1.1 INTRODUCTION

Financial Management is nothing but management of the limited financial resources the organisation has, to its utmost advantage. Resources are always limited, compared to its demands or needs.
This is the case with every type of organisation. Proprietorship or limited company, be it public or private, profit oriented or even non-profitable organisation.

### 1.2 FINANCE FUNCTION– IMPORTANCE

In general, the term “Finance” is understood as provision of funds as and when needed. Finance is the essential requirement—*sine qua non*—of every organisation.

**Required Everywhere:** All activities, be it production, marketing, human resources development, purchases and even research and development, depend on the adequate and timely availability of finance both for commencement and their smooth continuation to completion. Finance is regarded as the life-blood of every business enterprise.

**Efficient Utilisation More Important:** Finance function is the most important function of all business activities. The efficient management of business enterprise is closely linked with the efficient management of its finances. The need of finance starts with the setting up of business. Its growth and expansion require more funds. The funds have to be raised from various sources. The sources have to be selected keeping in relation to the implications, in particular, risk attached. Raising of money, alone, is not important. Terms and conditions while raising money are more important. Cost of funds is an important element. Its utilisation is rather more important. If funds are utilised properly, repayment would be possible and easier, too. Care has to be exercised to match the inflow and outflow of funds. Needless to say, profitability of any firm is dependent on its cost as well as its efficient utilisation.

### 1.3 CONCEPT OF FINANCIAL MANAGEMENT

As already discussed, the general meaning of finance refers to providing funds, as and when needed. However, as management function, the term ‘Financial Management’ has a distinct meaning. Financial management deals with the study of procuring funds and its effective and judicious utilisation, in terms of the overall objectives of the firm, and expectations of the providers of funds. The basic objective is to maximise the value of the firm. The purpose is to achieve maximisation of share value to the owners i.e. equity shareholders.

The term financial management has been defined, differently, by various authors. Some of the authoritative definitions are given below:

1. “Financial Management is concerned with the efficient use of an important economic resource, namely, Capital Funds” —*Solomon*
2. “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” —*Philippattus*
3. “Business finance is that business activity which is concerned with the conservation and acquisition of capital funds in meeting financial needs and overall objectives of a business enterprise” —*Wheeler*

The definition provided by Kuchhal is most acceptable as it focuses, clearly, the Basic requirements of financial management. From his definition, two basic aspects emerge:

(A) Procurement of funds.
(B) Effective and judicious utilisation of funds.

Financial management has become so important that it has given birth to Financial Management as a separate subject.

1.4 NATURE OF FINANCIAL MANAGEMENT

Financial management refers to that part of management activity, which is concerned with the planning and controlling of firm’s financial resources. Financial management is a part of overall management. All business decisions involve finance. Where finance is needed, role of finance manager is inevitable. Financial management deals with raising of funds from various sources, dependant on availability and existing capital structure of the organisation. The sources must be suitable and economical to the organisation. Emphasis of financial management is more on its efficient utilisation, rather than raising of funds, alone.

The scope and complexity of financial management has been widening, with the growth of business in different diverse directions. As business competition has been increasing, with a greater pace, support of financial management is more needed, in a more innovative way, to make the business grow, ahead of others.

1.5 SCOPE OF FINANCIAL MANAGEMENT

Financial management is concerned with optimum utilisation of resources. Resources are limited, particularly in developing countries like India. So, the focus, everywhere, is to take maximum benefit, in the form of output, from the limited inputs.

Financial management is needed in every type of organisation, be it public or private sector. Equally, its importance exists in both profit oriented and non-profit organisations. In fact, need of financial management is more in loss-making organisations to turn them to profitable enterprises. Study reveals many organisations have sustained losses, due to absence of professional financial management.

Financial management has undergone significant changes, over the years in its scope and coverage.

Approaches: Broadly, it has two approaches:

Traditional Approach-Procurement of Funds
Modern Approach-Effective Utilisation of Funds
Traditional Approach

The scope of finance function was treated, in the narrow sense of procurement or arrangement of funds. The finance manager was treated as just provider of funds, when organisation was in need of them. The utilisation or administering resources was considered outside the purview of the finance function. It was felt that the finance manager had no role to play in decision-making for its utilisation. Others used to take decisions regarding its application in the organisation, without the involvement of finance personnel. Finance manager had been treated, in fact, as an outsider with a very specific and limited function, supplier of funds, to perform when the need of funds was felt by the organisation.

