**FINANCIAL MANAGEMENT**

**UNIT – 1**

**FINANCIAL MANAGEMENT -** Financial management is the process of planning, organizing, directing, and controlling the financial activities of an individual or organization. It is essentially the act of managing your money in a way that meets your present and future needs. The goal of financial management is to use your financial resources effectively and efficiently to achieve your financial goals.

**OBJECTIVES OF FINANCIAL MANAGEMENT-**

**Profitability and Growth:**

* **Profit Maximization:** While not always the sole objective, financial management often strives to maximize profits for businesses, either through increasing revenue or reducing costs.
* **Wealth Maximization:** Similar to profit maximization, but in this case, the focus is on maximizing the long-term wealth of shareholders or the owner of a business.

**Financial Stability:**

* **Liquidity:** Ensuring the organization has enough cash flow to meet its short-term obligations and avoid financial difficulties.
* **Solvency:** Maintaining the ability to meet long-term financial commitments and avoid insolvency.

**Efficiency and Effectiveness:**

* **Proper Resource Utilization:** Making sure financial resources are used effectively and efficiently to achieve organizational goals.
* **Cost Reduction:** Minimizing unnecessary expenses and optimizing spending across different areas.

**Risk Management:**

* **Reducing Risks:** Identifying and mitigating potential financial risks, such as market fluctuations, economic downturns, and unforeseen events.
* **Maintaining Compliance:** Ensuring the organization adheres to relevant financial regulations and avoids legal or financial penalties.

**PROFIT MAXIMIZATION VS WEALTH MAXIMIZATION**

Profit Maximization is a term which denotes the maximum profit to be earned by an organization in a given period of time. The profit maximization goal implies that the Investment, Financing and Dividend decisions of the enterprise should be oriented to profit maximization.

Wealth maximization is a broader and more holistic objective compared to profit maximization. While profit maximization focuses on short-term gains, wealth maximization considers the long-term value creation for shareholders.

Profit Maximization Wealth Maximization

1.Its main objective is to earn Its main objective is to achieve large amount of profits. highest market value

2.It emphasizes short term It emphasizes long term

3.It ignores time value of money. It considers time value of money.

4.It ignores risk and uncertainty. It recognizes risk and uncertainty.

5.It ignores timing of return It recognizes the timings of return.

**FINANCIAL MARKETS -** Financial markets are essentially marketplaces where the buying and selling of financial instruments, such as stocks, bonds, commodities, and derivatives, occur. They play a crucial role in facilitating the flow of capital between investors and businesses, enabling businesses to raise funds for operations and growth, and offering investors opportunities to earn returns on their investments. They are classified into capital and money market

The capital market is a segment of the financial market where long-term securities such as stocks and bonds are bought and sold.

The money market is a segment of the financial market where short-term debt securities and instruments are bought and sold.

**Types of Financial Markets:**

* **Stock Markets:** These markets allow companies to raise capital by selling shares of ownership (stocks) to investors. Investors can buy and sell these shares, hoping to profit from price fluctuations
* **Bond Markets:** In bond markets, governments and corporations issue bonds to raise debt capital. Investors purchase these bonds, essentially loaning money to the issuer in exchange for fixed interest payments over a predetermined term.
* **Foreign Exchange Markets (Forex Markets):** These markets facilitate the trading of currencies. Individuals, businesses, and governments can buy and sell foreign currencies to conduct international transactions, manage foreign exchange risk, or speculate on currency movements.
* **Derivatives Markets:** These markets deal in financial contracts (derivatives) whose value is derived from underlying assets like stocks, bonds, commodities, or currencies. Common derivatives include futures contracts, options contracts, and swaps.

**UNIT – 2 CAPITAL BUDGETING**

**Meaning:** Capital budgeting is the process used by businesses and organizations to evaluate potential **long-term investments** and **major projects.** The primary purpose of capital budgeting is to ensure that businesses allocate their limited financial resources effectively and efficiently, maximizing returns and minimizing risks.

