion policies. These two are the primary activities of marketing department and involves huge cash outflows. Therefore finance and marketing managers need to work with coordination to maximize value of the firm.

Relationship with R & D Department

Innovation of products and process is the only way to survive in the competitive market. Innovation needs to invest funds on R&D. But R&D department does not give 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 balance.

Relationship with accounting

Finance is also connected with accounting. Accounting is a staff function which supplies data to top management, financial management, sales management, production management and personnel management. The finance manager requires accurate and scientifically arranged financial records of the enterprise to guide him in managing the inflow and outflow of funds.

Relationship with Purchasing Department

Materials required for production of commodities should be procured on economic terms and should be utilized in efficient manner to achieve maximum productivity. In this function the finance manager plays a key role in providing finance. In order to minimize cost and exercise control various materials management techniques such as Economic Order Quantity (EOQ), determination of stock levels, perpetual inventory systems are applied. The task of finance manager is to arrange the availability of cash when the bills for purchase become due.

FINANCIAL OBJECTIVES/GOALS

The financial goals can be classified into two categories:

1. Specific objectives
2. General objectives

1. Specific objectives

Profit Maximization

Profit maximization refers to the process where in companies focus on maximizing their profit or getting the best possible profit in the particular kind of business. Under profit maximisation companies experience the best output and price levels in order to maximize its return. In simple Profit maximization implies maximizing the Rupee income of the firm.

Profit is a yardstick for measuring the efficiency of a business which is associated with economic activity. The survival of the firm depends upon its ability to earn profits which can act as a guard against risk. The profits which are accumulated in business can help business overcome the unforeseen situations like market fluctuations, changes in price, competition, sudden change in government policies etc. Thus, profit maximization achieved by an organization is regarded as a primary measure of success.

Hence, it is rightly said, No business can survive without earning profit. Profit is the only means through which an efficiency of business enterprise can be measured.

Features of Profit Maximisation

Profit maximization consists of the following important features:

1. Profit maximization is called as cashing per share maximization. It leads to maximization of the business operation for profit maximization.
2. Ultimate aim of the business concern is earning profit; hence, it considers all the possible ways to increase the profitability of the concern.
3. Profit is the parameter of measuring the efficiency of the business concern. Thus, it shows the entire position of the business concern.
4. Profit maximization objectives help to reduce the risk of the business.
5. Profit maximization leads to exploitation of workers and consumers.
6. Profit maximization creates immoral practices such as corrupt practices, unfair trade practices, etc.
7. Profit maximization objectives leads to inequalities among the stake holders such as customers, suppliers, public shareholders, etc.
8. Profit maximisation is the parameter of the business operation.
9. Profit maximisation reduces risk of the business concern.
10. Profitability meets the social needs.

Advantages of Profit Maximisation

1. Profit maximization leads to maximizing the business operation.
2. It considers all the possible ways to increase the profitability of the concern.
3. Profit is the parameter of measuring the efficiency of the business concern. Thus, it shows the status of the business concern.
4. It is a technique which is mainly focused on efficient utilization of capital resources to maximize profit.
5. Profit maximization objectives help to reduce the risk of business.
5. It will be easy to determine the link between financial decisions and profits.
6. The company can adjust influential factors such as production costs, sale prices, and output levels as a way of reaching its profit goal.
7. It attracts the investors to invest their savings in securities.
8. Profit maximization can be achieved in a short-period.
9. Profit indicates the efficient use of funds for different requirements.
10. Profit maximization will give way to the business for expansion and diversification of a company.

Disadvantages of Profit Maximisation

1. Profit is not defined precisely or correctly under profit maximisation objective.
2. It creates some unnecessary opinion regarding earning habits of the business concern.
3. It ignores the time value of money. Profit maximization does not consider the time value of money or the net present value of the cash inflow.
4. It leads to certain differences between the actual cash inflow and net present cash flow during a particular period.
5. It ignores risk. Profit maximization does not consider risk of the business concern. Risks may be internal or external which will affect the overall operation of the business concern.
6. Profit maximization leads to exploitation of workers and consumers.
7. Profit maximization creates immoral practices such as corrupt practice, unfair trade practices, etc.
8. Profit maximization objectives leads to inequalities among the stake holders such as customers, suppliers, public shareholders, etc.
9. Profit maximization is a good thing for a company, but can be a bad thing for consumers if the company starts to use cheaper products or decides to increase prices.
10. Profit maximisation can lead to management anxiety and frustration.