As per this approach, the following aspects only were included in the scope of financial management:

(i) Estimation of requirements of finance,
(ii) Arrangement of funds from financial institutions,
(iii) Arrangement of funds through financial instruments such as shares, debentures, bonds and loans, and
(iv) Looking after the accounting and legal work connected with the raising of funds.

Limitations

The traditional approach was evolved during the 1920s and 1930s period and continued till 1950. The approach had been discarded due to the following limitations:

(i) No Involvement in Application of Funds: The finance manager had not been involved in decision-making in allocation of funds. He had been treated as an outsider. He had been ignored in internal decision making process and considered as an outsider.

(ii) No Involvement in day to day Management: The focus was on providing long-term funds from a combination of sources. This process was more of one time happening. The finance manager was not involved in day to day administration of working capital management. Smooth functioning depends on working capital management, where the finance manager was not involved and allowed to play any role.

(iii) Not Associated in Decision-Making Allocation of Funds: The issue of allocation of funds was kept outside his functioning. He had not been involved in decision-making for its judicious utilisation.
Raising finance was an infrequent event. Its natural implication was that the issues involved in working capital management were not in the purview of the finance function. In a nutshell, during the traditional phase, the finance manager was called upon, in particular, when his speciality was required to locate new sources of funds and as and when the requirement of funds was felt.

The following issues, as pointed by Solomon, were ignored in the scope of financial management, under this approach:

(A) Should an enterprise commit capital funds to a certain purpose?
(B) Do the expected returns meet financial standards of performance?
(C) How does the cost vary with the mixture of financing methods used?

The traditional approach has outlived its utility in the changed business situation. The scope of finance function has undergone a sea change with the emergence of different capital instruments.

**Modern Approach**

Since 1950s, the approach and utility of financial management has started changing in a revolutionary manner. Financial management is considered as vital and an integral part of overall management. The emphasis of Financial Management has been shifted from raising of funds to the effective and judicious utilisation of funds. The modern approach is analytical way of looking into the financial problems of the firm. Advice of finance manager is required at every moment, whenever any decision with involvement of funds is taken. Hardly, there is an activity that does not involve funds.

In the words of Solomon “The central issue of financial policy is the use of funds. It is helpful in achieving the broad financial goals which an enterprise sets for itself”.

Nowadays, the finance manager is required to look into the financial implications of every decision to be taken by the firm. **His Involvement of finance manager has been before taking the decision, during its review and, finally, when the final outcome is judged.** In other words, his association has been continuous in every decision-making process from the inception till its end.

### 1.6 AIMS OF FINANCE FUNCTION

The following are the aims of finance function:

1. **Acquiring Sufficient and Suitable Funds:** The primary aim of finance function is to assess the needs of the enterprise, properly, and procure funds, in time. Time is also an important element in meeting the needs of the organisation. If the funds are not available as and when required, the firm may become sick or, at least, the profitability of the firm would be, definitely, affected.

   It is necessary that the funds should be, reasonably, adequate to the demands of the firm. The funds should be raised from different sources, commensurate to the nature of business
and risk profile of the organisation. When the nature of business is such that the production does not commence, immediately, and requires long gestation period, it is necessary to have the long-term sources like share capital, debentures and long term loan etc. A concern with longer gestation period does not have profits for some years. So, the firm should rely more on the permanent capital like share capital to avoid interest burden on the borrowing component.

2. **Proper Utilisation of Funds**: Raising funds is important, more than that is its proper utilisation. If proper utilisation of funds were not made, there would be no revenue generation. Benefits should always exceed cost of funds so that the organisation can be profitable. Beneficial projects only are to be undertaken. So, it is all the more necessary that careful planning and cost-benefit analysis should be made before the actual commencement of projects.

3. **Increasing Profitability**: Profitability is necessary for every organisation. The planning and control functions of finance aim at increasing profitability of the firm. To achieve profitability, the cost of funds should be low. Idle funds do not yield any return, but incur cost. So, the organisation should avoid idle funds. Finance function also requires matching of cost and returns of funds. If funds are used efficiently, profitability gets a boost.

