CHAPTER - 1 Scope and Objective of Financial Management

1.1 INTRODUCTION

For the purpose of starting any new business/venture, an entrepreneur goes through the following stages of decision making:-

Stage 1	Stage 2	Stage 3	Stage 4
Decide which assets to buy. (premises, machinery, Equipment etc.)	Determining what is total investment (since assets cost money) required for buying assets.	To determine how much cash he would need to run the daily operations (payment for raw material, salaries, wages etc.). This is also defined as Working Capital requirement.	To decide what all sources, does the entrepreneur need to tap to finance the total investment (assets and working capital). The sources could be Share Capital (Including Entrepreneur's own funds) or Borrowing from Banks or Investment from Financial Institutions etc.

While deciding how much to take from each source, the entrepreneur would keep in mind the cost of capital for each source (Interest/Dividend etc.).

As an entrepreneur he would like to keep the cost of capital low.

Any business enterprise requiring money and the 3 key questions being enquired into

1. Where to get the money from? (Financing Decision)
2. Where to invest the money? (Investment Decision)
3. How much to distribute amongst shareholders to keep them satisfied? (Dividend Decision)

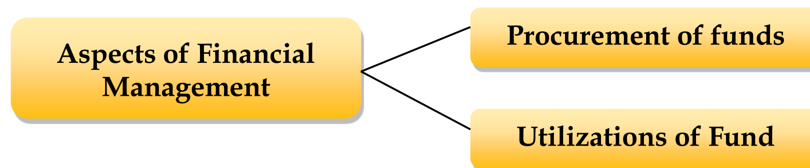
1.2 MEANING OF FINANCIAL MANAGEMENT

- Financial management is concerned with **efficient acquisition (financing) and allocation** (investment in assets, working capital etc.) of funds with an objective to make profit (dividend) for owners.
- It is that **managerial activity which is concerned with planning and controlling of the firm's financial resources.**
- It is concerned with acquiring, financing and managing assets to accomplish the overall goal of a business enterprise (mainly to maximise the shareholder's wealth).
- It can also be defined as planning for the future of a business enterprise to ensure a positive cash flow.
- Some experts also refer to financial management as the science of money management.
- Financial Management comprises of forecasting, planning, organizing, directing, co-ordinating and controlling of all activities relating to acquisition and application of the financial resources of an undertaking in keeping with its financial objective.
- According to Phillippatus, "Financial Management is concerned with the managerial decisions that result in the acquisition and financing of short term and long term credits for the firm."
- Focus of financial management is to address three major financial decision areas namely, **investment, financing and dividend decisions.**

TWO BASIC ASPECTS OF FINANCIAL MANAGEMENT

There are two basic aspects of financial management viz.,

- procurement of funds
- an effective use of these funds to achieve business objectives.



1.2.1 PROCUREMENT OF FUNDS

Some of the **sources for funds** for a business enterprise are:

- Funds procured from different sources have different characteristics in terms of risk, cost and control.
- The cost of funds should be at the minimum level for that a proper balancing of risk and control factors must be carried out.

Another key consideration in choosing the source of new business finance is to strike a balance between equity and debt to ensure the funding structure suits the business.

Let us discuss some of the sources of funds (discussed in detail in later chapters):

a) **Equity:**

- ☑ The funds raised by the issue of equity shares are the best from the risk point of view for the firm.
- ☑ There is no question of repayment of equity capital except when the firm is under liquidation.
- ☑ Equity capital is usually the most expensive source of funds. This is because the dividend expectations of shareholders are normally higher than prevalent interest rate and also because dividends are an appropriation of profit, not allowed as an expense under the Income Tax Act.
- ☑ Issue of new shares to public may dilute the control of the existing shareholders.

b) **Debentures:**

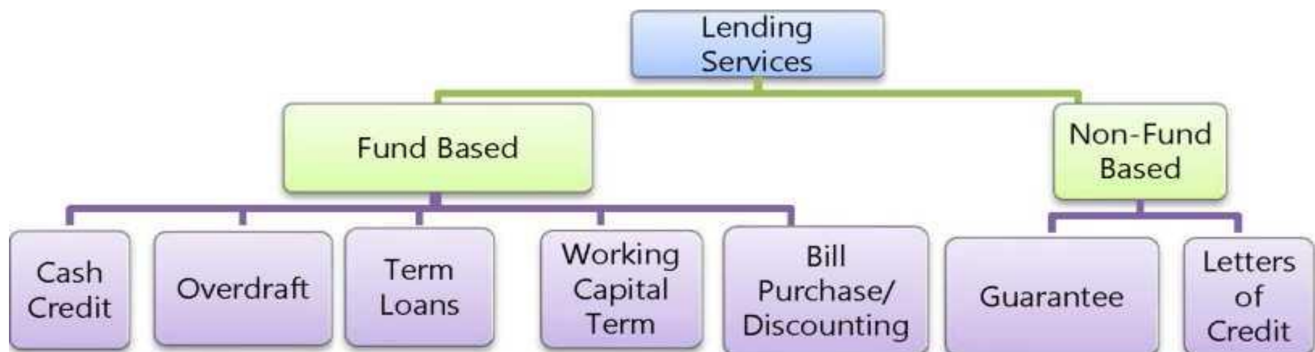
- ☑ Debentures are comparatively cheaper than the shares because of their tax advantage.
- ☑ The interest the company pays on a debenture is tax deductible expense.
- ☑ Interest on debenture loans must be paid irrespective of profitability.
- ☑ Debentures entail a high degree of risk since they have to be repaid as per the terms of agreement.

c) **Funding from Banks:**

- ☑ Commercial Banks play an important role in funding of the business enterprises.
- ☑ They support businesses in their routine activities (deposits, payments etc).
- ☑ They play an important role in meeting the long term and short term needs of a business

enterprise.

- ☑ Different lending services provided by Commercial Banks are depicted as follows:-



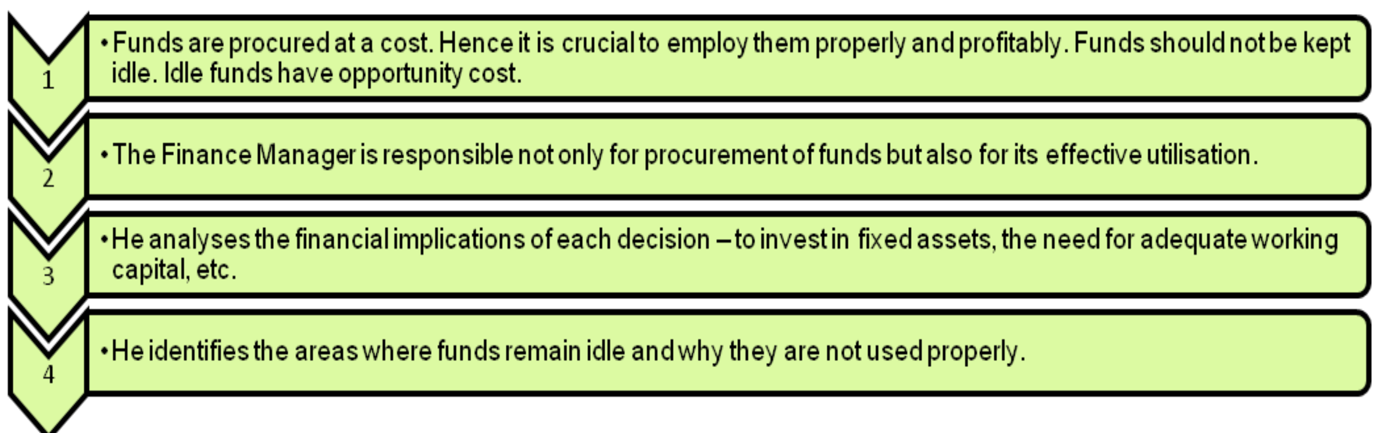
d) International Funding:

- ☑ A businessenterprise has options to raise capital from International markets also.
- ☑ Foreign Direct Investment (FDI) and Foreign Institutional Investors (FII) are two major routes for raising funds from foreign sources besides ADR's (American depository receipts) and GDR's (Global depository receipts).

e) Angel Financing :

- ☑ Angel Financing is a form of an equity-financing where an angel investor is a wealthy individual who provides capital for start-up or expansion, in exchange for an ownership/equity in the company.
- ☑ Angel investors have idle cash available and are looking for a higher rate of return than what is given by traditional investments.
- ☑ Typically, angels, as they are known as, will invest around 25 to 60 per cent to help a company get started.
- ☑ This source of finance sometimes is the last option for startups which doesn't qualify for bank funding and are too small for venture capital financing.