Arguments in favour of Profit Maximization

1. ***Profit is the test of economic efficiency:*** It is a measuring rod by which the economic performance of the company can be judged.
2. ***Efficient allocation of fund:*** Profit leads to efficient allocation of resources as resources tend to be directed to uses, which in terms of profitability are the most desirable.
3. ***Social welfare:*** It ensures maximum social welfare i.e., maximum dividend to shareholders, timely payments to creditors, more and more wages and other benefits to employees, better quality at lesser rate to consumers, more employment opportunities and maximization of capital to the entrepreneur.
4. ***Internal resources for expansion:*** It will consume a lot of time to raise equity funds in a primary market. Retained profits can be used for expansion and modernization.
5. ***Reduction in risk and uncertainty:*** After availing huge profits the company develops risk bearing capacity. The gross present value of a course of action is found by discounting and low capitalizing is a benefit at a rate which reflects their timing and uncertainty. A financial action which has positive net present value creates wealth and therefore it is desirable. The negative present value should be rejected.
6. ***More competitive:*** More and more profits enhance the competitive spirit thus, under such conditions firms having more and more profits are considered to be more dependable and can survive in any environment.
7. ***Desire for controls:*** More and more profits are desirable and imperative for the management to make optimum use of available financial resources for continued survival.
8. ***Increase in confidence:*** Profit maximization increases the confidence of management in expansion and diversification programme's of a company.
9. ***Attraction of Investors:*** Profit maximization attracts the investors to invest their savings in securities.
10. ***Survival:*** Profit helps the business to survive under unfavorable conditions like recession, sever competition etc.

Arguments against Profit Maximization

1. It is argued that profit maximization assumes perfect competition, and in the face of imperfect modern markets, it cannot be a legitimate objective of the firm.
2. It is also argued that profit maximization, as a business objective, developed in the early 19th century for single entrepreneurship. The only aim of single owner was to enhance his individual wealth. But the modern business environment is characterized by limited liability and a difference between management and ownership. Share holders and lenders today finance the firm but it is controlled and directed by professional management. In the new business environment, profit maximization is regarded as unrealistic, difficult, inappropriate and immoral.

3. It is also feared that profit maximization behaviour in a market economy may tend to produce goods and services that are wasteful and unnecessary from the society's point of view.

4. Firms producing same goods and services differ substantially in terms of technology, costs and capital. In view of such conditions, it is difficult to have a truly competitive price system, and thus, it is doubtful if the profit maximizing behaviour will lead to the optimum social welfare.

5. Profit cannot be ascertained well in advance to express the probability of return as future is uncertain. It is not possible to maximize something that is unknown. Moreover the term profit is vague and not clearly expressed.

6. The executive or the decision maker may not have enough confidence in the estimates of future returns so that he does not attempt further to maximize. It is argued that a firm's goal cannot be, to maximize profits but to attain a certain level or certain share of the market or certain level of sales.

7. The criterion of profit maximization ignores the time value factors. It considers the total benefits or profits into account while considering a project whereas the length of time in earning that profit is not considered at all.

8. Profit maximization encourages corrupt practices to increase the profits.

9. Profit maximization does not consider the element of risks and it attracts cut-throat competition.

10. Profit maximization may exploit workers and customers and a huge profit invites problems from worker, they demand high salary and fringe benefits.

Shareholders Wealth Maximisation

Wealth maximisation is a process that increases the current net value of business or shareholder capital gains, with the objective of bringing in the highest possible return. The wealth maximization strategy generally involves making sound financial investment decisions which takes into consideration any risk factors that would compromise or outweigh the anticipated benefits.

It refers to maximization of the net present value of a course of action for increasing shareholders wealth.

The concept of 'wealth maximization' refers to the gradual growth of the value of assets of the firm in terms of benefits it can offer. The wealth maximization attained by an organization is reflected by the market value of shares. It is the method of creating wealth in an organization.

Wealth maximization given importance on net present value of a business. Mathematically NPV can be equated as equal to the gross present value of the benefits minus the amount invested to receive such benefits.