4. **Maximising Firm’s Value**: The ultimate aim of finance function is maximising the value of the firm, which is reflected in wealth maximisation of shareholders. The market value of the equity shares is an indicator of the wealth maximisation.

### 1.7 FUNCTIONS OF FINANCE

Finance function is the most important function of a business. Finance is, closely, connected with production, marketing and other activities. In the absence of finance, all these activities come to a halt. In fact, only with finance, a business activity can be commenced, continued and expanded. Finance exists everywhere, be it production, marketing, human resource development or undertaking research activity. **Understanding the universality and importance of finance, finance manager is associated, in modern business, in all activities as no activity can exist without funds.**

**Financial Decisions or Finance Functions are closely inter-connected.** All decisions mostly involve finance. When a decision involves finance, it is a financial decision in a business firm. In all the following financial areas of decision-making, the role of finance manager is vital. We can classify the finance functions or financial decisions into four major groups:

(A) Investment Decision or Long-term Asset mix decision  
(B) Finance Decision or Capital mix decision  
(C) Liquidity Decision or Short-term asset mix decision  
(D) Dividend Decision or Profit allocation decision

**A) Investment Decision**

Investment decisions relate to selection of assets in which funds are to be invested by the firm. Investment alternatives are numerous. Resources are scarce and limited. They have to be rationed
and discretely used. Investment decisions allocate and ration the resources among the competing investment alternatives or opportunities. The effort is to find out the projects, which are acceptable.

**Investment decisions relate to the total amount of assets to be held and their composition in the form of fixed and current assets.** Both the factors influence the risk the organisation is exposed to. The more important aspect is how the investors perceive the risk.

The investment decisions result in purchase of assets. Assets can be classified, under two broad categories:

(i) Long-term investment decisions – Long-term assets
(ii) Short-term investment decisions – Short-term assets

**Long-term Investment Decisions:** The long-term capital decisions are referred to as capital budgeting decisions, which relate to fixed assets. The fixed assets are long term, in nature. Basically, fixed assets create earnings to the firm. They give benefit in future. It is difficult to measure the benefits as future is uncertain.

The investment decision is important not only for setting up new units but also for expansion of existing units. Decisions related to them are, generally, irreversible. Often, reversal of decisions results in substantial loss. When a brand new car is sold, even after a day of its purchase, still, buyer treats the vehicle as a second-hand car. The transaction, invariably, results in heavy loss for a short period of owning. So, the finance manager has to evaluate profitability of every investment proposal, carefully, before funds are committed to them.

**Short-term Investment Decisions:** The short-term investment decisions are, generally, referred as working capital management. The finance manager has to allocate among cash and cash equivalents, receivables and inventories. Though these current assets do not, directly, contribute to the earnings, their existence is necessary for proper, efficient and optimum utilisation of fixed assets.

**(B) Finance Decision**

Once investment decision is made, the next step is how to raise finance for the concerned investment. **Finance decision is concerned with the mix or composition of the sources of raising the funds required by the firm. In other words, it is related to the pattern of financing.** In finance decision, the finance manager is required to determine the proportion of equity and debt, which is known as capital structure. There are two main sources of funds, shareholders’ funds (variable in the form of dividend) and borrowed funds (fixed interest-bearing). These sources have their own peculiar characteristics. The key distinction lies in the fixed commitment. Borrowed funds are to be paid interest, irrespective of the profitability of the firm. Interest has to be paid, even if the firm incurs loss and this permanent obligation is not there with the funds raised from the shareholders. **The borrowed funds are relatively cheaper compared to shareholders’ funds, however they carry risk.** This risk is known as financial risk i.e. Risk of insolvency due to non-payment of interest or non-repayment of borrowed capital.

On the other hand, the shareholders’ funds are permanent source to the firm. The shareholders’ funds could be from equity shareholders or preference shareholders. Equity share capital is not repayable and does not have fixed commitment in the form of dividend. However, preference share
capital has a fixed commitment, in the form of dividend and is redeemable, if they are redeemable preference shares.

Barring a few exceptions, every firm tries to employ both borrowed funds and shareholders’ funds to finance its activities. The employment of these funds, in combination, is known as financial leverage. Financial leverage provides profitability, but carries risk. Without risk, there is no return. This is the case in every walk of life!