1.2.2 EFFECTIVE UTILISATION OF FUNDS



1.3 EVOLUTION OF FINANCIAL MANAGEMENT

3 STAGES

➡ TRADITIONAL PHASE

- During this phase, financial management was considered necessary only during occasional events such as takeovers, mergers, expansion, liquidation, etc.
- Also, when taking financial decisions in the organisation, the needs of outsiders (investment bankers, people who lend money to the business and other such people) to the business was kept in mind.
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MODEM PHASE

- Modem phase is still going on. The scope of financial management has greatly increased now.
- It is important to carry out financial analysis for a company. This analysis helps in decision making.
- During this phase, many theories have been developed regarding efficient markets, capital budgeting, option pricing, valuation models and also in several other important fields in financial management.

1.4 FINANCE FUNCTIONS / FINANCE DECISION

Value of a firm will depend on various finance functions/decisions. It can be expressed as :

$$V = f(I,F,D).$$

The finance functions are divided into long term and short term functions/decisions

Long term Finance Function Decisions.

a) **Investment decisions (I):**

- ☑ These decisions relate to the **selection of assets in which funds will be invested by a firm**.
- ☑ Long term funds are used in a project for various fixed assets and also for current assets.
- ☑ The investment of funds in a project has to be made after careful assessment of the various projects through capital budgeting.
- ☑ A part of long term funds is also to be kept for financing the working capital requirements.
- ☑ Asset management policies are to be laid down regarding various items of current assets.

b) **Financing decisions (F):**

- ☑ These decisions relate to **acquiring the optimum finance** to meet financial objectives and seeing that fixed and working capital are effectively managed.
- ☑ The financial manager needs to possess a good knowledge of the sources of available funds and their respective costs and needs to ensure that the company has a sound capital structure, i.e. a proper balance between equity capital and debt.
- ☑ Financing decisions also call for a good knowledge of evaluation of risk, e.g. excessive debt carried high risk for an organization's equity because of the priority rights of the lenders.

c) **Dividend decisions(D):**

- ☑ These decisions relate to the **determination as to how much and how frequently cash can be paid out of the profits** of an organisation as income for its owners/shareholders.
- ☑ The dividend decision thus has two elements - the amount to be paid out and the amount to be retained to support the growth of the organisation.
- ☑ The level and regular growth of dividends represent a significant factor in determining a profit-making company's market value, i.e. the value placed on its shares by the stock market.

Short- term Finance Decisions/Function.

Working capital Management (WCM) : Generally short term decision are reduced to management of current asset and current liability (i.e., working capital Management)

1.5 IMPORTANCE OF FINANCIAL MANAGEMENT

Money is to an enterprise, what oil is to an engine.

It is the key to successful business operations.

Without proper administration of finance, no business enterprise can reach at its full potentials for growth and success.

Some of the tasks that financial management involves:-

- **Taking care** not to over-invest in fixed assets
- **Balancing** cash-outflow with cash-inflows
- **Ensuring** that there is a sufficient level of short-term working capital
- **Setting** sales revenue targets that will deliver growth
- **Increasing** gross profit by setting the correct pricing for products or services
- **Controlling** the level of general and administrative expenses by finding more cost-efficient ways of running the day-to-day business operations, and
- **Tax planning** that will minimize the taxes a business has to pay.

1.6 SCOPE OF FINANCIAL MANAGEMENT

Financial management is mainly concerned with acquisition and use of funds by an organization.

Based on financial management guru Ezra Solomon's concept of financial management, following aspects are taken up in detail under the study of financial management:

a) **Determination** of size of the enterprise and determination of rate of growth.

b) **Determining** the composition of assets of the enterprise.

c) **Determining** the mix of enterprise's financing i.e. consideration of level of debt to equity, etc.

d) **Analysis, planning and control** of financial affairs of the enterprise.

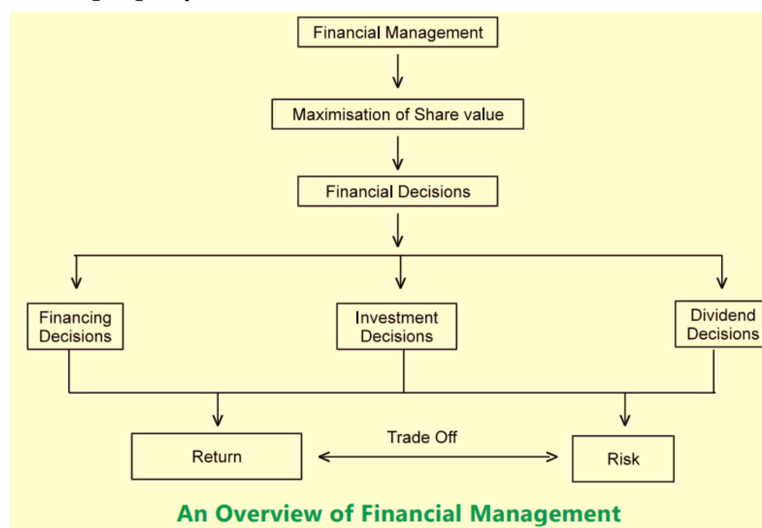
The scope of financial management has undergone changes over the years.

The given figure depicts the overview of the scope and functions of financial management.

It also gives the interrelation between the market value, financial decisions and risk return trade off.

The finance manager, in a bid to maximize shareholders' wealth, should strive to maximize returns in relation to the given risk; he should seek courses of actions that avoid unnecessary risks.

To ensure maximum return, funds flowing in and out of the firm should be constantly monitored to assure that they are safeguarded and properly utilized.



An Overview of Financial Management

1.7 OBJECTIVES OF FINANCIAL MANAGEMENT

What is an "Objective"

An objective refers to the purpose, target, aim or goal.

Why is an objective necessary?

- It will help us to select between alternatives available.
- It provides a benchmark against which performance can be evaluated.
- It would help in synchronisation of efforts.

The two main objectives of financial management are:

1.7.1 PROFIT MAXIMISATION

The finance manager has to make his decisions to maximise the profits of the concern. Profit Maximisation, as an objective has the following advantages and limitations.

Advantages	Disadvantages / Limitations
Must for survival of business, else, Capital is lost.	**The term "Profit" is vague and ambiguous**. It conveys different meaning to different people. Profit may be in short term or long term period; it may be total profit or rate of profit. It may be profit before tax or profit after tax.
Essential for growth and development of business.	**Higher the profits, higher the risks involved.** If profit maximisation is the only goal, then the risk factor is altogether ignored. The finance manager will accept highly risky proposal if they give high profits.
Impact on society through factor payments.	**Ignores time pattern of return.** Costs and returns are considered in absolute terms without considering the timing of return. Proposal A may give a higher amount of profits as compared to proposal B, yet if the returns begin to flow say 10 years later, proposal B may be preferred which may have lower overall profit but the returns flow is more early and quick.
Profit is regarded as the yard-stick for judging the economic efficiency of a firm.	**Profit maximisation as an objective is too narrow. Ignores social and moral obligations of business.** It fails to take into account the obligations to various interests of workers, consumers, society as well as ethical trade practices. Profit maximisation at the cost of social and moral obligations is a short sighted policy. For example : Child Labour, Pollution, Corruption, Adulteration
Profit-making firms only can pursue social obligations	**Profits calculations can be influenced by accounting policy.**

1.7.2 Wealth / Value Maximisation

Shareholders wealth are the result of cost benefit analysis adjusted with their timing and risk i.e. time value of money.

So,

Wealth = Present value of benefits - Present Value of Costs

Benefits are measured by the finance manager are in terms of cash flow.

Financing decisions are based on cash flows and not on Accounting profit.

