Unit V

Business Finance Definition and Meaning

Finance is the lifeline of every business as it helps in the overall conduct, growth, and expansion of a business. It is next to impossible to conduct a business without finance. Therefore, it is imperative and unavoidable to thoroughly understand the working of business finance. In the subsequent sections of this article, we'll cover – what is business finance, what is financial management, and various other aspects of business finance.

Meaning of Business Finance

Business finance is the cornerstone of every organization. It refers to the corpus of funds and credit employed in a business. Business finance is required for purchasing assets, goods, raw materials and for performing all other economic activities. Precisely, it is required for running all the business operations.

To understand what business finance is, we must know that business finance includes activities concerning the acquisition and conservation of capital funds for meeting an organization's financial needs and objectives. The importance of business finance is evident from the fact that business finance is required to undertake every business operation successfully.

The amount of capital that is pooled by a business owner into their company is often not enough to meet the financial needs of a company. Herein, the importance of business finance and its management rises even more. Consequently, business owners along with their teams look out for various other ways to generate funds.

A business may require additional funds for anything ranging from buying plant or apparatus, raw materials or further development. Different types of business finance are:

- *Fixed Capital*
- *Working Capital*
- *Diversification*
- *Technology upgrading*

Importance of Business Finance

Here are some reasons why business finance is important for all organizations:

Maximization of wealth

Business finance ensures that a shareholder's wealth is maximized. It is also important to understand that wealth maximization is different from profit maximization. Wealth maximization is holistic and ensures the growth of an organization.

Ensure constant availability of money

For any business to survive, it should be in optimum financial condition. This includes the availability of funds at the time they are needed. Unless there are enough funds, the business may not be able to function properly.

Attaining optimum capital structure

This requires a perfect combination of shares and debentures. This way the organization will be able to maintain a perfect balance and not give away too much equity

Effective utilization of funds

This is another reason for the high importance of business finance and its efficient utilization. A business should be able to cut down unnecessary costs and not invest funds in assets that are not required. An exhaustive course in financial management, diploma in banking and finance or any other course related to finance can give your career in financial management a head start. Or, if you are already in the field, it can give your career the necessary boost.

What is Financial Management in Businesses?

Now that you know all about what business finance is and its importance, it'll be easier for you to understand financial management.
Financial management can be defined as the activities involving planning, raising, controlling, and administering money that is used in the business. Financial management involves procuring funds for buying fixed assets, raw materials, and working capital. Now that we know what financial management is, it is also important to understand that proper financial management helps businesses supply better products and services to customers besides offering other benefits.

Meaning of Financial Management

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

Scope/Elements of Financial Management

1. **Investment decisions** includes investment in fixed assets (called as capital budgeting). Investment in current assets are also a part of investment decisions called as working capital decisions.
2. **Financial decisions-** They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.
3. **Dividend decision-** The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two:
   - *Dividend for shareholders-* Dividend and the rate of it has to be decided.
   - *Retained profits-* Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

Objectives of Financial Management

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

1. To ensure regular and adequate supply of funds to the concern.
2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.

4. To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
5. To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

Functions of Financial Management

1. **Estimation of capital requirements:** A finance manager has to make estimation with regards to capital requirements of the company. This will depend upon expected costs and profits and future programmes and policies of a concern. Estimations have to be made in an adequate manner which increases earning capacity of enterprise.
2. **Determination of capital composition:** Once the estimation have been made, the capital structure have to be decided. This involves short- term and long- term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.
1. **Choice of sources of funds:** For additional funds to be procured, a company has many choices like-
- Issue of shares and debentures
- Loans to be taken from banks and financial institutions
- Public deposits to be drawn like in form of bonds.

Choice of factor will depend on relative merits and demerits of each source and period of financing.

2. **Investment of funds:** The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.
3. **Disposal of surplus:** The net profits decision have to be made by the finance manager. This can be done in two ways:
- Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
- Retained profits - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.
4. **Management of cash:** Finance manager has to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintainance of enough stock, purchase of raw materials, etc.
5. **Financial controls:** The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.

What is Profit Maximization in Financial Management?

The profit maximization principle is an important concept to understand, especially for any company that wants to maximise its profits. In financial management, profit maximization refers to finding the most profitable way to produce goods or provide any services. It simply means to maximise the profits of the company.

