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Scope and Objectives of Financial Management

BASIC CONCEPTS

1. Definition of Financial Management	“Financial management comprises the 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.”
2. Two Basic Aspects of Financial Management	<ul style="list-style-type: none"> • Procurement of Funds: Obtaining funds from different sources like equity, debentures, funding from banks, etc. • Effective Utilisation of Funds: Employment of funds properly and profitably.
3. Three Stages of Evolution of Financial Management	<ul style="list-style-type: none"> • Traditional Phase: During this phase, financial management was considered necessary only during occasional events such as takeovers, mergers, expansion, liquidation, etc. • Transitional Phase: During this phase, the day-to-day problems that financial managers faced were given importance. • Modern Phase: Modern phase is still going on.
4. Two Main Objectives of Financial Management	<ul style="list-style-type: none"> • Profit Maximisation: Profit Maximisation means that the primary objective of a company is to earn profit. • Wealth / Value maximisation: Wealth / Value maximisation means that the primary goal of a firm should be 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. • Conflict between Profit Maximisation and Wealth / Value maximisation: 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.

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<p>5. Three Important Decisions for Achievement of Wealth Maximization</p>	<ul style="list-style-type: none"> • Investment Decisions: Investment decisions relate to the selection of assets in which funds will be invested by a firm. • Financing Decisions: Financing decisions relate to acquiring the optimum finance to meet financial objectives and seeing that fixed and working capitals are effectively managed. • Dividend Decisions: Dividend 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.
<p>6. Calculation of Net Present Worth</p>	<p>(i) $W = V - C$ (ii) $V = E/K$ (iii) $E = G - (M + T + I)$ (iv) $W = A_1/(1+K) + A_2/(1+K)^2 + \dots + A_n/(1+K)^n - C$</p>
<p>7. Role of Chief Financial Officer (CFO)</p>	<p>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.</p>

Question 1

Explain two basic functions of Financial Management.

Answer

Two Basic Functions of Financial Management

Procurement of Funds: Funds can be obtained from different sources having different characteristics in terms of risk, cost and control. The funds raised from the issue of equity shares are the best from the risk point of view since repayment is required only at the time of liquidation. However, it is also the most costly source of finance due to dividend expectations of shareholders. On the other hand, debentures are cheaper than equity shares due to their tax advantage. However, they are usually riskier than equity shares. There are thus risk, cost and control considerations which a finance manager must consider while procuring funds. The cost of funds should be at the minimum level for that a proper balancing of risk and control factors must be carried out.

Effective Utilization of Funds: The Finance Manager has to ensure that funds are not kept idle or there is no improper use of funds. The funds are to be invested in a manner such that they generate returns higher than the cost of capital to the firm. Besides this, decisions to invest in fixed assets are to be taken only after sound analysis using capital budgeting techniques. Similarly, adequate working capital should be maintained so as to avoid the risk of insolvency.

Question 2

Differentiate between Financial Management and Financial Accounting.

Answer

Differentiation between Financial Management and Financial Accounting: Though financial management and financial accounting are closely related, still they differ in the treatment of funds and also with regards to decision - making.

Treatment of Funds: In accounting, the measurement of funds is based on the accrual principle. The accrual based accounting data do not reflect fully the financial conditions of the organisation. An organisation which has earned profit (sales less expenses) may said to be profitable in the accounting sense but it may not be able to meet its current obligations due to shortage of liquidity as a result of say, uncollectible receivables. Whereas, the treatment of funds, in financial management is based on cash flows. 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). Thus, cash flow based returns help financial managers to avoid insolvency and achieve desired financial goals.

Decision-making: The chief focus of an accountant is to collect data and present the data while the financial manager's primary responsibility relates to financial planning, controlling and decision-making. Thus, in a way it can be stated that financial management begins where financial accounting ends.

Question 3

Explain the limitations of profit maximization objective of Financial Management.

Answer

Limitations of Profit Maximisation objective of financial management.

- (a) Time factor is ignored.
- (b) It is vague because it is not cleared whether the term relates to economics profit, accounting profit, profit after tax or before tax.
- (c) The term maximisation is also ambiguous
- (d) It ignore, the risk factor.

Question 4

Discuss the conflicts in Profit versus Wealth maximization principle of the firm.

Answer

Conflict in Profit versus Wealth Maximization Principle of the Firm: Profit maximisation is a short-term objective and 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 like the term profit

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is vague, profit maximisation has to be attempted with a realisation of risks involved, it does not take into account the time pattern of returns and as an objective it is too narrow.

Whereas, on the other hand, wealth maximisation, as an objective, means that the company is using its resources in a good manner. If the share value is to stay high, the company has to reduce its costs and use the resources properly. If the company follows the goal of wealth maximisation, it means that the company will promote only those policies that will lead to an efficient allocation of resources.

Question 5

Explain as to how the wealth maximisation objective is superior to the profit maximisation objective.

Answer

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

- (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 long-term 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.

Question 6

"The profit maximization is not an operationally feasible criterion." Comment on it.