So for measuring and maximising shareholders wealth finance manager should follow:

- **Cash Flow approach not Accounting Profit**
- **Cost benefit analysis**
- **Application of time value of money.**

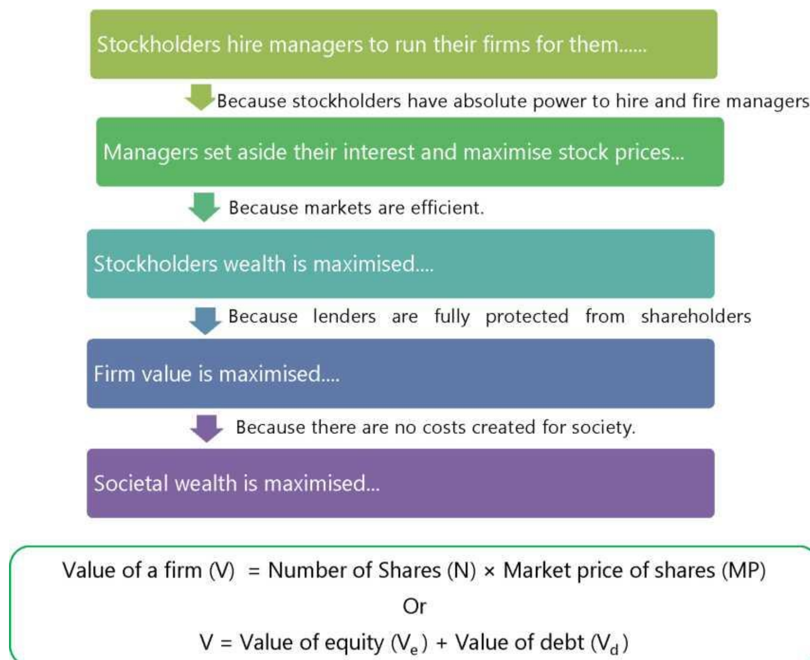
How do we measure the value/wealth of a firm?

Value of a firm is represented by the market price of the company's common stock.

The market price of a firm's stock represents the focal judgment of all market participants as to what the value of the particular firm is.

It takes into account present and prospective future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock.

The market price serves as a performance index or report card of the firm's progress. It indicates how well management is doing on behalf of stockholders.



Some of the other goals a business enterprise may follow are:-

- Achieving a higher growth rate
- Attaining a larger market share
- Gaining leadership in the market in terms of products and technology
- Promoting employee welfare
- Increasing customer satisfaction
- Improving community life, supporting education and research, solving societal problems, etc.

Though, the above goals are important but the primary goal remains to be wealth maximization, as it is critical for the very existence of the business enterprise.

1.8 CONFLICTS IN PROFIT VERSUS VALUE MAXIMISATION PRINCIPLE

Profit maximization can be achieved in the short term at the expense of the long term goal, that is, wealth maximization.

For example, a costly investment may experience losses in the short term but yield substantial profits in the long term.

Also, a firm that wants to show a short term profit may, for example, postpone major repairs or replacement, although such postponement is likely to hurt its long term profitability.

The wealth maximization objective is generally in accord with the interests of the various groups such as owners, employees, creditors and society, and thus, it may be consistent with the management objective of survival.

Wealth maximization is a better objective. Where the time period is short and degree of uncertainty is not great, wealth maximization and profit maximization amount to essentially the same.

The table below highlights some of the advantages and disadvantages of both profit maximization and wealth maximization goals:-

Goal	Objective	Advantages	Disadvantages
Profit Maximization	Large amount of profits	(i) Easy to calculate profits (ii) Easy to determine the link between financial decisions and profits.	(i) Emphasizes the short term gains (ii) Ignores risk or uncertainty (iii) Ignores the timing of returns (iv) Requires immediate resources.
Shareholders Wealth Maximisation	Highest market value of shares.	(i) Emphasizes the long term gains (ii) Recognises risk or uncertainty (iii) Recognises the timing of returns (iv) Considers shareholders' return.	(i) Offers no clear relationship between financial decisions and share price. (ii) Can lead to management anxiety and frustration.

PROBLEM : 1

Profit maximization does not consider risk or uncertainty, whereas wealth maximization considers both risk and uncertainty. Suppose there are two products, X and Y, and their projected earnings over the next 5 years are as shown below:

Year	Product X	Product Y
1.	10,000	11,000
2.	10,000	11,000
3.	10,000	11,000
4.	10,000	11,000
5.	10,000	11,000
	50,000	55,000

A profit maximization approach would favour product Y over product X. However, if product Y is more risky than product X, then the decision is not as straightforward as the figures seem to indicate. It is important to realize that a trade-off exists between risk and return. Stockholders expect greater returns from investments of higher risk and vice-versa. To choose product Y, stockholders would demand a sufficiently large return to compensate for the comparatively greater level of risk. (Study Material)

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1.9 ROLE OF FINANCE EXECUTIVE

The finance executive of an organisation plays an important role in the company's goals, policies, and financial success. His responsibilities include:

a) **Financial analysis and planning:** Determining the proper amount of funds to employ in the firm, i.e. designating the size of the firm and its rate of growth.

b) **Investment decisions:** The efficient allocation of funds to specific assets.

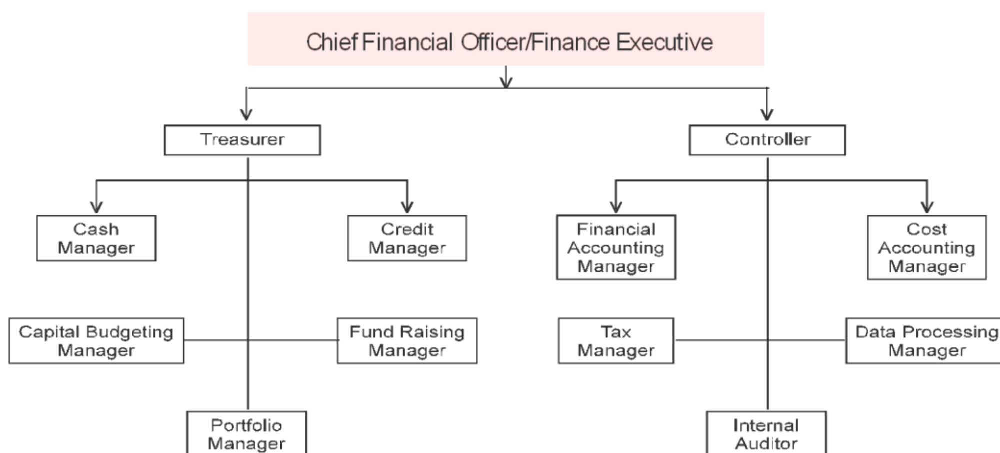
c) **Financing and capital structure decisions:** Raising funds on favourable terms as possible i.e. determining the composition of liabilities.

d) **Management of financial resources** (such as working capital).

e) **Risk management:** Protecting assets.

TYPICAL ORGANISATION CHART DEPICTING THE FINANCE FUNCTION

The figure below shows how the finance function in a large organization may be organized.



Organisation of Finance Function

1.9.1 ROLE OF FINANCE EXECUTIVE IN TODAY'S WORLD VIS-A-VIS IN THE PAST

Today, the role of chief financial officer, or CFO, is no longer confined to accounting, financial reporting and risk management.

It's about being a strategic business partner of the chief executive officer, or CEO.

What a CFO used to do?	What a CFO now does?
Budgeting	Budgeting
Forecasting	Forecasting
Accounting	Managing M&As
Treasury (cash management)	Profitability analysis (for example, by customer or product)
Preparing internal financial reports for management.	Pricing analysis
Preparing quarterly, annual filings for investors.	Decisions about outsourcing
Tax filing	Overseeing the IT function.

Tracking accounts payable and accounts receivable.	Overseeing the HR function.
Travel and entertainment expense management.	Strategic planning (sometimes overseeing this function).
	Regulatory compliance.
	Risk management.

1.10 FINANCIAL DISTRESS AND INSOLVENCY

- There are various factors like price of the product/ service, demand, price of inputs e.g. raw material, labour etc., which is to be managed by an organisation on a continuous basis.
- Proportion of debt also need to be managed by an organisation very delicately.
- Higher debt requires higher interest and if the cash inflow is not sufficient then it will put lot of pressure to the organisation.
- Both short term and long term creditors will put stress to the firm.
- If all the above factors are not well managed by the firm, it can create situation known as distress, so financial distress is a position where Cash inflows of a firm are inadequate to meet all its current obligations.
- Now if distress continues for a long period of time, firm may have to sell its asset, even many times at a lower price.
- Further when revenue is inadequate to revive the situation, firm will not be able to meet its obligations and become insolvent.
- So, **insolvency basically means inability of a firm to repay various debts and is a result of continuous financial distress.**

1.11 RELATIONSHIP OF FINANCIAL MANAGEMENT WITH RELATED DISCIPLINES

As an integral part of the overall management, financial management is not a totally independent area.

It draws heavily on related disciplines and areas of study namely

- economics,
- accounting,
- production,
- marketing and
- quantitative methods.