Net Present Value (NPV) can be derived by using the following formula:

$$NPV = \left[\frac{CI_1}{(1+r)^1} + \frac{CI_2}{(1+r)^2} + \frac{CI_3}{(1+r)^3} + ...+ \frac{CI_2}{(1+r)^2}\right] - \frac{C_0}{(1+r)^0}$$

$$NPV = \sum_{i=1}^{n} \frac{CI_i}{(1+r)^i} - \frac{C_0}{(1+r)^0}$$

= Sum of present value of cash inflow – cash outflows

Where,

CI = Cash inflows, r = Rate of return (discount rate)

n = Numbers of years, Co = Cash outflows

Further, the wealth of an organization should be maximized by keeping in mind the various factors like avoiding high level of risk in business, paying regular dividends to the shareholders which increases the goodwill of the company and maintaining the stable growth in sales, along with social responsibility of business and coping up with restrictions imposed by government body.

Maximization wealth of shareholders i.e. maximization of value of share (market value of share) is the aim of wealth maximization. It is a long run goal and indicates wealth for growth, survival of overall interest of the business. Wealth i.e. economic value i.e. presents value of future cash flows generated by a decision, discounted at opportunity rate of discount repressing the amount of risk. Economic value gives importance on cash flow rather than profit i.e. the value of the firm – market price of the company's stock. Market value of the share at long run takes into account

- Present and prospective future earning per share.
- Timing and risk of these earning.
- Dividend policy of the firm and retain earning policy.
- Risk and return mix of the firm which related to inflation, cost of living etc.
- Technical factors machinery, manpower, technology, mass physiology, goodwill, name fame.
- The wealth maximization structurally related to investment decision, financial decision and dividend decision.
- The market price of share= EPS x capitalization rate.
- EPS = profit afire tax / No. of equity share.
- Capitalization rate = How much profit return by firm in %
- Shareholder's current wealth = No of share held x current price of stock.

Features of Wealth Maximization

1. ***Protection of interest of shareholders:*** Shareholders interest is protected by increased market value of their holdings in the firm.

2. ***Security to financial lenders:*** It provides security to short term and long term financial lenders, who supply funds to the business enterprise. Short term lenders are interested in the firm's liquidity position, whereas long term lenders enjoy priority over shareholder at the time of return of funds besides getting fixed rate of interest.
3. ***Protection of interest of the employees:*** Employees contribution is a primary consideration in raising the wealth of an enterprise. Their productivity and efficiency ultimately leads to fulfilling company's objective of wealth maximization.
4. ***Survival of Management:*** Management is a representative body of shareholders. When shareholders interest is protected, they may not wish to change the management and hence it can survive for a longer period of time.
5. ***Interest of society:*** When all the available productive resources are put to optimum and efficient use, economic interest of the society is served.

Advantages of Wealth Maximization

i) Wealth maximization is a clear term. Here, the present value of cash flow is taken into consideration. The net effect of investment and benefits can be measured clearly.

ii) It considers the concept of time value of money. The present values of cash inflows and outflows help the management to achieve the overall objectives of a company.

iii) The concept of wealth maximization is universally accepted, because, it takes care of interests of financial institution, owners, employees and society at large.

iv) Wealth maximization guides the management in framing consistent strong dividend policy, in order to earn maximum returns to the equity holders.

v) The concept of wealth maximization considers the impact of risk factor. While calculating the 'Net Present Value' at a particular discount rate, adjustment is made to cover the risk that is associated with the investments.

Disadvantage of Wealth Maximization

1. Absence of and efficient capital market.
2. It is a prescriptive idea.
3. It is not socially desirable.
4. Ignores other stakeholders.
5. Creates conflict between managerial interest and owners interest.

Favourable Arguments for Wealth Maximization

(i) Wealth maximization is superior to the profit maximization because the main aim of the business concern under this concept is to improve the value or wealth of the shareholders.

(ii) Wealth maximization considers the comparison of the value to cost associated with the business concern is total value deducted from the total cost incurred for the business operation. It provides extract value of the business concern.

(iii) Wealth maximization considers both time and risk of the business concern.

(iv) Wealth maximization provides efficient allocation of resources.

(v) It ensures the economic interest of the society.

(vi) The concept of wealth maximization is universally accepted, because it takes care of interest of financial institutions, owners, employees and society at large.

(vii) Wealth Maximization guide the management in framing consistent strong dividend policy to reach maximum returns to the equity holders.

