Chapter-1
Introduction to Financial Management

Companies do not work in a vacuum, isolated from everything else. It interacts and transacts with the other entities present in the economic environment. These entities include Government, Suppliers, Lenders, Banks, Customers, Shareholders, etc. who deal with the organisation in several ways. Most of these dealings result in either money flowing in or flowing out from the company. This flow of money (or funds) has to be managed so as to result in maximum gains to the company.

Managing this flow of funds efficiently is the purview of finance. So we can define finance as the study of the methods which help us plan, raise and use funds in an efficient manner to achieve corporate objectives. Finance grew out of economics as a special discipline to deal with a special set of common problems.

The corporate financial objectives could be to:

1. Provide the link between the business and the other entities in the environment and
2. Investment and financial decision making

Let us first look at what we mean by investment and financial decision making.

1. **Investment Decision:** The investment decision, also referred to as the capital budgeting decision, simply means the decisions to acquire assets or to invest in a project. Assets are defined as economic resources that are expected to generate future benefits.
2. **Financing Decision:** The second financial decision is the financing decision, which basically addresses two questions:
   a. How much capital should be raised to fund the firm's operations (both existing & proposed)
   b. What is the best mix of financing these assets?

Financing could be through two ways: debt (loans from various sources like banks, financial institutions, public, etc.) and equity (capital put in by the investors who are also known as owners/ shareholders). Shareholders are owners because the shares represent the ownership in the company.

Funds are raised from financial markets. Financial markets is a generic term used to denote markets where financial securities are teat. These markets include money markets, debt market and capital markets. We will understand them in detail later in the 3rd chapter.

Financing and investing decisions are closely related because the company is going to raise money to invest in a project or assets. Those who are going to give money to the company (whether lenders or investors) need to understand where the company is investing their money and what it hopes to earn from the investments so that they can assure themselves of the safety of their money.

The questions that you may thinking about right now are "Why do we need to learn finance? Shall we not leave it to the people who are going to specialise in finance? Finance won't help me in the area that I am going to work in, so why learn?" This is to say that the knowledge of finance does not add any value to you. Is it so? Think about it. When you get your pocket money from your parents, you do not go out and blow the whole lot in one day because if you do, your parents are not going to give you more money to last through that month. You quickly learn that you need to plan your expenditure so that the money lasts throughout the month and you may actually plan to save some of it. Those who do not get enough to meet their requirements, think about some clever means to raise more money (like falling sick!). Alternatively if they need more money for the month because of certain special events (like Valentine's day) they can plan to borrow money for a month and repay in the next month.

So you plan, raise and efficiently utilise funds that are your disposal (or at least try to). That a business organisation also needs to do the same can hardly be overemphasised. The scale of operations is much bigger and to efficiently manage funds at this scale, decisions cannot be taken without sound methodology. Finance teaches you this terminology.

For managing these funds the first thing you would need is information. External information has to be collected from the environment and accounting provides internal information about the firm's operations. Accounting can be defined as an information and measurement system that identifies, records, and communicates relevant information about a company's economic activities to people to help them make better decisions.

You would now agree that a company needs to manage its own funds efficiently but your question still remains "Why am I concerned with it?" Further arguing, you say that, "I am going to specialise in Marketing/ Information Technology/ Human Resource Management/ Operations Management and there is no need for me to learn finance. Also Finance is a separate function in my organisation (or the organisation that I am going to work for) and I am hardly going to use finance to work in my respective department."

Think again. Everything that you do has an impact on the profitability of the company (including drinking ten cups of coffee in a day!). So if you want to grow up to be the CEO of the company in a few years from now (which I undoubtedly think that you would love to) you should take the advice of the top CEOs.

> *79 per cent of the top CEOs rate Finance skills, as the most required for the CEO of the future.*
>
> ***KPMG survey***

Better take the CEOs advice. But don't get the feeling that only the CEOs require the Finance Skills, all other functions of management also cannot do without finance and the financial information.

Fields of Finance

The academic discipline of financial management may be viewed as made up of five specialized fields. In each field, the financial manager is dealing with the management of money and claims against money. Distinctions arise because different organizations pursue different objectives and do not face the same basic set of problems. There are five generally recognized areas of finance.