Some of the relationships are being discussed below:

1.11.1 Financial Management and Accounting

- Accounting is an important input in financial decision making.
- Financial accounting generates information relating to operations of the organisation.
- The outcome of accounting is the financial statements such as balance sheet, income statement, and the statement of changes in financial position.
- The information contained in these statements and reports helps the financial managers in understanding the past performance and future directions of the organisation.

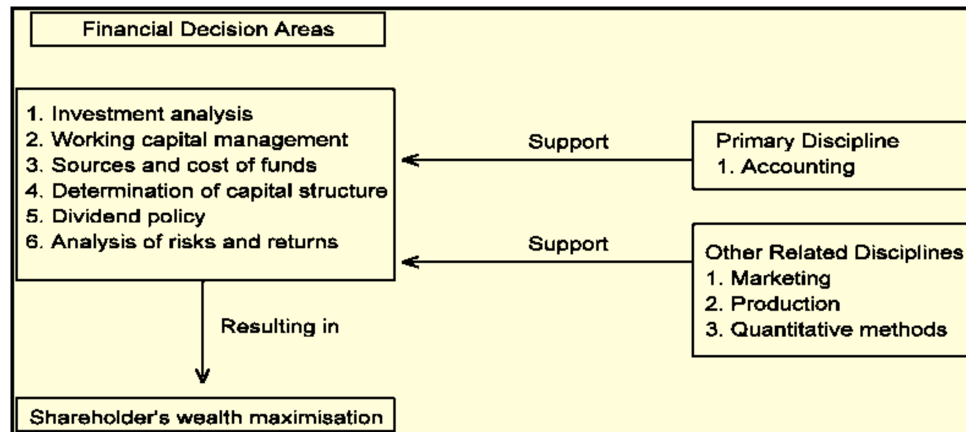
DIFFERENCES BETWEEN FINANCIAL MANAGEMENT AND FINANCIAL ACCOUNTING

S. N.	Financial Accounting	Financial management
1	**Decision - making**	
	An accountant's job is mainly concerned with **maintaining financial records, ensuring proper classification of transactions** under assets, liabilities, income and expense groups, preparing Financial statements, etc.	The financial manager uses these data for financial decision making. Finance manager handles the task of **procurement and optimum allocation of funds,** keeping in mind risk, cost and control aspects. Financial management begins where accounting ends.
2	***Hierarchy level***	
	Accounting is performed at **medium and lower level** in the organisational hierarchy.	Financial management is performed at **top level** in the organisation.
3	***Time period covered***	
	It deals with **past events**, i.e., the transactions which have already occurred.	It is **future oriented**. It deals with estimated transactions.
4	***Accrual Vs Cash-flow method***	
	Accounts are maintained on **accrual basis.** Revenue is recognised at the point of sale and not when collected and expenses are recognised when they are incurred rather than when actually paid.	Finance manager uses **cash basis** since he decides about availability of funds not only for present but also for future. The revenues are recognised only when cash is actually received (i.e. Cash inflow) and expenses are recognised on actual payment (i.e. Cash outflow).
5	***Function***	
	It is more related to **measurement of funds.**	It is more related **management of funds.**

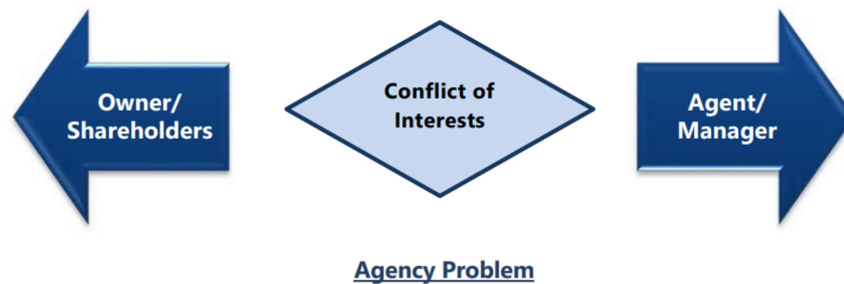
1.11.2 Financial Management and Other Related Disciplines

Function	Investment Aspect	Decision-Making Aspect
Finance and Production	This includes decisions on investment in ☑ inventories, ☑ Purchase of new asset ☑ stock levels, ☑ purchase policies etc. ☑ Expansion	Decisions such as Make or Buy Components, Retain or Replace Machinery etc. are taken after analysing financial implications thereof.
Finance and Marketing	This includes decisions on ☑ Investment in finished goods inventories. ☑ Advertising ☑ Sales promotion ☑ Credit period	Marketing decisions and strategies such as Credit Granting, Change in Sale Prices to sell additional quantities, acceptance of additional order etc. are taken after analysing their financial impact.
Finance and Personnel	This includes decisions on ☑ capital costs associated with personnel policies ☑ substantial training expenditure, ☑ Recruitment ☑ Promotion ☑ Voluntary Retirement Scheme (VRS)	Investments in HRD are bound to increase in future. Restructuring of pay package, drafting of voluntary retirement schemes, etc. are some major decisions in Human Resource Management.

Impact of Other Disciplines on Financial Management



1.12 AGENCY PROBLEM AND AGENCY COST



Agency Problem

In corporate form of organisation, owners are not active in management, so, there is a separation between owner/ shareholders and managers.

So there is a **principal agent relationship between managers and owners, which is known as Agency Problem**.

Agency Problem is the chances that managers may place personal goals ahead of the goal of owners.

Agency Problem leads to Agency Cost. Agency cost is the additional cost borne by the shareholders to monitor the manager and control their behaviour so as to maximise shareholders wealth.

Generally, Agency Costs are of four types (i) monitoring (ii) bonding (iii) opportunity (iv) structuring.

Addressing the agency problem

The agency problem arises if manager's interests are not aligned to the interests of the debt lender and equity investors.

The agency problem of debt lender would be addressed by imposing negative covenants i.e. the managers cannot borrow beyond a point.

This is one of the most important concepts of modern day finance and the application of this would be applied in the Credit Risk Management of Bank, Fund Raising, Valuing distressed companies.

Agency problem between the managers and shareholders can be addressed if the interests of the managers are aligned to the interests of the share- holders. It is easier said than done.

However, following efforts have been made to address these issues:

- Managerial compensation is linked to profit of the company to some extent and also with the long term objectives of the company.
- Employee is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors.
- Effecting monitoring can be done.

PROBLEM : 2

"The profit maximization is not an operationally feasible criterion. DISCUSS

(May 2018 RTP + Nov. 2018 RTP + May 2020 RTP)

SOLUTION : 2

" The profit maximisation is not an operationally feasible criterion." This statement is true because Profit maximisation can be a short-term objective for any organisation and cannot be its sole objective. Profit maximization fails to serve as an operational criterion for maximizing the owner's economic welfare. It fails to provide an operationally feasible measure for ranking alternative courses of action in terms of their economic efficiency. It suffers from the following limitations:

(a) Vague term: The definition of the term profit is ambiguous. Does it mean short term or long term profit? Does it refer to profit before or after tax? Total profit or profit per share?

(b) Timing of Return: The profit maximization objective does not make distinction between returns received in different time periods. It gives no consideration to the time value of money, and values benefits received today and benefits received after a period as the same.

(c) It ignores the risk factor.

(d) The term maximization is also vague

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PROBLEM : 3

Write short notes on the following:

(a) Functions of Finance Manager.

(b) Inter relationship between investment, financing and dividend decisions.

(May 2019 – RTP + Nov. 2019 RTP + Oct 2019 – MTP – 4 Marks + April 2024 – MTP – 4 Marks)

SOLUTION : 3

(a) Functions of Finance Manager

The Finance Manager's main objective is to manage funds in such a way so as to ensure their optimum utilisation and their procurement in a manner that the risk, cost and control considerations are properly balanced in a given situation. To achieve these objectives the Finance Manager performs the following functions:

(i) **Estimating the requirement of Funds:** Both for long-term purposes i.e. investment in fixed assets and for short-term i.e. for working capital. Forecasting the requirements of funds involves the use of techniques of budgetary control and long-range planning.

(ii) **Decision regarding Capital Structure:** Once the requirement of funds has been estimated, a decision regarding various sources from which these funds would be raised has to be taken. A proper balance has to be made between the loan funds and own funds. He has to ensure that he raises sufficient long term funds to finance fixed assets and other long term investments and to provide for the needs of working capital.