Unfavourable Arguments for Wealth Maximization

(i) Wealth maximization is nothing but profit maximization, it is the indirect name of the profit maximization. Because the ultimate aim of the wealth maximization objectives is to maximize the profit.

(ii) Wealth maximization creates ownership-management controversy.

(iii) Management alone enjoys certain benefits.

(iv) Wealth maximization can be activated only with the help of profitable position of the business concern.

(v) There is some controversy as to whether the objective is to maximize the stockholders wealth or the wealth of the firm, which includes other financial claimholders such as debenture holders, preference shareholders etc.

2. General Objectives

The general objective of the business considers the following:

1. ***Balance assets structure:*** A proper balance between the fixed and current assets is an important factor for efficient management of funds. This is one of the objectives of financial management where the size of current asset must permit the company to exploit the investments on fixed assets. The subject of financial management must have a goal of maintaining balanced asset structure of company. The sizes of fixed assets are to be decided scientifically. The size of current assets must permit the company to exploit the investment on fixed assets. Therefore balanced asset structure has to be maintained.

2. ***Liquidity:*** Liquidity refers to available cash and it is an indication of positive growth of a company. It is an important factor for meeting the short and long term obligations of a firm. The liquidity objective of a company will exploit the long-term vision of the company. If a firm is liquid it is an indication of positive growth. Hence company should maintain liquidity.

3. ***Proper planning of funds:*** Proper planning of funds includes acquisition and allocation of funds in the best possible manner i.e. minimum cost of acquisition of funds but maximum returns through wise decisions. The concept of wealth or profit maximization is achieved only when a company reduces its overall cost with judicious planning about requirement of funds and application of funds and also with proper blend of different sources in the capital structure.

4. ***Efficiency:*** Efficiency and effectiveness are very much necessary in controlling the flow of funds. The efficiency level should continuously increase for the betterment of organisation.

5. ***Financial discipline:*** There shouldn't be any bulk handling of funds, misuse etc. Proper discipline should be practiced in matters relating to finance, its flow and control. This can be done through various techniques such as budgeting, fund flow statements etc. In recent scenario country has witnessed different types of scandals, financial indiscipline, window dressing etc. Hence it has become an obligatory responsibility of a company to have financial discipline through various financial management techniques to uplift the dignity of the company and also it is moral responsibility of corporate.

Distinguish between Profit Maximization and Wealth Maximization

Profit Maximization	Wealth Maximization
1. Profit cannot be ascertained well in advance to express the probability of return. The term profit has no clear meaning.	1. There is no vagueness in wealth maximization goal. It represents the value of benefits minus the cost of investment.
2. The executive or the decision maker may not have enough confidence in the estimates of future returns so he does not attempt to maximize further.	2. It is argued that a firm's goal cannot be, to maximize profits but to attain a certain level or share of the market or certain level of sales.
3. The risk variations and related capitalization rate is not considered in the concept of profit maximization.	3. Inwealth maximization, it is considered that there should be balance between expected return and risk.
4. The goal of profit maximization is considered as narrow outlook.	4. The goal of wealth maximization is considered as broad outlook.
5. It ignores the interests of the community.	5. Its objective is to enhance the shareholders wealth.
6. The criterion of profit maximization ignores the time value factor for the profits of a project.	6. Wealth maximization concept fully considers the time value factor of cash inflows.

APPROACHES OF FINANCIAL MANAGEMENT

Financial management has undergone significant changes over the years. So as the role of finance manager. The approaches are classified into:

A. Traditional Approach

In traditional approach, the role of financial management is limited to raising and administering of funds needed by the business enterprises to meet their financial needs. It generally covers the following areas:

i) Management of funds from financial institutions.

ii) Arrangement of funds through financial instruments such as shares, bonds, debentures etc.

iii) Administering of funds.

Thus the role of finance manager is limited to raising the funds externally. He is expected to keep accurate financial records, prepare reports on the company's status.

The traditional approach evolved during 1920 confined to dominate, later in 1950's it started to be severely criticized on account of the following reasons.

(i) It ignored balancing of funds for routine problems in an enterprise.

(ii) It ignored non corporate enterprises.

(iii) No emphasis made on allocation of funds.