1. **Public Finance.** Central, state and local governments handle large sums of money, which are received from many sources and must be utilized in accordance with detailed policies and procedures. Governments have the authority to tax and otherwise raise funds, and must dispense funds according to legislative and other limitations. Also, government do not conduct their activities to achieve the same goals as private organizations. Businesses try to make profits, whereas a government will attempt to accomplish social or economic objectives. As a result of these and other differences, a specialized field of public finance has emerged to deal with government financial matters.
2. **Securities and Investment Analysis.** Purchase of stocks, bonds, and other securities involve analysis and techniques that are highly specialized. An investor must study the legal and investment characteristics of each type of security, measure the degree of risk involved with each investment, and forecast probable performance in the market. Usually this analysis occurs without the investor having any direct control over the firm or institution represented by the form of security. The field of investment analysis deals with these matters and attempts to develop techniques to help the investor reduce the risk and increase the likely return from the purchase of selected securities.
3. **International Finance.** When money crosses international boundaries individuals, businesses, and governments must deal with special kinds of problems. Each country has its own national currency; thus a citizen of the United States must convert dollars to French francs before being able to purchase goods or services in Paris. Most governments have imposed restrictions on the exchange of currencies, and these may affect business transactions. Governments may be

facing financial difficulties, such as balance-of-payments deficits, or may be dealing with economic problems, such as inflation or high levels of unemployment. In these cases, they may require detailed accounting for the flows of funds or may allow only certain types of international transactions. The study of flows of funds between individuals and organizations across national borders and the development of methods of handling the flows more efficiency are properly within the scope of international finance.

4. **Institutional Finance.** A nation's economic structure contains a number of financial institutions, such as banks, insurance companies, pension funds, credit unions. These institutions gather money from individual savers and accumulate sufficient amounts for efficient investment. Without these institutions, funds would not be readily available to finance business transactions, the purchase of private homes and commercial facilities, and the variety of other activities that require organizations that perform the financing function of the economy.

5. **Financial Management.** Individual businesses face problems dealing with the acquisition of funds to carryon their activities and with the determination of optimum methods of employing the funds. In a competitive marketplace, businesses and actively manage their funds to achieve their goals. Many tools and techniques have been developed to assist financial managers to recommend proper courses of action.

These tools help the manager determine which sources offer the lowest cost of funds and which activities will provide the greatest return on invested capital. Financial management is the field of greatest concern to the corporate financial officers and will be the major thrust of the approach we shall use in studying finance.

An overview of the five fields of finance is given in Figure 1.1.

Public Finance	**Securities and Investment Analysis**
• Used in central, state and local government. • Examines taxes and other revenues. • Pursues nonprofit goals.	• Used by individual and institutional investors. • Measures risk in securities transactions. • Measures likely return.
Institutional Finance • Examines banks, insurances companies and pension funds. • Studies saving and capital formation.	**International Finance** • Studies economic transactions among nations. • Concerned with flows among countries.
Financial Management • Studies financial problems in individual firms. • Seeks sources of low-cost funds. • Seeks profitable business activities.	

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Objectives of the Firm - Profit Maximisation and Wealth Maximisation

To put it simply, we might say that the goal of any business is to maximise the returns to the owners of the business. So the goal of finance is to help the business in maximising returns. But if you talk to the companies, you also hear about many other goals that they are pursuing at the same time. These goals could include maximisation of sales, maximisation of market share, maximisation of growth rates of sales, maximisation of the market price of the share (whether real or specifically pushed up to benefit the owners), etc. Individually speaking, managers would be more concerned with the money that they are making from the organisation and the benefits that they are receiving rather than care about what the owners are making!