(iii) **Investment Decision:** The investment of funds, in a project has to be made after careful assessment of various projects through capital budgeting. Assets management policies are to be laid down regarding various items of current assets. For e.g. receivable in coordination with sales manager, inventory in coordination with production manager.

(iv) **Dividend decision:** The finance manager is concerned with the decision as to how much to retain and what portion to pay as dividend depending on the company's policy. T rend of earnings, trend of share market prices, requirement of funds for future growth, cash flow situation etc., are to be considered.

(v) **Evaluating financial performance:** A finance manager has to constantly review the financial performance of the various units of organisation generally in terms of ROI Such a review helps the management in seeing how the funds have been utilised in various divisions and what can be done to improve it.

(vi) **Financial negotiation:** The finance manager plays a very important role in carrying out negotiations with the financial institutions, banks and public depositors for raising of funds on favourable terms.

(vii) **Cash management:** The finance manager lays down the cash management and cash disbursement policies with a view to supply adequate funds to all units of organisation and to ensure that there

is no excessive cash.

(viii) **Keeping touch with stock exchange:** Finance manager is required to analyse major trends in stock market and their impact on the price of the company share.

(b) Inter-relationship between Investment, Financing and Dividend Decisions

The finance functions are divided into three major decisions, viz., investment, financing and dividend decisions. It is correct to say that these decisions are interrelated because the underlying objective of these three decisions is the same, i.e. maximisation of shareholders' wealth. Since investment, financing and dividend decisions are all interrelated, one has to consider the joint impact of these decisions on the market price of the company's shares and these decisions should also be solved jointly. The decision to invest in a new project needs the finance for the investment. The financing decision, in turn, is influenced by and influences dividend decision because retained earnings used in internal financing deprive shareholders of their dividends. An efficient financial management can ensure optimal joint decisions. This is possible by evaluating each decision in relation to its effect on the shareholders' wealth.

The above three decisions are briefly examined below in the light of their interrelationship and to see how they can help in maximising the shareholders' wealth i.e. market price of the company's shares.

Investment decision: The investment of long term funds is made after a careful assessment of the various projects through capital budgeting and uncertainty analysis. However, only that investment proposal is to be accepted which is expected to yield at least so much return as is adequate to meet its cost of financing. This have an influence on the profitability of the company and ultimately on its wealth.

Financing decision: Funds can be raised from various sources. Each source of funds involves different issues. The finance manager has to maintain a proper balance between long-term and short-term funds. With the total volume of long-term funds, he has to ensure a proper mix of loan funds and owner's funds. The optimum financing mix will increase return to equity shareholders and thus maximise their wealth.

Dividend decision: The finance manager is also concerned with the decision to pay or declare dividend. He assists the top management in deciding as to what portion of the profit should be paid to the shareholders by way of dividends and what portion should be retained in the business. An optimal dividend pay-out ratio maximises shareholders' wealth.

The above discussion makes it clear that investment, financing and dividend decisions are interrelated and are to be taken jointly keeping in view their joint effect on the shareholders' wealth.

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PROBLEM : 4

Write short notes on the following:

STATE the functions of treasury department. **(Nov. 2019 - RTP)**

SOLUTION : 4

(1) **Cash Management:** It involves efficient cash collection process and managing payment of cash both inside the organisation and to third parties.

There may be complete centralization within a group treasury or the treasury may simply advise subsidiaries and divisions on policy matter viz., collection/payment periods, discounts, etc.

Treasury will also manage surplus funds in an investment portfolio. Investment policy will consider future needs for liquid funds and acceptable levels of risk as determined by company policy.

(2) **Currency Management:** The treasury department manages the foreign currency risk exposure of the company. In a large multinational company (MNC) the first step will usually be to set off intra-group indebtedness. The use of matching receipts and payments in the same currency will save transaction costs. Treasury might advise on the currency to be used when invoicing overseas sales.

The treasury will manage any net exchange exposures in accordance with company policy. If risks are to be minimized then forward contracts can be used either to buy or sell currency forward.

(3) **Fund Management:** Treasury department is responsible for planning andsourcing the company's short, medium and long-term cash needs. Treasury department will also participate in the decision on capital

structure and forecast future interest and foreign currency rates.

(4) **Banking:** It is important that a company maintains a good relationship with its bankers. Treasury department carry out negotiations with bankers and act as the initial point of contact with them. Short-term finance can come in the form of bank loans or through the sale of commercial paper in the money market.

(5) **Corporate Finance:** T reasury department is involved with both acquisition and divestment activities within the group. In addition, it will often have responsibility for investor relations. The latter activity has assumed increased importance in markets where share-price performance is regarded as crucial and may affect the company's ability to undertake acquisition activity or, if the price falls drastically, render it vulnerable to a hostile bid.

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PROBLEM : 5

EXPLAIN agency problem and agency cost. How to address the issues of the same.

(Nov. 2020 – RTP + May 2022 – RTP + April 2021 MTP – 4 Marks + Nov. 2023 RTP)

SOLUTION : 5

Though in a sole proprietorship firm, partnership etc., owners participate in management but in corporates, owners are not active in management so, there is a separation between owner/ shareholders and managers. In theory managers should act in the best interest of shareholders, however, in reality, managers may try to maximise their individual goal like salary, perks etc., so there is a **principal agent relationship between managers and owners, which is known as Agency Problem.** In a nutshell, Agency Problem is the chances that managers may place personal goals ahead of the goal of owners. Agency Problem leads to Agency Cost. Agency cost is the additional cost borne by the shareholders to monitor the manager and control their behaviour so as to maximise shareholders wealth. Generally, Agency Costs are of four types (i) monitoring (ii) bonding (iii) opportunity (iv) structuring

Addressing the agency problem

The agency problem arises if manager's interests are not aligned to the interests of the debt lender and equity investors. The agency problem of debt lender would be addressed by imposing negative covenants i.e. the managers cannot borrow beyond a point. This is one of the most important concepts of modern day finance and the application of this would be applied in the Credit Risk Management of Bank, Fund Raising, Valuing distressed companies.

Agency problem between the managers and shareholders can be addressed if the interests of the managers are aligned to the interests of the shareholders. It is easier said than done.

However, following efforts have been made to address these issues:

- Managerial compensation is linked to profit of the company to some extent and also with the long term objectives of the company.
- Employee is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors.
- Effecting monitoring can be done.

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PROBLEM : 6

"Profit Maximization cannot be the sole objective of a company". COMMENT.

(May 2021 – RTP + May 2022 RTP)

SOLUTION : 6

Following are the reasons due to which Profit Maximization cannot be the sole objective of a company:

(a) **The term profit is vague. It does not clarify what exactly it means.** It conveys a different meaning to different people. For example, profit may be in short term or long-term period; it may be total profit or rate of profit etc.

(b) **Profit maximisation has to be attempted with a realisation of risks involved.** There is a direct

relationship between risk and profit. Many risky propositions yield high profit. Higher the risk, higher is the possibility of profits. If profit maximisation is the only goal, then risk factor is altogether ignored. This implies that finance manager will accept highly risky proposals also, if they give high profits. In practice, however, risk is very important consideration and has to be balanced with the profit objective.

(c) **Profit maximisation as an objective does not take into account the time pattern of returns.** Proposal A may give a higher amount of profits as compared to proposal B, yet if the returns of proposal A begin to flow say 10 years later, proposal B may be preferred which may have lower overall profit but the returns flow is more early and quick.

(d) **Profit maximisation as an objective is too narrow.** It fails to take into account the social considerations as also the obligations to various interests of workers, consumers, society, as well as ethical trade practices. If these factors are ignored, a company cannot survive for long. Profit maximization at the cost of social and moral obligations is a short sighted policy.

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PROBLEM : 7

DISCUSS the points that demonstrates the Importance of good financial management.

(Nov. 2021 - RTP)

SOLUTION : 7

Points that demonstrate the "Importance of good financial management":

- **Taking care** not to over-invest in fixed assets
- **Balancing** cash-outflow with cash-inflows
- **Ensuring** that there is a sufficient level of short-term working capital
- **Setting** sales revenue targets that will deliver growth
- **Increasing** gross profit by setting the correct pricing for products or services
- **Controlling** the level of general and administrative expenses by finding more cost-efficient ways of running the day-to-day business operations, and
- **Tax planning** that will minimize the taxes a business has to pay.