When the return on capital employed (equity and borrowed funds) is greater than the rate of interest paid on the debt, shareholders’ return get magnified or increased. In period of inflation, this would be advantageous while it is a disadvantage or curse in times of recession.

Example:

<table>
<thead>
<tr>
<th>Total investment:</th>
<th>Rs. 1,00,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return</td>
<td>15%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Composition of investment:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Rs. 60,000</td>
</tr>
<tr>
<td>Debt @ 7% interest Rs. 40,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Return on investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>@ 15% Rs. 15,000</td>
</tr>
<tr>
<td>Interest on Debt Rs.</td>
</tr>
<tr>
<td>7% on Rs.40,000</td>
</tr>
<tr>
<td>Earnings available to Equity shareholders Rs. 12,200</td>
</tr>
</tbody>
</table>

Return on equity (ignoring tax) is 20%, which is at the expense of debt as they get 7% interest only.

In the normal course, equity would get a return of 15%. But they are enjoying 20% due to financing by a combination of debt and equity.

This area would be discussed in detail while dealing with Leverages, in the later chapter.

The finance manager follows that combination of raising funds which is optimal mix of debt and equity. The optimal mix minimises the risk and maximises the wealth of shareholders.

(C) Liquidity Decision

Liquidity decision is concerned with the management of current assets. Basically, this is Working Capital Management. Working Capital Management is concerned with the management of current assets. It is concerned with short-term survival. Short term-survival is a prerequisite for long-term survival.

When more funds are tied up in current assets, the firm would enjoy greater liquidity. In consequence, the firm would not experience any difficulty in making payment of debts, as and when they fall due. With excess liquidity, there would be no default in payments. So, there would be no threat of insolvency for failure of payments. However, funds have economic cost. Idle
current assets do not earn anything. Higher liquidity is at the cost of profitability. Profitability would suffer with more idle funds. Investment in current assets affects the profitability, liquidity and risk. A proper balance must be maintained between liquidity and profitability of the firm. This is the key area where finance manager has to play significant role. The strategy is in ensuring a trade-off between liquidity and profitability. This is, indeed, a balancing act and continuous process. It is a continuous process as the conditions and requirements of business change, time to time. In accordance with the requirements of the firm, the liquidity has to vary and in consequence, the profitability changes. This is the major dimension of liquidity decision-working capital management. Working capital management is day to day problem to the finance manager. His skills of financial management are put to test, daily.

(D) Dividend Decision

Dividend decision is concerned with the amount of profits to be distributed and retained in the firm.

Dividend: The term ‘dividend’ relates to the portion of profit, which is distributed to shareholders of the company. It is a reward or compensation to them for their investment made in the firm. The dividend can be declared from the current profits or accumulated profits.

Which course should be followed – dividend or retention? Normally, companies distribute certain amount in the form of dividend, in a stable manner, to meet the expectations of shareholders and balance is retained within the organisation for expansion. If dividend is not distributed, there would be great dissatisfaction to the shareholders. Non-declaration of dividend affects the market price of equity shares, severely. One significant element in the dividend decision is, therefore, the dividend payout ratio i.e. what proportion of dividend is to be paid to the shareholders. The dividend decision depends on the preference of the equity shareholders and investment opportunities, available within the firm. A higher rate of dividend, beyond the market expectations, increases the market price of shares. However, it leaves a small amount in the form of retained earnings for expansion. The business that reinvests less will tend to grow slower. The other alternative is to raise funds in the market for expansion. It is not a desirable decision to retain all the profits for expansion, without distributing any amount in the form of dividend.

There is no ready-made answer, how much is to be distributed and what portion is to be retained. Retention of profit is related to

- Reinvestment opportunities available to the firm.
- Alternative rate of return available to equity shareholders, if they invest themselves.

1.8 INTER-RELATIONSHIP OF FINANCE FUNCTIONS OR DECISIONS

All the major functions or decisions – Investment function, Finance function, Liquidity function and Dividend function, are inter-related and inter-connected. They are inter-related because the goal of all the functions is one and the same. Their ultimate objective is only one – achievement of maximisation of shareholders’ wealth or maximising the market value of the shares.
All the decisions are also inter-connected or inter-dependent also. Let us illustrate, both these aspects with an example.