Profit maximization, in economics, is one of the most common objectives of every company. Generally, profit in accounting and business terms means that part of the amount which arrived after revenue exceeds the cost of production involved

Here, revenue is the money a business receives from selling its goods and services, and the cost is the money invested into production. In other words, this profit can be looked at as the net benefit earned for the shareholders by a company in the long run

What is Wealth Maximization in Financial Management?

Wealth maximization is a goal that all individuals and businesses should aim to achieve. Not only will it improve one's quality of life, but such wealth maximisation will help sustain the company's business in the long run. While wealth maximization is the company's objective, profit maximization is the objective of every company owner.

In other words, wealth maximization is the maximization of the owner's wealth, and its value is calculated by the computation of stock value. Hence, maximizing wealth is comparatively different from maximizing profit.

Profit Maximisation vs Wealth Maximization: The Differences

The prime consideration in managing every business is profitability. But only looking for profits would not make the business thrive in the long run. Therefore, this necessitates the combination of both profit maximization and wealth maximization in the company.

Profit maximization is the management of financial resources through a range of activities to increase the profits of the company. Wealth Maximization manages financial resources in such a way that there is increase in the value of shares of a company's shareholders.

Now let's look into the differences between profit maximization and wealth maximization:

1. Profit maximization is done by increasing the earning capacity of the company. Whereas, if the company's ability is focused on increasing the value of stocks for the shareholders and stakeholders, this is known as Wealth Maximization.
2. While profit maximization is a short-term goal of any business, Wealth Maximisation is a long-term goal.
3. Risks and uncertainties do not form part of the entire process of profit maximization. While as Wealth Maximization considers and recognises the need to assess all possible risks and uncertainties.
4. Profit maximization ensures the survival and growth of the business. In contrast, Wealth Maximization focuses on a company's long-term growth rate by increasing its share in the market.
5. The **time value of money is not accounted for in the profit maximization,** whereas **wealth maximisation acknowledges it**. According to the

concept of time value of money, a certain amount of money is worth more now than it will be in the future. This is so because investment is the only way to make money grow. An opportunity is lost when an investment is postponed.

6. Companies with profit maximization as their main goal focus on efficiency improvement with less cost and maximum profitable output. While in the case of the companies whose focus is wealth maximization, they heavily concentrate on increasing and improving the share market price of the company so that the value of the shareholders is increased.
7. The benefits of **profit maximization limit the company's growth to the current financial year,** whereas the benefits of **wealth maximization extend beyond the current year with a huge market share and higher share price,** which ultimately benefits every stakeholder related to the company.
8. In the case of profit maximization, a company prefers to maximise its profits. It solely relies on the profits made from the difference between the total revenue and cost plus tax expenses of the current financial year. In contrast, a company with a wealth maximization goal aims to increase the value of the shareholders' wealth as they are the real owners of the company. It does so by investing its capital in the market with uncertain risks but with higher returns.

Profit Maximization vs. Wealth Maximization: Comparison Table

Points of Difference	Profit Maximization	Wealth Maximization
Definition	It is the management of financial resources through a range of activities to increase the profits of the company.	It manages financial resources in such a way that these increase the value of the overall stakeholders of the company.
Process of Maximization	It is attained through the process of increasing the earning capacity of the company.	Wealth is maximized by increasing the value of stocks for the shareholders and stakeholders.
Term of the Goal	It is a short-term goal.	It is a long-term goal.
Risks Involvement	Risks and uncertainties do not form part of the entire process of profit maximization.	It recognises the need for assessing all possible risks and uncertainties.
Benefits of Maximization	It ensures the survival and growth of the business.	It aims to stimulate and attain a substantial growth rate by enhancing its share market holding in the economy.
Time Value of Money	Profit maximization does not take into account the time value of money.	Wealth maximization acknowledges it.
Center of Focus	It focuses on efficiency improvement with less cost and maximum profitable output.	It heavily concentrates on increasing and improving the share market price of the company.
Extend and Time of Benefits	The growth of the company through profit maximization is limited to the current financial year.	The benefits of Wealth Maximization extend beyond the current year with a huge market share and a higher market price of the share.
Main Motive	A company with a profit maximization goal prefers to maximise and rely solely on the profits.	A company with a Wealth Maximization goal is to increase the value of the shareholders' wealth.