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PROBLEM : 8

STATE Agency Cost. DISCUSS the ways to reduce the effect of it. **(August 2018 – MTP – 4 Marks)**

SOLUTION : 8

Agency Cost: In a sole proprietorship firm, partnership etc., owners participate in management but in corporate, owners are not active in management so, there is a separation between owner/ shareholders and managers. In theory managers should act in the best interest of shareholders however in reality, managers may try to maximise their individual goal like salary, perks etc., so there is a principal-agent relationship between managers and owners, which is known as Agency

Problem. In a nutshell, Agency Problem is the chances that managers may place personal goals ahead of the goal of owners. Agency Problem leads to Agency Cost. Agency cost is the additional cost borne by the shareholders to monitor the manager and control their behaviour so as to maximise shareholders wealth. Generally, Agency Costs are of four types (i) monitoring (ii) bondingopportunity (iv) structuring

However, following efforts can be made to address Agency Cost:

Managerial compensation to be linked to profit of the company to some extent with the long term objectives of the company.

Employees' Stock option plan (ESOP) is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors.

Effective monitoring through corporate governance can be done.

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PROBLEM : 9

DISCUSS the three major decisions taken by a finance manager to maximize the wealth of shareholders.

(Oct. 2018 – MTP – 4 Marks + Oct. 2021 – MTP – 4 Marks)

SOLUTION : 9

To achieve wealth maximization, a finance manager has to take careful decision in respect of:

(i) **Investment decisions:** These decisions relate to the selection of assets in which funds will be invested by a firm. Funds procured from different sources have to be invested in various kinds of assets. Long term funds are used in a project for various fixed assets and also for current assets. The investment of funds in a project has to be made after careful assessment of the various projects through capital budgeting. A part of long term funds is also to be kept for financing the working capital requirements. Asset management policies are to be laid down regarding various items of current assets. The inventory policy would be determined by the production manager and the finance manager keeping in view the requirement of production and the future price estimates of raw materials and the availability of funds.

(ii) **Financing decisions:** These decisions relate to acquiring the optimum finance to meet financial objectives and seeing that fixed and working capital are effectively managed. The financial manager needs to possess a good knowledge of the sources of available funds and their respective costs and needs to ensure that the company has a sound capital structure, e. a proper balance between equity capital and debt. Financing decisions also call for a good knowledge of evaluation of risk, e.g. excessive debt carried high risk for an organization's equity because of the priority rights of the lenders.

(iii) **Dividend decisions:** These decisions relate to the determination as to how much and how frequently cash can be paid out of the profits of an organisation as income for its owners/shareholders. The dividend decision thus has two elements - the amount to be paid out and the amount to be retained to support the growth of the organisation, the latter being also a financing decision; the level and regular growth of dividends represent a significant factor in determining a profit-making company's market value, i.e. the value placed on its shares by the stock market.

All three types of decisions are interrelated, the first two pertaining to any kind of organisation while the third relates only to profit-making organisations, thus it can be seen that financial management is of vital importance at every level of business activity, from a sole trader to the largest multinational corporation.

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PROBLEM : 10.

EXPLAIN as to how the wealth maximisation objective is superior to the profit maximisation objective What is the cost of these sources? **(March 2019 – MTP – 4 Marks + May 2024 RTP)**

SOLUTION : 10

A firm's financial management may often have the following as their obj ectives:

(i) The maximisation of firm's profit.

(ii) The maximisation of firm's value / wealth.

The maximisation of profit is often considered as an implied objective of a firm. To achieve the aforesaid objective various type of financing decisions may be taken. Options resulting into maximisation of profit may be selected by the firm's decision makers. They even sometime may adopt policies yielding exorbitant profits in short run which may prove to be unhealthy for the growth, survival and overall interests of the firm. The profit of the firm in this case is measured in terms of its total accounting profit available to its shareholders.

The value/wealth of a firm is defined as the market price of the firm's stock. The market price of a firm's stock represents the focal judgment of all market participants as to what the value of the particular firm is. It takes into account present and prospective future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock.

The value maximisation objective of a firm is superior to its profit maximisation objective due to following reasons.

(1) The value maximisation objective of a firm considers all future cash flows, dividends, earning per

share, risk of a decision etc. whereas profit maximisation objective does not consider the effect of EPS, dividend paid or any other returns to shareholders or the wealth of the shareholder.

(2) A firm that wishes to maximise the shareholders wealth may pay regular dividends whereas a firm with the objective of profit maximisation may refrain from dividend payment to its shareholders.

(3) Shareholders would prefer an increase in the firm's wealth against its generation of increasing flow of profits.

(4) The market price of a share reflects the shareholders expected return, considering the longterm prospects of the firm, reflects the differences in timings of the returns, considers risk and recognizes the importance of distribution of returns.

The maximisation of a firm's value as reflected in the market price of a share is viewed as a proper goal of a firm. The profit maximisation can be considered as a part of the wealth maximisation strategy.

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PROBLEM : 11

WRITE two main objectives of Financial Management.

(Oct 2021 – MTP – 4 Marks + Nov. 2018 Sugg. Ans – 4 Marks)

SOLUTION : 11

Two main objectives of Financial Management

Profit Maximisation

It has traditionally been argued that the primary objective of a company is to earn profit; hence the objective of financial management is also profit maximisation. This implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximised. Each alternative, therefore, is to be seen as to whether or not it gives maximum profit.

Wealth / Value Maximisation

We will first like to define what is Wealth / Value Maximization Model. Shareholders wealth are the result of cost benefit analysis adjusted with their timing and risk i.e. time value of money.

So, Wealth = Present Value of benefits - Present Value of Costs

It is important that benefits measured by the finance manager are in terms of cash flow. Finance manager should emphasis on Cash flow for investment or financing decisions not on Accounting profit. The shareholder value maximization model holds that the primary goal of the firm is to maximize its market value and implies that business decisions should seek to increase the net present value of the economic profits of the firm.

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PROBLEM : 12

What are the roles of Finance Executive in Modem World? **(May 2018 – Sugg. Ans – 2 Marks)**

SOLUTION : 12

Role of Finance Executive in modern World

Today, the role of Financial Executive, is no longer confined to accounting, financial reporting and risk management. Some of the key activities that highlight the changing role of a Finance Executive are as follows:-

- Budgeting
- Forecasting
- Managing M & As
- Profitability analysis relating to customers or products
- Pricing Analysis
- Decisions about outsourcing
- Overseeing the IT function.

- Overseeing the HR function.
- Strategic planning (sometimes overseeing this function).
- Regulatory compliance.
- Risk management.

*****

PROBLEM : 13

List out the role of Chief Financial Officer in today's World. **(Nov. 2020 Sugg. Ans – 4 Marks)**

SOLUTION : 13

Role of Chief Financial Officer (CFO) in Today's World: Today, the role of chief financial officer, or CFO, is no longer confined to accounting, financial reporting and risk management. It's about being a strategic business partner of the chief executive officer, or CEO. Some of the role of a CFO in today's world are as follows-

- Budgeting
- Forecasting
- Managing M&As
- Profitability analysis (for example, by customer or product)
- Pricing analysis
- Decisions about outsourcing
- Overseeing the IT function.
- Overseeing the HR function.
- Strategic planning (sometimes overseeing this function).
- Regulatory compliance.
- Risk management

*****

PROBLEM : 14

State four tasks involved to demonstrate the importance of good Financial Management.

(Jan 2021 – Sugg Ans – 4 Marks)

SOLUTION : 14

The best way to demonstrate the importance of good financial management is to describe some of the tasks that it involves:

- Taking care not to over-invest in fixed assets
- Balancing cash-outflow with cash-inflows
- Ensuring that there is a sufficient level of short-term working capital
- Setting sales revenue targets that will deliver growth
- Increasing gross profit by setting the correct pricing for products or services
- Controlling the level of general and administrative expenses by finding more cost- efficient ways of running the day-to-day business operations, and
- Tax planning that will minimize the taxes a business has to pay.

*****

PROBLEM : 15

List out the steps to be followed by the manager to measure and maximize the Shareholder's Wealth

(July 2021 Exam. – 2 Marks)

SOLUTION : 15

For measuring and maximising shareholders' wealth, manager should follow:

Cash Flow approach not Accounting Profit

Cost benefit analysis

Application of time value of money.

*****

PROBLEM : 16

Explain in brief the phases of the evolution of financial management **(Dec. 2021 Exam – 2 Marks)**

SOLUTION : 16

Evolution of Financial Management: Financial management evolved gradually over the past 50 years. The evolution of financial management is divided into three phases. Financial Management evolved as a separate field of study at the beginning of the century.