**Example:** If a firm wants to undertake a project requiring funds, this investment decision cannot be taken, in isolation, without considering the availability of finances, which is a finance decision. Both the decisions are inter-connected.

If the firm allocates more funds for fixed assets, lesser amount would be available for current assets. So, financing decision and liquidity decision are inter-connected.

The firm has two options to finance the project, either from internal resources or raising funds, externally, from the market. If the firm decides to meet the total project cost only from internal resources, the profits, otherwise available for distribution in the form of dividend, have to be retained to meet the project cost. Here, the finance decision has influenced the dividend decision.

So, an efficient financial management takes the optimal decision by considering the implications or impact of all the decisions, together, on the market value of the company’s shares. The decision has to be taken considering all the angles, simultaneously.

**No Function is Superior:** All the functions are important. Importance of the function depends on the situation of the firm. If a firm has adequate investment opportunities but experiences difficulty to raise funds, then the finance function is superior to the firm, at that juncture. It does not mean that investment decision is less important compared to finance decision, always.

The essence is no financial function or decision is superior to others.
1.9 LIQUIDITY VS PROFITABILITY (RISK–RETURN TRADE-OFF)

In the course of performance of duties, a finance manager has to take various types of financial decisions – Investment Decision, Finance Decision, Liquidity Decision and Dividend Decision, as detailed above, from time to time. In every area of financial management, the finance manager is always faced with the dilemma of liquidity vs. profitability. He has to strike a balance between the two.

Liquidity means that the firm has:

(A) Adequate cash to pay bills as and when they fall due, and
(B) Sufficient cash reserves to meet emergencies and unforeseen demands, at all time.

Profitability goal, on the other hand, requires that the funds of the firm be so utilised as to yield the highest return.

Liquidity and profitability are conflicting decisions. When one increases, the other decreases. More liquidity results in less profitability and vice versa. This conflict finance manager has to face as all the financial decisions involve both liquidity and profitability.

Example: Firm may borrow more, beyond the risk-free limit, to take the advantage of cheap interest rate. This decision increases the liquidity to meet the requirements of firm. Firm has to pay committed fixed rate of interest, at fixed time, irrespective of the return the liquidity (funds) gives. Profitability suffers, in this process of decision, if the expected return does not materialise. This is the risk the organisation faces by this financial decision.

Risk: Risk is defined as the variability of the expected return from the investment.

Return: Return is measured as a gain or profit expected to be made, over a period, at the time of making the investment.

Example: If an investor makes a deposit in a nationalised bank, carrying an interest of 7% p.a., virtually, the investment is risk free for repayment, both principal and interest. However, if a similar amount is invested in the equity shares, there is no certainty for the amount of dividend or even for getting back initial investment as market price may fall, subsequently, at the time of sale. The expected dividend may or may not materialise. In other words, the dividend amount may vary or the company may not declare dividend, at all. A bank deposit is a safe investment, while equity shares are not so. So, risk is associated with the quality of investment.

The relationship between risk and return can be expressed as follows:

\[
\text{Return} = \text{Risk free rate} + \text{Risk premium}
\]

Risk free rate is a compensation or reward for time and risk premium for risk. Risk and return go hand in hand. Higher the risk, higher the required return expected. It is only an expectation, at the time of investment. There is no guarantee that the return would be, definitely, higher. If one wants to make an investment, without risk, the return is always lower. For this reason only, deposit in a bank and post office carry lower returns, compared to equity shares.
So, every financial decision involves liquidity and profitability implications, which carries risk as well as return. However, the quantum of risk differs from one decision to another. Equally, the return from all the decisions is not uniform and also varies, even from time to time.

**Relationship between Liquidity & Profitability and Risk & Return:**

**Example:** If higher inventories are built, in anticipation of an increase in price, more funds are locked in inventories. So, organisation may experience problems in making other payments, in time. If the expected price increase materialises, firm enjoys a boost in profits due to the windfall return the decision yields. The expected increase in price is a contingent event. In other words, the increase in price may or may not happen. But, firm suffers liquidity problems, immediately. This is the price firm has to pay, which otherwise is the risk the firm carries.