This approach was concentrated with the raising and administering of funds. It treated finance from the viewpoint of outsiders viz., bankers, investors, etc., It completely ignored the viewpoint of those who had to take internal financing decisions. This approach emphasized on the problems faced by long term financing but ignored short term finance or working capital.

B. Modern Approach

According to modern concept, financial management is concerned with both acquisitions and allocation of funds as well. The modern approach is an analytical way of looking at the financial problems of an organization. It relates to broad areas of financial management like funds requirement decision, financing decision, investment decision and dividend decision.

An existing modern theory of financial management is expressly concerned with the relation between profitability and the volume of capital used, indicating clear shift from controlling the sources and application of funds to the function of efficient and effective use of funds.

Finance manager should be able to perform decisions by allocating the total funds required by an organization and provision of funds at the right time. Apart from this, finance manager is also involved in evaluating different investment proposals. Eventually, the dividend policies decisions will reflect the profits earned by an organization which has to be paid to its shareholders. The modern approach in finance is of decision making related to various facets of financial planning and control.

A'S OF FINANCIAL MANAGEMENT

1. Anticipating financial requirements

Financial needs can be anticipated by forecasting expected funds for a business and recording their financial implications. The finance manager anticipates the financial needs by consulting and collection of documents such as:

1. Cash budget which is essentially a cash flow statement.
2. A Proforma of income statement summarizing sales, other costs, taxes and net income for the period.
3. A Proforma of balance sheet showing the assets and liabilities during the forecast period and
4. A statement of sources and uses of funds showing where the funds, to operate the business will come from and how they will be absorbed during the period.

2. Acquiring financial resources

It refers to when, where and how to obtain the funds which a business needs. Funds should be acquired well before the need for them is actually felt. The finance manager should know how to tap different sources of funds both short term and long term. At a given point of time, generating different financial sources may vary significantly according to the terms and conditions, size and strength of the borrowing corporation. The financial image of a business has to be improved in appropriate financial circles which are primarily responsible for supplying finance.

3. Allocating funds in Business

Investing funds in the best plan of assets in a business is called allocation of funds. Assets are balanced by weighing their profitability against their liquidity. Profitability refers to the earning of profits. Liquidity means closeness to money. The finance manager should also be careful in controlling funds between over and under financing. This primary financial responsibility from the owner's viewpoint may be to maximize value. To do so, he has to preserve the continuity of the flow of funds so that no essential decision of the top management is frustrated for the lack of purchasing power.

4. Administering the allocation of funds

Once funds are allocated on various investment opportunities, it is the basic responsibility of the finance manager to watch the performance of each rupee that has been invested. A close supervision will ensure continuous flow of funds as per the requirements of the organization. This will help the management to increase is efficiency by reducing the cost of operations and earn fair amount of profits out of those investments.

5. Analyzing the performance of finance

Once funds are administered, the finance manager should continuously analyze the performance of finance by comparing the actual with standards. The cost of each financial decision and returns of each investment must be analyzed. Wherever deviations are found necessary steps of strategies are to be adopted to overcome such events. This helps in achieving liquidity of a business unit.

6. Accounting and reporting to the management

The finance manager has to advice and supply information about the performance of finance to the top management. He is also responsible for maintaining up to date records of the performance of financial decisions. The finance manager will have to keep all assets intact, which is necessary to conduct its business. It is also necessary for the finance manager to ensure that sufficient funds are available for the smooth conduct of business. Liquidity and profitability has to be given significance while considering management of funds. Financial management is concerned with many responsibilities which are the main thrust of a business enterprise. Although a business failure may not always be the result of financial failures, but financial failures do lead to business failures. Hence accounting and reporting of the performance of finance is an important aspect of financial management.

FINANCIAL DECISIONS

Financial decisions refer to the decisions concerning financial matters of a business concern. There are many kinds of financial management decisions that the firm makes in pursuit of maximizing shareholder's wealth, viz, kind of assets to be acquired, pattern of capitalization, distribution of firm's income.