As there could be many goals for the organisation, we should try and summarise the organisational goals in financial terms so that we can call them the financial goals. They boil down to two:

1. Maximise profits or
2. Maximise wealth

Maximise Profits

Let us first look at profit maximisation. Profit (also called net income or earnings) can be defined as the amount a business earns after subtracting all expenses necessary for its sales. To put it in an equation form:

Sales - Expenses = Profit

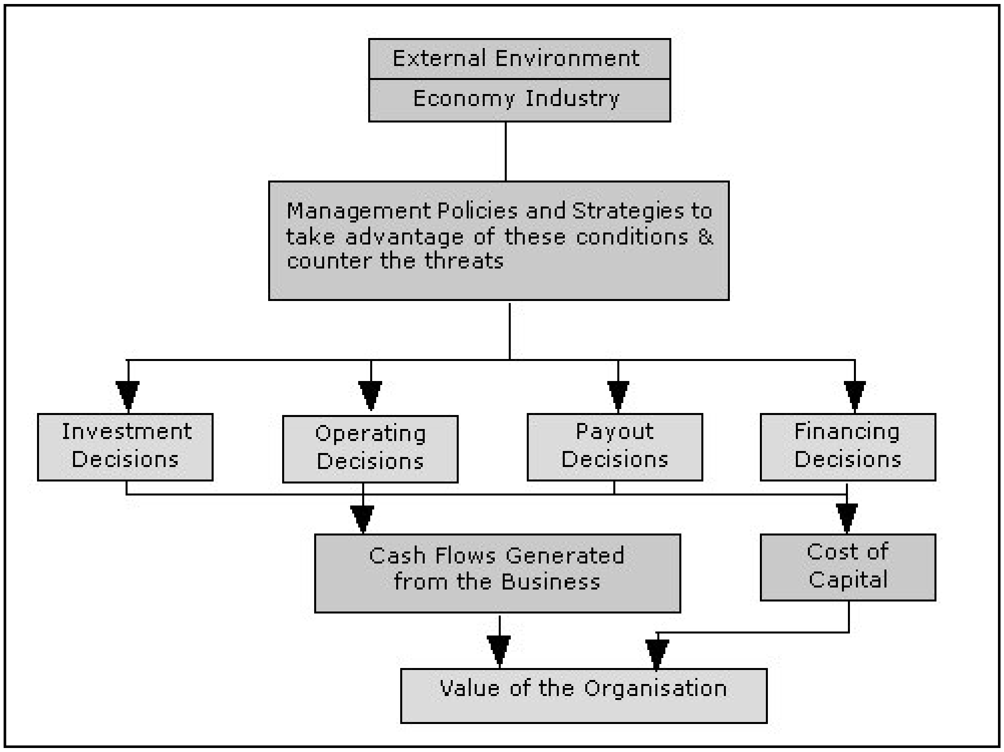
If you want to maximise profits, there are only two ways to do it. Either you reduce your expenses (also called costs) or you increase the sales (also called revenues). Both of these are not easy to achieve. Sales can be increased by selling more products or by increasing the price of the products. Selling more products is difficult because of the competition in the market and you cannot increase the price of the products without adding more features or value to it (assuming a competitive market). If you are a competitive company, reducing expenses beyond a certain level is possible only by reducing the investments in advertising, research and development, etc. which ultimately leads to reduction in sales in the long term and threatens the survival of the company. Profit maximisation goal assumes that many of the complexities of the real world do not exist and is, therefore, not acceptable.

Still, profit maximisation remains one of the key goals for the managers of the company because many managers' compensations are linked to the profits that the company is generating. Owners need to be aware of these goals and understand that it is the long-term viability of their companies that add value to them and not the short-term profitability.

Therefore, the long-term survival of the company should not be sacrificed for the short-term benefits.

Wealth Maximisation

Shareholders' wealth can be defined as the total market value of all the equity shares of the company. So when we talk about maximising wealth we talk about maximising the value of each share. How the decisions taken by the organisation affects the value of the organisation is reflected in the figure 1.1.



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The shareholders' wealth maximisation goal gives us the best results because effects of all the decisions taken by the company and its managers are reflected in it. In order to employee use this goal, we do not have to consider every price change of our shares in the market as an interpretation of the worth of the decisions that the company has taken. What the company needs to focus on is the affect that its decision should have on the share price if everything else was held constant. This conflict of the decisions by the managers and the decisions required by the owners is known as the agency problem. How are companies solving this problem will be discussed later.

Scope of Financial Management

The approach to the scope and functions of financial management is divided, for purposes of exposition, into two broad categories: (a) The Traditional Approach, and (b) The Modern Approach.