The three stages of its evolution are:

The Traditional Phase: During this phase, financial management was considered necessary only during occasional events such as takeovers, mergers, expansion, liquidation, etc. Also, when taking financial decisions in the organisation, the needs of outsiders (investment bankers, people who lend money to the business and other such people) to the business was kept in mind.

The Transitional Phase: During this phase, the day-to-day problems that financial managers faced were given importance. The general problems related to funds analysis, planning and control were given more attention in this phase.

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PROBLEM : 17

State advantages of Wealth maximisation goals in financial management. **(May 2022 Exam – 2 Marks)**

SOLUTION : 17

Advantages of "Wealth Maximization" goals in Financial Management

(i) Emphasizes the long-term gains.

(ii) Recognises risk or uncertainty.

(iii) Recognises the timing of returns.

(iii) Considers shareholders' return.

*****

PROBLEM : 18

What are the main responsibilities of a Chief Financial Officer of an organisation?

SOLUTION : 18

Responsibilities of Chief Financial Officer (CFO)

The chief financial officer of an organisation plays an important role in the company's goals, policies, and financial success. His main responsibilities include:

(a) Financial analysis and planning: Determining the proper amount of funds to be employed in the firm.

(b) Investment decisions: Efficient allocation of funds to specific assets.

(c) Financial and capital structure decisions: Raising funds on favourable terms as possible, i.e., determining the composition of liabilities.

(d) Management of financial resources (such as working capital).

(e) Risk Management: Protecting assets.

*****

QUESTION : 19

Elucidate the fundamental tasks of treasury department of a firm. **(Nov. 2022 - Exam – 4 Marks)**

SOLUTION : 19

The fundamental tasks for which treasury department of any enterprise is responsible are :-

(1) Cash Management:

a. It involves efficient cash collection process and managing payment of cash both inside the organisation and to third parties.

b. There may be complete centralization within a group treasury or the treasury may simply advise subsidiaries and divisions on policy matter viz., collection/payment periods, discounts, etc.

(2) Currency Management:

a. The treasury department manages the foreign currency risk exposure of the company.

b. In a large multinational company (MNC) the first step will usually be to set off intra-group indebtedness.

(3) Fund Management:

a. Treasury department is responsible for planning and sourcing the company's short, medium and long-term cash needs.

b. They also facilitate temporary investment of surplus funds by mapping the time gap between funds inflow and outflow.

(4) Banking:

a. It is important that a company maintains a good relationship with its bankers.

b. Treasury department carry out negotiations with bankers with respect to interest rates, foreign exchange rates etc. and act as the initial point of contact with them.

(5) Corporate Finance:

a. Treasury department is involved with both acquisition and divestment activities within the group.

b. In addition, it will often have responsibility for investor relations.

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QUESTION : 20

What are the important factors considered for deciding the source and quantum of capital ?

(Nov. 2022 - Exam – 2 Marks)

SOLUTION : 20

FACTORS TO BE KEPT IN MIND WHILE DECIDING SOURCE AND QUANTUM OF CAPITAL:

1. **Control:** Capital structure should be designed in such a manner that existing shareholders continue to hold majority stake.

2. **Risk:** Capital structure should be designed in such a manner that financial risk of a company does not increase beyond tolerable limit.

3. **Cost:** Overall cost of capital remains minimum.

PROBLEM : 21

DISCUSS Agency Problem and Agency Cost. **(MARCH 2023 MTP - 4 Marks)**

SOLUTION : 21

Agency Problem and Agency Cost: Though in a sole proprietorship firm, partnership etc., owners participate in management but incorporates, owners are not active in management so, there is a separation between owner/ shareholders and managers. In theory, managers should act in the best interest of shareholders however in reality, managers may try to maximise their individual goal like salary, perks etc., so there is a principal agent relationship between managers and owners, which is known as **Agency Problem**. In a nutshell, Agency Problem is the chances that managers may place personal goals ahead of the goal of owners. Agency Problem leads to Agency Cost. **Agency cost** is the additional cost borne by the shareholders to monitor the manager and control their behaviour to maximise shareholders wealth. Generally, Agency Costs are of four types (i) monitoring (ii) bonding (iii) opportunity (iv) structuring.

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PROBLEM : 22

DISTINGUISH between Profit maximisation vis-a-vis wealth maximization.

(APRIL 2023 MTP - 4 Marks)

SOLUTION : 22

(i) It has traditionally been argued that the primary objective of a company is to earn profit; hence the objective of financial management is also profit maximisation. This implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximised. Each alternative, therefore, is to be seen as to whether or not it gives maximum profit.

However, profit maximisation cannot be the sole objective of a company. It is at best a limited objective. If profit is given undue importance, a number of problems can arise. Some of these have been discussed below:

- (i) The term profit is vague. It does not clarify what exactly it means. It conveys a different meaning to different people. For example, profit may be in short term or long term period; it may be total profit or rate of profit etc.
- (ii) Profit maximisation has to be attempted with a realisation of risks involved. There is a direct relationship between risk and profit. Many risky propositions yield high profit. Higher the risk, higher is the possibility of profits. If profit maximisation is the only goal, then risk factor is altogether ignored. This implies that finance manager will accept highly risky proposals also, if they give high profits. In practice, however, risk is very important consideration and has to be balanced with the profit objective.
- (iii) Profit maximisation as an objective does not take into account the time pattern of returns. Proposal A may give a higher amount of profits as compared to proposal B, yet if the returns of proposal A begin to flow say 10 years later, proposal B may be preferred which may have lower overall profit but the returns flow is more early and quick.
- (iv) Profit maximisation as an objective is too narrow. It fails to take into account the social considerations as also the obligations to various interests of workers, consumers, society, as well as ethical trade practices. If these factors are ignored, a company cannot survive for long. Profit maximization at the cost of social and moral obligations is a short sighted policy.

Wealth / Value Maximisation

We will first like to define what is Wealth / Value Maximization Model. Shareholders wealth are the result of cost benefit analysis adjusted with their timing and risk i.e. time value of money.

So, It is important that benefits measured by the finance manager are in terms of cash flow. Finance manager should emphasis on Cash flow for investment or financing decisions not on Accounting

profit. The shareholder value maximization model holds that the primary goal of the firm is to

maximize its market value and implies that business decisions should seek to increase the net present value of the economic profits of the firm. So for measuring and maximising shareholders wealth finance manager should follow:

(A) Cash Flow approach not Accounting Profit

(B) Cost benefit analysis

(C) Application of time value of money.

How do we measure the value/wealth of a firm?

According to Van Horne, "Value of a firm is represented by the market price of the company`s common stock. The market price of a firm`s stock represents the focal judgment of all market participants as to what the value of the particular firm is. It takes into account present and prospective future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock. The market price serves as a performance index or report card of the firm`s progress. It indicates how well management is doing on behalf of stockholder`s".

Why Wealth Maximization Works? Before we answer this question it is important to first understand and know what other goals a business enterprise may have. Some of the other goals a business enterprise may follow are:-

A) Achieving a higher growth rate

B) Attaining a larger market share

C) Gaining leadership in the market in terms of products and technology

D) Promoting employee welfare

E) Increasing customer satisfaction

F) Improving community life, supporting education and research, solving societal problems, etc.

Though, the above goals are important but the primary goal remains to be wealth maximization, as it is critical for the very existence of the business enterprise. If this goal is not met, public/institutions would lose confidence in the enterprise and will not invest further in the growth of the organization. If the growth of the organization is restricted than the other goals like community welfare will not get fulfilled.

Conflicts in Profit vs. Value maximisation principle

In any company, the management is the decision taking authority. As a normal tendency the management may pursue its own personal goals (profit maximization). But in an organization where there is a significant outside participation (shareholding, lenders etc.), the management may not be able to exclusively pursue its personal goals due to the constant supervision of the various stakeholders of the company-employees, creditors, customers, government, etc.

Every entity associated with the company will evaluate the performance of the management from the fulfilment of its own objective. The survival of the management will be threatened if the objective of any of the entities remains unfulfilled.

The wealth maximization objective is generally in accord with the interests of the various groups such as owners, employees, creditors and society, and thus, it may be consistent with the management objective of survival.

Owing to limitation (timing, social consideration etc.) in profit maximization, in today`s real world situations which is uncertain and multi-period in nature, wealth maximization is a better objective. Where the time period is short and degree of uncertainty is not great, wealth maximization and profit maximization amount to essentially the same.