Answer

"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:

- (i) 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?
- (ii) 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.
- (iii) It ignores the risk factor.
- (iv) The term maximization is also vague.

Question 7

"The information age has given a fresh perspective on the role of finance management and finance managers. With the shift in paradigm it is imperative that the role of Chief Financial Officer (CFO) changes from a controller to a facilitator." Can you describe the emergent role which is described by the speaker/author?

Answer

The information age has given a fresh perspective on the role financial management and finance managers. With the shift in paradigm it is imperative that the role of Chief Finance Officer (CFO) changes from a controller to a facilitator. In the emergent role Chief Finance Officer acts as a catalyst to facilitate changes in an environment where the organisation succeeds through self

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managed teams. The Chief Finance Officer must transform himself to a front-end organiser and leader who spends more time in networking, analysing the external environment, making strategic decisions, managing and protecting cash flows. In due course, the role of Chief Finance Officer will shift from an operational to a strategic level. Of course on an operational level the Chief Finance Officer cannot be excused from his backend duties. The knowledge requirements for the evolution of a Chief Finance Officer will extend from being aware about capital productivity and cost of capital to human resources initiatives and competitive environment analysis. He has to develop general management skills for a wider focus encompassing all aspects of business that depend on or dictate finance.

Question 8

Discuss the functions of a Chief Financial Officer.

Answer

Functions of a Chief Financial Officer: The twin aspects viz procurement and effective utilization of funds are the crucial tasks, which the CFO faces. The Chief Finance Officer is required to look into financial implications of any decision in the firm. Thus all decisions involving management of funds comes under the purview of finance manager. These are namely

- Estimating requirement of funds
- Decision regarding capital structure
- Investment decisions
- Dividend decision
- Cash management
- Evaluating financial performance
- Financial negotiation
- Keeping touch with stock exchange quotations & behaviour of share prices.

Question 9

Write short notes on the following:

- (a) *Inter relationship between investment, financing and dividend decisions.*
- (b) *Finance function*

Answer

- (a) **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 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 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 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.

- (b) **Finance Function:** The finance function is most important for all business enterprises. It remains a focus of all activities. It starts with the setting up of an enterprise. It is concerned with raising of funds, deciding the cheapest source of finance, utilization of funds raised, making provision for refund when money is not required in the business, deciding the most profitable investment, managing the funds raised and paying returns to the providers of funds in proportion to the risks undertaken by them. Therefore, it aims at acquiring sufficient funds, utilizing them properly, increasing the profitability of the organization and maximizing the value of the organization and ultimately the shareholder's wealth.

Question 10

Explain the role of Finance Manager in the changing scenario of financial management in India.

Answer

Role of Finance Manager in the Changing Scenario of Financial Management in India: In the modern enterprise, the finance manager occupies a key position and his role is becoming more and more pervasive and significant in solving the finance problems. The traditional role of the finance manager was confined just to raising of funds from a number of sources, but the recent development in the socio-economic and political scenario throughout the world has placed him in a central position in the business organisation. He is now responsible for shaping the fortunes of the enterprise, and is involved in the most vital decision of allocation of capital like mergers, acquisitions, etc. He is working in a challenging environment which changes continuously.

Emergence of financial service sector and development of internet in the field of information technology has also brought new challenges before the Indian finance managers. Development of new financial tools, techniques, instruments and products and emphasis on public sector undertaking to be self-supporting and their dependence on capital market for fund requirements have all changed the role of a finance manager. His role, especially, assumes significance in the present day context of liberalization, deregulation and globalization.

Question 11

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

Answer

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 of 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 12

Discuss emerging issues affecting the future role of Chief Financial Officer (CFO).

Answer

Emerging Issues/Priorities Affecting the Future Role of Chief Financial Officer (CFO)

- (i) **Regulation:** Regulation requirements are increasing and CFOs have an increasingly personal stake in regulatory adherence.

- (ii) **Globalisation:** The challenges of globalisation are creating a need for finance leaders to develop a finance function that works effectively on the global stage and that embraces diversity.
- (iii) **Technology:** Technology is evolving very quickly, providing the potential for CFOs to reconfigure finance processes and drive business insight through 'big data' and analytics.
- (iv) **Risk:** The nature of the risks that organisations face is changing, requiring more effective risk management approaches and increasingly CFOs have a role to play in ensuring an appropriate corporate ethos.
- (v) **Transformation:** There will be more pressure on CFOs to transform their finance functions to drive a better service to the business at zero cost impact.
- (vi) **Stakeholder Management:** Stakeholder management and relationships will become important as increasingly CFOs become the face of the corporate brand.
- (vii) **Strategy:** There will be a greater role to play in strategy validation and execution, because the environment is more complex and quick changing, calling on the analytical skills CFOs can bring.
- (viii) **Reporting:** Reporting requirements will broaden and continue to be burdensome for CFOs.
- (ix) **Talent and Capability:** A brighter spotlight will shine on talent, capability and behaviours in the top finance role.