Traditional Approach

The traditional approach to the scope of financial management refers to its subject-matter, in academic literature in the initial stages of its evolution, as a separate branch of academic study. The term 'corporation finance' was used to describe what is now known in the academic world as 'financial management'. As the name suggests, the concern of corporation finance was with the financing of corporate enterprises. In other words, the scope of the finance function was treated by the traditional approach in the narrow sense of procurement of funds by corporate enterprise to meet their financing needs. The term 'procurement' was used in a broad sense so as to include the whole gamut of raising funds externally. Thus defined, the field of study dealing with finance was treated as encompassing three interrelated aspects of raising and administering resources from outside: (i) the institutional arrangement in the form of financial institutions which comprise the organization of the capital market; (ii) the financial instruments through which funds are raised from the capital markets and the related aspects of practices and the procedural, aspects of capital markets; and (iii) the legal and accounting relationships between a firm and its sources of funds. The coverage of corporation finance was, therefore, conceived to describe the rapidly evolving complex of capital market institutions, instruments and practices. A related aspect was that firms require funds at certain episodic events such as merger, liquidation, reorganization and soon. A detailed description of these major events constituted the second element of the scope of this field of academic study. That these were the broad features of the subject-matter of corporation finance is eloquently reflected in the academic writings around the period during which the traditional approach dominated academic thinking. Thus, the issue to which literature on finance addressed itself was how resources could best be raised from the combination of the available sources.

The traditional approach to the scope of the finance function evolved during the 1920s and 1930s and dominated academic during the forties and through the early fifties. It has now been discarded as it suffers from serious limitations. The weaknesses of the traditional approach fall into two broad categories: (i) those relating to the treatment of various topics and the emphasis attached to them; and (ii) those relating to the basic conceptual and analytical framework of the definitions and scope of the finance function.

The first argument against the traditional approach was based on its emphasis on issues relating to the procurement of funds by corporate enterprises. This approach was challenged during the period when the approach dominated the scene itself. Further, the traditional treatment of finance was criticised because the finance function was equated with the issues involved in raising and administering funds, the theme was woven around the viewpoint of the suppliers of funds such as investors, investment bankers and so on, that is, the outsiders. It implies that no consideration was given to the viewpoint of those who had to take internal financial decisions. The traditional treatment was, in other words, the *outsider-looking-in approach.* The limitation was that internal decision making (i.e. *insider-looking out*) was completely ignored.

The second ground of criticism of the traditional treatment was that the focus was on financing problems of corporate enterprises. To that extent the scope of financial management was confined only to a segment of the industrial enterprises, as non-corporate organisations lay outside its scope.

Yet another basis on which the traditional approach was challenged was that the treatment was built too closely around episodic events, such as promotion, incorporation, merger, consolidation, reorganisation and so on. Financial management was confined to a description of these infrequent happenings in the life of an enterprise. As a logical corollary, the day-to-day financial problems of a normal company did not receive much attention.

Finally, the traditional treatment was found to have a lacuna to the extent that the focus was on long-term financing. Its natural implication was that the Issues involved in working capital management were not in the purview of the finance function.

The limitations of the traditional approach were not entirely based on treatment or emphasis of different aspects. In other words, its weaknesses were more fundamental. The conceptual and analytical shortcoming of this approach arose from the fact that it confined financial management to issues involved in procurement of external funds, it did not consider the important dimension of allocation of capital. The conceptual framework of the traditional treatment ignored what Solomon aptly describes as the *central issues of financial management.* These issues are reflected in the following fundamental questions which a finance manager should address. Should an enterprise commit capital funds to certain purposes do the expected returns meet financial standards of performance? How should these standards be set and what is the cost of capital funds to the enterprise? How does the cost vary with the mixture of financing methods used? In the absence of the coverage of these crucial aspects, the traditional approach implied a very narrow scope for financial management. The modern approach provides a solution to these shortcomings.

Modern Approach

The modern approach views the term financial management in a broad sense and provides a conceptual and analytical framework for financial making. According to it, the finance function covers both acquisition of funds as well as their allocations. Thus, apart from the issues involved in acquiring-external funds, the main concern of financial management is the efficient and wise allocation of funds to various uses. Defined in a broad sense, it is viewed as an integral part of overall management.