The table below highlights some of the advantages and disadvantages of both profit maximization and wealth maximization goals:-

Goal	Objective	Advantages	Disadvantages
Profit Maximization	Large amount of profits	(i) Easy to calculate profits (ii) Easy to determine the link between financial decisions and profits.	(i) Emphasizes the short term gains (ii) Ignores risk or uncertainty (iii) Ignores the timing of returns (iv) Requires immediate resources
Shareholders Wealth Maximisation	Highest market value of shares.	(i) Emphasizes the long term gains (ii) Recognises risk or uncertainty (iii) Recognises the timing of returns (iv) Considers shareholders` return.	(i) Offers no clear relationship between financial decisions and share price. (ii) Can lead to management anxiety and frustration.

Example: Profit maximization can be achieved in the short term at the expense of the long term goal, that is, wealth maximization. For example, a costly investment may experience losses in the short term but yield substantial profits in the long term. Also, a firm that wants to show a short term profit may, for example, postpone major repairs or replacement, although such postponement is likely to hurt its long term profitability.

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PROBLEM : 23

DESCRIBE the inter relationship between investing, financing, and dividend decisions.

(Nov. 2023-RTP)

SOLUTION : 23

Inter-relationship between Investment, Financing and Dividend Decisions

The finance functions are divided into three major decisions, viz., investment, financing, and dividend decisions. It is correct to say that these decisions are inter-related because the underlying objective of these three decisions is the same, i.e., maximisation of shareholders' wealth. Since investment, financing and dividend decisions are all interrelated, one must consider the joint impact of these decisions on the market price of the company's shares and these decisions should also be solved jointly. The decision to invest in a new project needs the finance for the investment. The financing decision, in turn, is influenced by and influences dividend decision because retained earnings used in internal financing deprive shareholders of their dividends. An efficient financial management can ensure optimal joint decisions. This is possible by evaluating each decision in relation to its effect on the shareholders' wealth.

The above three decisions are briefly examined below in the light of their inter-relationship and to see how they can help in maximising the shareholders' wealth i.e., market price of the company's shares.

Investment decision: The investment of long-term funds is made after a careful assessment of the various projects through capital budgeting and uncertainty analysis. However, only that investment proposal is to be accepted which is expected to yield at least so much return as is adequate to meet its cost of financing. This has an influence on the profitability of the company and ultimately on its wealth.

Financing decision: Funds can be raised from various sources. Each source of funds involves different issues. The finance manager must maintain a proper balance between long-term and short-term funds. With the total volume of long-term funds, he must ensure a proper mix of loan funds and owner's funds. The optimum financing mix will increase return to equity shareholders and thus maximise their wealth.

Dividend decision: The finance manager is also concerned with the decision to pay or declare dividend. He assists the top management in deciding as to what portion of the profit should be paid to the shareholders by way of dividends and what portion should be retained in the business. An optimal dividend pay-out ratio maximises shareholders' wealth.

The above discussion makes it clear that investment, financing, and dividend decisions are interrelated and are to be taken jointly keeping in view their joint effect on the shareholders' wealth.

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PROBLEM : 24

What are disadvantages of Profit Maximization?. **(Nov. 2023 – Exam – 2 Marks)**

SOLUTION : 24

Disadvantages of Profit Maximisation objective of financial management.

(i) Emphasizes the short-term gains

(ii) Ignores risk or uncertainty

(iii) Ignores the timing of returns

(iv) Requires immediate resources.

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PROBLEM : 25

EXPLAIN the limitations of profit maximization objective of Financial Management.

(March 2024 - MTP)

SOLUTION : 25

Limitations of Profit Maximisation objective of financial management.

(i) **The term profit is vague. It does not clarify what exactly it means.** It conveys a different meaning to different people. For example, profit may be in short term or long term period; it may be total profit or rate of profit etc.

(ii) **Profit maximisation has to be attempted with a realisation of risks involved.** There is a direct relationship between risk and profit. Many risky propositions yield high profit. Higher the risk, higher is the possibility of profits. If profit maximisation is the only goal, then risk factor is altogether ignored. This implies that finance manager will accept highly risky proposals also, if they give high profits. In practice, however, risk is very important consideration and has to be balanced with the profit objective.

(iii) **Profit maximisation as an objective does not take into account the time pattern of returns.** Proposal A may give a higher amount of profits as compared to proposal B, yet if the returns of proposal A begin to flow say 10 years later, proposal B may be preferred which may have lower overall profit but the returns flow is more early and quick.

(iv) **Profit maximisation as an objective is too narrow.** It fails to take into account the social considerations as also the obligations to various interests of workers, consumers, society, as well as ethical trade practices. If these factors are ignored, a company cannot survive for long. Profit maximization at the cost of social and moral obligations is a short sighted policy.

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SUMMARY

- Financial Management is concerned with efficient acquisition (financing) and allocation (investment in assets, working capital etc) of funds.
- In the modern times, the financial management includes besides procurement of funds, the three different kinds of decisions as well namely investment, financing and dividend.
- Out of the two objectives, profit maximization and wealth maximization, in today's real world situations which is uncertain and multi-period in nature, wealth maximization is a better objective.
- Today the role of chief financial officer, or CFO, is no longer confined to accounting, financial reporting and risk management. It's about being a strategic business partner of the chief executive officer.
- The relationship between financial management and accounting are closely related to the extent that accounting is an important input in financial decision making.
- Managers may work against the interest of the shareholders and try to fulfill their own objectives. This is known as agency problem.

TEST YOUR KNOWLEDGE

MCQS BASED QUESTIONS

1. Focus of financial management is mainly concerned with the decision related to:

a) Financing
b) Investing
c) Dividend
d) All of above.

2. The main objective of financial management is to:

a) Secure profitability
b) Maximise shareholder wealth
c) Enhancing the cost of debt
d) None of above.

3. The shareholder value maximisation model holds that the primary goal of the firm is to maximise its:

a) Accounting profit
b) Liquidity
c) Market value
d) Working capital.

4. Wealth maximisation approach is based on the concept of:

a) Cost benefit analysis
b) Cash flow approach
c) Time value of money
d) All of the above.

5. Management of all matters related to an organisation's finances is called:

a) Cash inflows and outflows
b) Allocation of resources
c) Financial management
d) Finance.

6. Which of the following is the disadvantage of having shareholders wealth maximisation goals?

a) Emphasizes the short-term gains.

b) Ignores the timing of returns.

c) Requires immediate resources.

d) Offers no clear relationship between financial decisions and share price.

7. The most important goal of financial management is:

a) Profit maximisation

b) Matching income and expenditure

c) Using business assets effectively

d) Wealth maximisation.

8. To achieve wealth maximization, the finance manager has to take careful decision in respect of:

a) Investment

b) Financing

c) Dividend

d) All the above.

9. Early in the history of finance, an important issue was:

a) Liquidity

b) Technology

c) Capital structure

d) Financing options.

10. Which of the following are microeconomic variables that help define and explain the discipline of finance?

a) Risk and return

b) Capital structure

c) Inflation

d) All of the above.

11. Financial Management is mainly concerned with the-

a) Acquiring and developing assets to forfeit its overall benefit.

b) Acquiring, financing and managing assets to accomplish the overall goal of a business enterprise.

c) Efficient management of the business.

d) Sole objective of profit maximisation.

12. Which of the following need not be followed by the finance manager for measuring and maximising shareholders' wealth?

a) Accounting profit analysis.

b) Cash Flow approach.

c) Cost benefit analysis.

d) Application of time value of money.

ANSWERS TO THE MCQS BASED QUESTIONS

1.	(d)	2.	(b)	3.	(c)	4.	(d)	5.	(c)	6.	(d)
7.	(d)	8.	(d)	9.	(a)	10.	(d)	11.	(b)	12.	(a)

THEORETICAL QUESTIONS

1. POINT OUT the difference between Financial Management & Financial Accounting?

2. "Financial management is concerned with acquisition & financing of short term & long-term credit". ELABORATE.

3. DISCUSS the two main aspects of the finance function?
4. DISCUSS three main considerations in procuring funds?
5. EXPLAIN "Wealth maximisation" and "Profit maximisation" objectives of financial management.
6. DISCUSS the role of a chief financial officer.
7. In recent years, there have been a number of environmental, pollution and other regulations imposed on businesses. In view of these changes, is maximisation of shareholder wealth still a realistic objective? EXPLAIN.