**IMPORTANCE OF CAPITAL BUDGETING**

Capital budgeting is an essential financial decision-making process that plays a vital role in the success and sustainability of businesses. Its importance stems from its ability to optimize resource allocation, enhance profitability, and promote long-term growth. Here are some key reasons why capital budgeting is crucial for businesses:

1. **Efficient Resource Allocation:** Capital budgeting ensures that businesses allocate their limited financial resources to the most profitable and promising projects, maximizing returns on investment. It prevents the dispersion of resources on less viable projects, safeguarding the company's financial health.
2. **Profitability Enhancement:** Capital budgeting helps businesses identify projects that are likely to generate positive cash flows over their expected lifespan. By selecting projects with high profitability potential, businesses can increase their overall earnings and enhance shareholder value.
3. **Long-Term Growth Strategy:** Capital budgeting aligns investment decisions with the company's long-term strategic objectives. It promotes the pursuit of projects that contribute to sustainable growth, enabling businesses to expand their market reach, develop new products or services, and maintain a competitive advantage.
4. **Risk Management:** Capital budgeting incorporates risk assessment and mitigation strategies into the decision-making process. Businesses can identify and evaluate potential risks associated with each project and develop strategies to minimize potential losses and protect their financial stability.
5. **Accountability and Measurability:** Capital budgeting establishes a framework for accountability and measurability in investment decisions. Businesses can track the performance of implemented projects against projected outcomes, identifying areas for improvement and informing future capital budgeting decisions.

**PROCESS OF CAPITAL BUDEGTING**

**Key steps in the capital budgeting process:**

1. **Project Identification:** The first step involves identifying potential investment opportunities that align with the company's strategic goals and market opportunities. This may include considering new product development, expansion into new markets, or the acquisition of new assets.
2. **Project Evaluation:** Once potential projects have been identified, they are evaluated in terms of their expected cash flows, risks, and potential impact on the company's financial position. This may involve using various analytical techniques, such as net present value (NPV), internal rate of return (IRR), and payback period.
3. **Project Selection:** Based on the evaluation of potential projects, the company selects the projects that are most likely to generate positive cash flows, minimize risks, and contribute to the achievement of its strategic objectives.
4. **Project Implementation:** Once projects have been selected, they are implemented according to detailed plans and resource allocations. This may involve procurement of necessary equipment, construction of facilities, and hiring of personnel.
5. **Post-Implementation Review and Feedback:** Once projects have been completed, they are reviewed to assess their overall performance and identify areas for improvement. This feedback is used to inform future capital budgeting decisions and refine the company's project management practices.

**PAYBACK PERIOD**

It refers to the time taken by a proposed project to generate enough income to cover the initial investment. The project with the quickest payback is chosen by the company.

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| --- | --- |
| ***Payback Period =*** | ***Initial Cash Investment*** |
| ***Annual Cash Flow*** |

**Formula:**

**ACCOUNTING RATE OF RETURN**

The accounting rate of return is the ratio of the average after-tax profit divided by the average investment. The average investment would be equal to half of the original Investment if it were depreciated constantly.

ARR = Average Income/Average Investment

**NET PRESENT VALUE**

This method considers the time value of money and attributes it to the company's objective, which is to maximize profits for its owners. The capital cost factors in the cash flow during the entire lifespan of the product and the risks associated with such a cash flow.

**PROFITABILITY INDEX**

This method provides the ratio of the present value of future cash inflows to the initial investment. A Profitability Index that presents a value lower than 1.0 is indicative of lower cash inflows than the initial cost of investment. Aligned with this, a profitability index great than 1.0 presents better cash inflows and therefore, the project will be accepted.

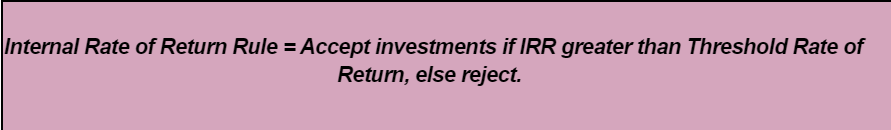
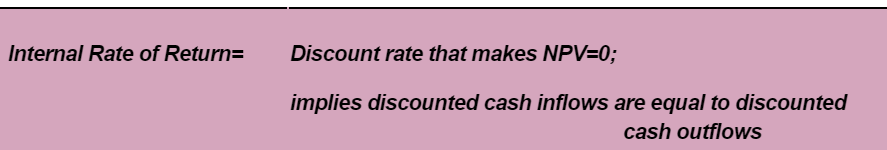
**Formula:**

|  |  |
| --- | --- |
| ***Profitability Index =*** | ***Present value of Cash Inflows*** |
| ***Initial Investment*** |

**INTERNAL RATE OF RETURN (IRR)**

RR refers to the method where the NPV is zero. In such as condition, the cash inflow rate equals the cash outflow rate. Although it considers the time value of money, it is one of the complicated methods.

It follows the rule that if the IRR is more than the average cost of the capital, then the company accepts the project, or else it rejects the project. If the company faces a situation with multiple projects, then the project offering the highest IRR is selected by them.

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**CAPITAL RATIONING**

Capital rationing refers to the situation where a company or an investor has **limited resources** available for new investments and needs to **make choices** about which projects or opportunities to pursue. It's essentially a situation where there are more good investment options than the available capital to fund them all.