The new approach is an analytical way of viewing the financial problems of a firm. The main contents of this approach are what is the total volume of funds an enterprise should commit? What specific assets should an enterprise acquire? How should the funds required be financed? Alternatively, the principal contents of the modern approach to financial management can be said to be: (i) How large should an enterprise be, and how fast should it grow? (ii) In what form should it hold assets? and (iii) What should be the composition of its liabilities?

The three questions posed above cover between them the major financial problems of a firm. In other words, financial management, according to the new approach, is concerned with the solution of three major problems relating to the financial operations of a firm, corresponding to the three questions of investment, financing and dividend decisions. Thus, financial management, in the modem sense of the term, can be broken down into three major decisions as functions of finance: (i) The investment decision, (ii) The financing decision, and (iii) The dividend policy decision.

The investment decision relates to the selection of assets in which funds will be invested by a firm. The assets which can be acquired fall into two broad group: (i) long-term assets which yield a return over a period of time in future, (ii) short-term or current assets, defined as those assets which in the normal course of business are convertible into without diminution in value, usually within a year. The first of these involving the first category of assets is popularly known in financial literature as *capital budgeting*. The aspect of financial decision making with reference to current assets or short-term assets is popularly termed as *working capital management.*

Capital Budgeting is probably the most financial decision for a firm. It relates to the selection of an asset or investment proposal or course of action whose benefits are likely to be available in future over the lifetime of the project. The long-term assets can be either new or old/existing ones. The first aspect of the capital budgeting decision relates to the choice of the new asset out of the alternatives available or the reallocation of capital when an existing asset fails to justify the funds committed. Whether an asset will be accepted or not will depend upon the relative benefits and returns associated with it. The measurement of the worth of the investment proposals is, therefore, a major element in the capital budgeting exercise. This implies a discussion of the methods of appraising investment proposals.

The second element of the capital budgeting decision is the analysis of risk and uncertainty. Since the benefits from the investment proposals extend into the future, their accrual is uncertain. They have to be estimated under various assumptions of the physical volume of sale and the level of prices. An element of risk in the sense of uncertainty of future benefits is, thus, involved in the exercise. The returns from capital budgeting decisions should, therefore, be evaluated in relation to the risk associated with it.

Finally the evaluation of the worth of a long-term project implies a certain norm or standard against which the benefits are to be judged. The requisite norm is known by different names such as *cut-off* rate, *hurdle rate, required rate, minimum rate of return* and so on. This standard is broadly expressed in terms of the cost of capital. The concept and measurement of the cost of capital is, thus, another major aspect of capital budgeting decision. In brief, the main elements of capital budgeting decisions are: (i) the long-term assets and their composition, (ii) the business risk complexion of the firm, and (iii) concept and measurement of the cost of capital.

Working Capital Management is concerned wit the management of current assets. It is an important and integral part of financial management as short-term survival is a prerequisite for long-term success. One aspect of working capital management is the trade-off between profitability and risk (liquidity). There is a conflict between profitability and liquidity. If a firm does not have adequate working capital, that is, it does not invest sufficient funds in current assets, it may become illiquid and consequently may not have the ability to meet its current obligations and, thus, invite the risk of bankruptcy. If the current assets are too large, profitability is adversely affected. The key strategies and considerations in ensuring a tradeoff between profitability and liquidity is one major dimension of working capital management. In addition, the individual current assets should be efficiently managed so that neither inadequate nor unnecessary funds are locked up. Thus, the management of working capital has two basic ingredients: (1) an overview of working capital management as a whole, and (2) efficient management of the individual current assets such as cash, receivables and inventory.