It may be emphasised risk and return always go together, hand in hand. More risk, chances of higher return exist. One thing must be remembered, there is no guarantee of higher returns, with higher risk. The classical example is lottery. There is a great risk, if one invests amount in a lottery. There is no guarantee that you would win the lottery. However, liquidity and profitability are conflicting decisions. There is a direct relationship between higher risk and higher return. In the above example, building higher inventories, more than required, is a higher risk decision. This higher risk has created liquidity problem. But, the benefit of higher return is also available. Higher risk, on the one hand, endangers liquidity and higher returns, on the other hand, increases profitability.

Liquidity and Profitability are conflicting while Risk and Return go together. The pictorial presentation is as under:
**Balanced Approach:** A finance manager cannot avoid the risk, altogether, in his decision-making. At the same time, he should not take decisions, considering the returns aspect only. At the time of taking any financial decision, the finance manager has to weigh both the risks and returns in the proposed decision and optimise the risk and returns, at the same time. A proper balance between risk and return should be maintained by the finance manager to maximise the market value of shares. A particular combination where both risk and return are optimised is known as Risk–Return Trade-off.

**Basic objective of Finance Manager:** An efficient finance manager fixes that level of operations, where he can achieve maximisation of the shareholders’ wealth. Such a level is termed as risk-return trade-off. Every finance manager attempts to achieve that trade-off in every finance decision. At this level, the market value of the company’s shares would be maximum. To achieve maximum return, funds flowing in and out of the firm are to be constantly monitored to ensure their safety and proper utilisation.

**1.10 ROLE OF FINANCE MANAGER**

The finance manager handles finance. The role of finance manager is pivotal. He can change the fortunes of the organisation with proper planning, monitoring and timely guidance. Equally, if the manager is not competent, even a profitable organisation may dwindle or even sink. The finance manager is, now, responsible in shaping the fortunes of the enterprise. The role of finance manager, in a modern business, is pervasive in all the activities of business firm, including production and marketing.

It has been rightly said, money begets money. Business needs money to make more money. However, business can make money, when it is properly managed. The financial history is replete with stories how even the profitable organisations were wound up, when the management of finance had turned bad due to mismanagement of financial affairs.

It is misunderstood, in some corners, that the role of finance manager is important only in private organisations. It is not so. His role is important, both in private and public sector. He has a positive role to play in every type of organisation. Even in non-profit making organisations, his role exists as long as there is involvement of funds.

**Influences Fortunes of Firm:** The history of failures of organisations is interesting. Many firms have failed, not because of inefficiency of production, inability in marketing or non-availability of funds but due to the absence of competent finance manager. In many public sector undertakings, in particular, state government undertakings, importance is given to the appointment of peons, more than adequately, but not to the appointment of competent professional manager in finance, even after lapse of several years. That is the real secret of numerous loss-making organisations, in public sector! Over the years, the picture has been changing, but only after the real damage has already occurred in those public sector undertakings, due to the non-appointment of professional finance managers, at the time of formation of those undertakings.
In several public sector undertakings, the presence of competent finance manager is often found inconvenient. A finance manager can not play any significant role in the public sector, unless he is allowed to play.

**Exists Everywhere:** The role of finance manager, in modern times, can be well said, universal and pervasive. Hardly, we find any activity, which does not involve finance. Even entertainment in a firm requires financial management due to financial implications. In modern business, no decision is taken without the consultation of finance. Even in recruitment, the presence of finance representative has been a normal feature manager. Only the level of finance representative changes, dependant upon the status of position for which recruitment is held. At times, people working in other departments feel that the finance manager has been interfering in all matters, unconnected to him. It is due to inadequate understanding of the role and expectations expected of him in modern business. The finance manager can, definitely, contribute to the overall development of the organisation provided he is competent and allowed to perform his functions, independently.

In his new role, the finance manager must find answers for the following three questions, again in the words of Solomon:

- How large should an enterprise be, and how fast should it grow?
- How should the funds be raised?
- In what form, should the firm hold its assets?

To sum up, finance functions or decisions include the following important areas, where the finance manager has to contribute:

- Investment decision or long term asset-mix decision
- Finance decision or capital-mix decision
- Liquidity decision or short-term asset mix decision
- Dividend decision or profit allocation decision

The main objective of all the above decisions is to increase the value of the shares, held by the equity shareholders. **The finance manager has to strive for shareholders’ wealth maximisation.**

While discharging the functions, the finance manager has to focus his attention on the following aspects to maximise the shareholders’ wealth:

1. Procuring the funds as and when necessary, at the lowest cost,
2. Investing the funds in those assets, which are more profitable, and
3. Distributing the dividends to the shareholders to meet their expectations and facilitate expansion to achieve the long-term goals of organisation.
Aims and Functions of Finance

Check Your Understanding

(A) State whether the following statements are TRUE or FALSE.