MAJOR FINANCIAL DECISIONS

Financial decision can be divided into following catagories:

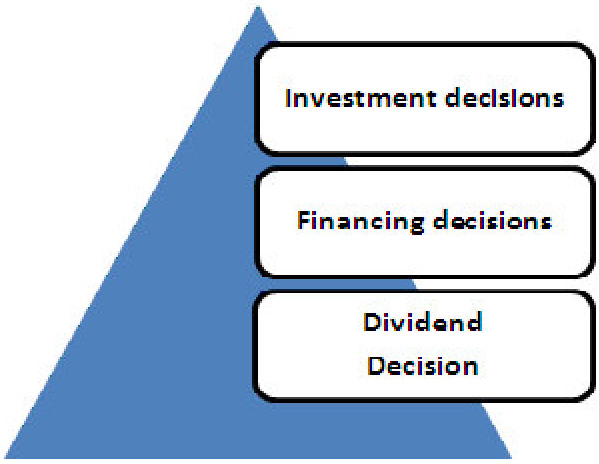


Fig: *Types of Financial Decision*

1. Investment Decisions

Investment decisions is referred to the activities of deciding the pattern of investments. It covers both short term as well as long term investment, nothing but fixed assets and the current assets. Long term investment decision is about the allocation of capital to investment projects whose benefits accrue in the long run, where as short term investment decision is about allocation of funds as among cash and receivables and inventory etc. The funds invested in assets should also yield maximum return to the business concern.

Hence, it is a risky decision where finance manager has to take maximum care in selecting the areas of investment. As the future is uncertain the returns expected must cover both risk as well as the uncertainties. The selection of proposal can be evaluated by using certain techniques such as costing technique, capital budgeting, CVP analysis etc., before making a final decision on the investment avenues.

Investment decisions pertain to the determination of total amount of assets to be held in the firm. It is the most important decision since funds involve cost and are available in a limited quantity. Its proper utilization is necessary to achieve the goal of wealth maximization.

Investment decisions can be classified into two categories:

(i) Long term investment decisions (ii) Short term investment decisions

(i) Long term investment decisions

The long term investment decisions is referred to as the capital budgeting decisions. Capital budgeting is the process of making investment decisions in capital expenditure. These are expenditure, the benefit of which is expected to be received over a long period of time. The finance manager has to assess the profitability of various projects before committing funds. The investment proposal should be evaluated in terms of profitability, cost involved and risk associated with the project.

(ii) Short term investment decisions

They are also called as working capital decisions. It is related to allocation of funds towards current assets. Short term decisions ensure sound liquidity position.

2. Financing Decisions

It is another important decision where a business concern has to take maximum care in financing different proposals. The profitability of the business depends upon the appropriate blend of finance with debt and equity. The instruments that are to be selected must aim at maximizing returns to the investors and to protect the interest to the creditors. Decision with regard to the combination of the capital structure is vital.

The finance manager must decide the mode of raising the funds to meet the firm's investment requirement. He has to select such sources which will minimize the cost of capital and maximize the profitability. The debt equity ratio should be fixed in such a way that it helps in maximizing profitability of the concern. Raising of more debt will involve fixed interest. It may help in increasing the return on equity but will also enhance risk. Therefore a finance manager has to strike a balance between debt and equity

The finance manager should have an alternative of mobilizing the funds through:

(i) Equity.

(ii) Equity plus debt.

(iii) Equity plus preference share.

(iv) Equity plus preference share plus debt.

Each opportunity must be evaluated with its benefits. If a company opts only for equity it loses its tax benefits. If it opts for both debt and equity proper balance must be maintained between the two. For instance, a finance manager would like to have more debt and less equity. This may bring in more dividends to shareholders and results in increase price of the share in the market, may lead to wealth maximization.

But the cost of borrowed funds may increase the risk of the business concern. Most of the earnings will be used only on the payment of interest on the borrowed funds which is also called as 'financial risk'. Hence the finance manager has to take a risky and tactful decision regarding the capital structure.

3. Dividend Decisions

The term dividend decisions refers to quantum of profits to be distributed among shareholders and the quantum of profits to be retained earnings. The higher rate of dividend may increase the market price of the shares and thus maximize the wealth of the shareholders.

A dividend decisions are the next major financial decision. The finance manager must decide whether the firm should distribute all profits or retain them or distribute a portion and retain the balance. The portion of the profit distributable as dividends is called the dividend payment ratio and the balance is termed as retained earnings. The distribution of profit as dividends should fulfill the desires of equity shareholders. Maintenance of stable dividend rate over the period attracts the investors. Hence a finance manager must take a careful decision in distribution of profits, keeping in view the psychology of investors who wish to get a better yield on the investment.