The second major decision involved in financial management is the financing decision. The investment decision is broadly concerned with the asset-mix or the composition of the assets of a firm. The concern of the financing decision is with the financing-mix or capital structure or leverage. The term capital structure refers to the proportion of debt (fixed-interest sources of financing) and equity capital (variable-dividend securities/ source of funds). The financing decision of a firm relates to the choice of the proportion of these sources to finance the investment requirements. There are two aspects of the financing decision. First, the theory of capital structure which shows the theoretical relationship between the employment of debt and the return of the shareholders. The use of debt implies a higher return to the shareholders as also the financial risk. A proper balance between debt and equity to ensure a trade-off between risk and return to the shareholders is necessary. A capital structure with a reasonable proportion of debt and equity capital is called the optimum capital structure. Thus, one dimension of the financing decision whether there is an optimum capital structure? And in what proportion should funds be raised to maximise the return to the shareholders? The second aspect of the financing decision is the determination of an appropriate capital structure, given the facts of a particular case. Thus, the financing decision covers two interrelated aspects: (1) capital structure theory, and (2) capital structure decision.

The third major decision of financial management is the decision relating to the dividend policy. The dividend should be analysed in relation to the financing decision of a firm. Two alternatives are available in dealing with the profits of a firm: they can be distributed to the shareholders in the form of dividends or they can be retained in the business itself. The decision as to which course should be followed depends largely on a significant element in the dividend decision, the dividend payout ratio, that is, what proportion of net profits should be paid out to the shareholders. The final decision will depend upon the preference of the shareholders and investment opportunities available within the firm. The second major aspect of the dividend decision is the factors determining dividend policy of a firm in practice.

To conclude, the traditional approach had a very narrow perception and was devoid of an integrated conceptual and analytical framework. It had rightly been discarded in current academic literature. The modern approach has broadened the scope of financial management which involves the solution of three major decisions, namely, investment, financing and dividend. These are interrelated and should be jointly taken so that financial decision-making is optimal. The conceptual framework for optimum financial decisions is the objective of financial management. In other words, to ensure an optimum decision in respect of these three areas, they should be related to the objectives of financial management.

Functions of Financial Management

The traditional function of financial management has been limiting the role of finance to raising and administrating of funds needed by the company to meet their financial needs. It broadly covered:

1. Arrangement of funds through financial institutions
2. Arrangement of funds through financial instruments
3. Looking after the legal and accounting relationship between a corporation and its sources of funds

This has outlived its utility. With the advent of technology and need to tighten ships because of competition, financial management became as much a science as art. Efficient allocation of funds became the imperative. The modern approach is an analytical way of looking at the financial problems of a firm with the main concerns like:

1. What is the total volume of funds committed
2. What specific assets should be acquired or divested
3. How should the funds required be financed and from which markets

The above questions relate to four broad decision areas, these are:

1. **Investment decision:** Decisions relating to investment in both capital and current assets. The finance manager has to evaluate different capital investment proposals and select the best keeping in view the overall objective of the enterprise. Capital Budgeting is the typical name given to this decision.
2. **Financing Decision:** Provision of funds required at the proper time is one of the primary tasks of the finance manager. Identification of the sources, deciding which types of funds to raise (debt or equity), and raising them is one of the crucial tasks.
3. **Dividend Decision:** Determination of funds requirements and how much of it will be generated from internal accruals and how much to be sourced from outside is a crucial decision. Equity holders are the owners and require returns, and how much money to be paid to them is a crucial decision.
4. **Working Capital Decision:** The investment in current assets is a major activity that a finance manager is engaged in a day to day basis. How much inventory to keep, how much receivables can be managed, and what is the optimum cash levels, are three of the key questions that are dealt with regularly.

All these decisions interact, investment decision cannot be taken without taking the financing decision, working capital decision also needs financing, dividend decision is a payout mechanism and has to be taken care of from financing. These tasks are divided and are taken care of by various entities.

Objectives of Financial Management

To make wise decisions a clear understanding of the objectives which are sought to be achieved in necessary. The objectives provide a framework for optimum financial decision-making. In other words, they are concerned with designing a method of operating the internal investment and financing of a firm. We discuss in this section the alternative approaches in financial literature. There are two widely-discussed approaches: (i) Profit maximisation approach and (ii) Wealth maximisation approach.