1. Finance function is limited to supply of funds to the requirements of the organisation.
2. Finance function involves procurement of funds, at economic cost, and their effective utilisation in business.
3. Financial Management involves receipt and disbursement of cash.
4. Finance function is concerned with all aspects of business operations, where money is involved.
5. The financial management decisions can be classified into four basic kinds¾ Investment Decisions, Financing Decisions, Liquidity Decisions and Dividend Decisions.
6. Investment decision is concerned with allocating limited resources among the competing investment alternatives.
7. Cash flows, at different times, carry different values.
8. The finance manager is required to look into the financial implications of every decision in the firm.
9. It is not the function of finance manager to look to the optimal mix of debt and equity to finance the investment needs.
10. It is not the job of finance manager to get involved with the change in distribution channel decision.
11. Finance manager creates problems in decision-making process where money is involved.
12. Market prices of shares in the stock market fall when expectations of shareholders in respect of dividend declaration are not fulfilled.
13. Board of Directors is the owners of Joint Stock Company.
14. Dividend can be declared by the company in the form of cash or bonus shares.
15. Board of Directors is the final authority to decide the quantum of dividend.
16. Dividend can be declared from the current as well as cumulative profits of an organisation.
17. It is not wise to borrow when interest rate is lower than the return on capital employed.
18. Bonus shares are issued by the company, capitalising profits.
19. Working Capital Management is concerned with management of fixed assets.

Answers

10. False (decision involves financial implication)
(B) Select the most appropriate answer from the following statements:

1. Financial management is mainly concerned with
   (A) Efficient management of every activity of business
   (B) Arrangement of funds required to the firm
   (C) Obtaining required funds in the appropriate mix and utilising them, efficiently

2. Financial decisions involve
   (A) Investment, sales and dividend decisions
   (B) Finance, investment and dividend decisions
   (C) Finance, investment and cash decisions

3. Financial management helps in
   (A) Short-term planning of company’s activities
   (B) Estimating the total funds’ requirement and their proper utilisation in fixed assets and working capital
   (C) Profit planning of the firm

Answers


(C) Fill in the Blanks

1. One who takes financial risks is called the ________________.
2. The finance function provides the _____________ required by the Business enterprises.
3. Ownership is divorced from the ___________ in a limited company

Answers

1. Entrepreneur 2. Funds 3. Management

Review Questions

1. The horizons of Financial Management have changed substantially in scope and complexity over the years. Justify the statement? (1.1 to 1.5)
2. Explain the scope of financial management. Describe the role of finance manager in a modern business? (1.5 and 1.10)
3. Detail the aims of finance function? (1.6)
4. The role of Finance Manager has remained as it had been. Discuss? (1.7, 1.9 and 1.10)
5. Detail the basic finance functions? How trade-off is possible between return and risk? (1.7, 1.8 and 1.9)
6. In addition to raising funds, financial management is directly concerned with production, marketing and all other functions within an organisation. Explain with suitable examples the inter-relationship with other functions? (1.7, 1.8 and 1.9)
7. “An optimal combination of decisions relating to investment, financing and dividends will maximise the value of the firm to its shareholders”, Examine? (1.7, 1.8 and 1.9)
8. What role should the finance manager play in the modern enterprise? (1.7, 1.9 and 1.10)
9. Examine inter-relationship among the investment, financing and dividend decisions with an example and analyse the superiority amongst the different decisions? (1.7 and 1.8)
10. The financial manager plays a pivotal role in the multifarious facets of a business enterprise. Do you advocate his role as interference or contribution? (1.7, 1.8, 1.9 and 1.10)
11. Describe the prominent areas of financial decision-making? (1.7)
12. “Liquidity and profitability are competing goals of the finance manager”- Comment? (1.9)
13. Write Short Notes on the following:
   (A) Finance (1.2)
   (B) Risk-return trade-off (1.9)