Modern Approach of Financial Management

The modern approach does bring financial managers to consider the analytical and border point. They asked to consider both the optimum use of resources and distribution of funds. As the arrangement of funds is an important component which does mean for short time and long term financial problems. The below three decisions may taken by the finance manager.

Investment Decision

The decision relates to selection of assets which invest by firms and the assets which firms acquire which might for long term or short term. Capital budgeting is the process of selecting assets or investment proposals which yield for the long term. They deal with assets of current which are highly liquid in nature.

Financing Decision

The scope of finance indicates the possible sources of raising the finance. The financial planning decision attempts sources and possible accumulation of funds. As the decision to ensure the availability of funds whenever required.

As the financial decision made to raise funds at the right time, and financial decision has to opt for various cost effective methods to run business smoothly.

Dividend Decision

The decision taken in regards to net profit distribution which divides into dividend for shareholders and retained profits. This may concerned with determining the percentage of profit earned and paid to every shareholder as dividend. The financial manager makes decisions regarding such profits paid out and works for a better firm.

Investment Decision (Capital Budgeting Decision):

This decision relates to careful selection of assets in which funds will be invested by the firms. A firm has many options to invest their funds but firm has to select the most appropriate investment which will bring maximum benefit for the firm and deciding or selecting most appropriate proposal is investment decision.

Financing Decision

The financing decision is about the amount of finance to be raised from various long-term sources, this determines the various sources of finance, as well as it also provides the cost of each source of finance. The main sources of finance are:

- Shareholders' Funds
- Borrowed Funds

The shareholders' funds or owners' funds consist of equity capital and retained earnings, whereas borrowed funds refer to finance raised as debentures or other forms of debt. The borrowed funds contain risk because they involve a commitment of fixed interest payment, although there will be loss in the organisation.On the other hand, owners' funds have less risk because there is no such commitment regarding payment of dividends and replacement of the capital amount. Financing decisions involve analysing the risk and cost associated with each source of finance. Both sources have their own merits and demerits.Burrowed funds are considered to be the cheapest source of finance because interest paid is a deductible expense for the calculation of tax liability. The cost of raising finance is known as floatation cost, and it is also considered while taking financing decisions. In this way, the financing decision is related to deciding how much amount is to be raised from each source. This decision determines the overall cost of capital and the financial risk of the enterprise.

The **Dividend Decision** is one of the crucial decisions made by the finance manager relating to the payouts to the shareholders. The payout is the proportion of **Earning Per Share** given to the shareholders in the form of dividends.

The companies can pay either dividend to the shareholders or retain the earnings within the firm. The amount to be disbursed depends on the preference of the shareholders and the investment opportunities prevailing within the firm.

The optimal dividend decision is when the wealth of shareholders increases with the increase in the value of shares of the company. Therefore, the finance department must consider all the decisions viz. Investment, Financing and Dividend while computing the payouts.

If attractive investment opportunities exist within the firm, then the shareholders must be convinced to forego their share of dividend and reinvest in the firm for better future returns. At the same time, the management must ensure that the value of the stock does not get adversely affected due to less or no dividends paid out to the shareholders.

The objective of the financial management is the **Maximization of Shareholder's Wealth**. Therefore, the finance manager must ensure a win-win situation for both the shareholders and the company.

What is inter-relationship between investment, financing and dividend decisions?

Although the basic decisions of finance includes three types of decisions i.e. investing, finance and dividend decisions but they are interlinked with each other somehow. It can be evident from the following points:

- The main objective of all the above decisions is same which is profit maximization of business and wealth maximization of shareholders.

- In order to make investment decisions such as investing in some major projects, the first thing we need to consider is the finance available and required to make investment.
- Finance decision is also influenced by dividend decision. If more of the dividend is distributed, there is a need to raise more finance from external sources.
- If more of the profits are retained for long term investment, there is less need of outside financing.

Hence, there is a need to take into account the joint impact of all the three decisions and effect of each of the decision on the market value of the company and its shares to achieve the overall objective of the business.