FINANCE MANAGER

Finance Manger is a person who heads the department of finance. He performs important activities in connection with each of the general functions of management. His focus is on profitability of the firm.

Finance manager is a person who manages the activities pertaining to financial activities and accountable for an organization .His primary focus is on profitability. Every business, irrespective of its size should have a financial manager who has to make decisions on the allocation and use of money to various departments. i.e., finance manger should anticipate financial needs; acquire financial resources and allocate funds to various departments of the business. Since finance is an integral part of top management activity, his decision plays a major role in overall development of the business.

FUNCTIONS OF FINANCE MANAGER

The following are the important functions of finance manager:

1. ***Estimation of the financial requirements:*** The requirement of finance in a business is perpetual and it is required in all stages of business cycle from initial stage to decline stage. Finance manager plans the required funds to meet capital expenditure and revenue expenditure i.e., Financial Manager should anticipate and estimate the total financial requirements of the firm i.e., preparing sound financial plan (Financial forecasting and Planning).
2. ***Selection of the right sources of funds:*** After estimating the funds required for business, the finance manager has to select the right source of funds at the right

time at right cost i.e., balancing the own capital (equity) and borrowed capital (debt) for the best advantage of the firm.

3. ***Allocation of funds:*** After mobilizing the total funds required for a firm, financial manager has to distribute the funds to capital and revenue expenditure. The evaluation of different proposals should be made before making a final decision on investment. Each investment should yield maximum benefits resulting in wealth maximization of the firm. Therefore Financial Manger has to allocate the available funds in the profitable avenues i.e. judicious fund allocation.

4. ***Analysis and interpretation of financial performance:*** It is the other task of finance manger which should not be ignored. He has to monitor the performance of each portfolio that can be measured in terms of profitability and returns on investment. Ratio analysis and comparison of actual with standards, aid financial manager to have maximum control over the entire operations of the business i.e. continuous financial appraisal activity.

5. ***Working capital management:*** Working capital refers to short term investments in business such as cash receivables, inventories etc. It can be said that working capital management is the nervous system of finance. Therefore, Finance manger has to administrate the activities of working capital management

6. ***Profit planning and control:*** Profit is the purpose of any business. It acts as a tool for evaluating the performance of financial management. It is determined in terms of volume of revenue generated and expenditure incurred in the business. Profit maximization is considered as an important objective of a business .Profit planning and control directly impacts the declaration of dividend, creation of surpluses, taxation, etc. Break-evenanalysis and cost-volume profit analysis are the tools required in profit planning and control. Hence, Finance Manger has focus on profit planning and control.

7. ***Fair returns to the investors:*** Returns are the profits available to investors. Equity share holders generally expect fair amount of profit and capital appreciation for their investment. It is also an economic obligation on the part of the organization to protect the interest of shareholders. This can be a motivating factor for investors in to invest in securities. Hence, a business firm must guarantee regular income to the shareholders.

10. ***Maintaining liquidity:*** Another important task of financial manager is to maintain liquidity, because liquidity of a firm increases the borrowing capacity of the firm.

ROLE OF A FINANCE MANAGER

Financial activities of a firm are vital part of an organization and it is complex. In order to take care of these activities a finance manager performs requisite financial activities. A finance manager is a person who is responsible for all the important financial functions of an organization. The decisions taken by finance manager will affect the profitability, growth and goodwill of the firm.

Following are the main functions of a finance manager:

1. Raising of Funds

In order to meet the obligation of the business, it is important to have enough cash and liquidity. A firm can raise funds by the way of equity and debt. It is the responsibility of a finance manager to decide the ratio between debt and equity. It is important to maintain a trade-off between equity and debt.

2. Allocation of Funds

Once the funds are raised through different channels, the next important function is to allocate the funds. The funds should be allocated in such a manner that they are optimally used. In order to allocate funds in the best possible manner, the following points must be considered.

a) The size of the firm and its growth capability.

b) Status of assets whether they are long term or short term.

c) Mode by which the funds are raised.

These financial decisions directly and indirectly influence other managerial activities. Hence formation of a good assets mix and proper allocation of funds is one of the most important activities.

3. Profit Planning

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

4. Understanding Capital Markets

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

As financial activities of a firm is a vital part of an organization, financial manager has to be careful in decision making pertaining to financial activities as it will impact the profitability of an organization and goodwill.