It should be noted at the outset that the term ‘objective’ is used in the sense of a goal or *decision criterion* for the three decisions involved in financial management. It implies that what is relevant is not the overall objective or goal of a business but an operationally useful criterion by which to judge a specific set of mutually interrelated business decisions, namely, investment, financing and dividend policy. The second point that should be clearly understood to that the term objectives provides a normative framework. That is the focus in financial literature is on what a firm should try to achieve and on policies that should be followed if certain goals are to be achieve. The implication is that these are not necessarily followed by firms in actual practice. They are rather employed to serve as a basis for theoretical analysis and do not reflect contemporary empirical industry practices. Thus, the term is used in a rather narrow sense of what a firm *should attempt* to achieve with its investment, financing and dividend policy decisions.

Profit Maximisation Decision Ceriterion

According to this approach, actions that increase profits should be undertaken and those that decrease profits are to be avoided. In specific operational terms, as applicable to financial management, the profit maximisation criterion implies that the investment, financing and dividend policy decisions of a firm should be oriented to the maximisation of profits.

The term ‘profit’ can be used in two senses. As a owner-oriented concept it refers to the amount and share of national income which is paid to the owners of business, that is, those who supply equity capital. As a variant it is described as profitability. It is an operational concepts and signifies economic efficiency. In other words, profitability refers to a situation where output exceeds input, that is, the value created by the use of resources is more than the total of the input resources. Used in this sense, profitability maximisation would imply that a firm should be guided in financial decision making by one test; select assets, projects and decisions which are profitable and reject those which are not. In the current financial literature, there is a general agreement that profit maximisation is used in the second sense.

The rationale & behind profitability maximisation, as a guide to financial decision making, is simple. Profit is a test of economic efficiency. It provides the yardstick by which economic performance can be judged. Moreover, it leads to efficient allocation of resources, as resources tend to be directed to uses which in terms of profitability are the most desirable. Finally, it ensures maximum social welfare. The individual search for maximum profitability provides the famous 'invisible hand' by which total economic welfare is maximised. Financial management is concerned with the efficient use of an important economic resource (input), namely, capital. It is, therefore, argued that profitability maximisation should serve as the basic criterion for financial management decisions.

The profit maximisation criterion has, however, been questioned and criticized on several grounds. The reasons for the opposition in academic literature all into two broad groups: (i) those that are based on misapprehensions about the workability and fairness of the private enterprise itself, and (2) those that arise out of the difficulty of applying this criterion management, refers to an explicit operational guide for the internal investment and financing of a firm and not the overall goal of business operations. We, therefore, focus on the second type of limitations to profit maximisation as an objective of financial management. The main technical flaws of this criterion are ambiguity, timing of benefits, and quality of benefits.

Ambiguity. One practical difficulty with profit maximisation criterion for financial decision making is that the term-profit is a vague and ambiguous concept. It has no precise connotation. It is amenable to different interpretations by different people. To illustrate, profit may be short term or long term; it may be total profit or rate of profit; it may be before-tax or before-tax or after-tax; it may be return on total capital employed or total assets or shareholders equity and so on. If profit maximisation is taken to be the objectives, the question arises, which of these variable of profit should a firm try to maximise? Obviously, a loose expression like profit of operational criterion for financial management.

Timing of Benefits. A more important technical objection to profit maximisation, as a guide to financial decision making, is that it ignores the differences in the time pattern of the benefits received from investment proposals or courses of action. While working out profitability, *'the bigger the better'* principle is adopted, as the decision is based on the total benefits received over the working life of the asset, irrespective of when they were received. Consider Table 1.1

[illegible]

	Alternative A (Rs. Lakhs)	Alternative B (Rs. Lakhs)
Period I	50	–
Period II	100	100
Period III	50	100
Total	**200**	**200**

It can be seen from Table 1.1 that the total profits associated with the alternatives, A and B, are identical. If the profit maximisation is the decision criterion, both the alternatives would be ranked equally. But the returns form both the alternatives differ in one important respect, while alternative A provides higher returns in earlier years, the returns from alternative B are larger in later years. As a result, the two alternative courses of "action are not strictly identical. This is primarily because a basic dictum of financial planning is the earlier the better as benefits received sooner are more voluble than benefits'. received later. The reason for the superiority of benefits now over benefits later lies in the fact that the former can be reinvested to earn a return. This is referred to as time value of money. The profit maximisation criterion does not consider the distinction between returns received in different time periods and treats all benefits irrespective of the timing, as equally valuable. This not true in actual practice as benefits in early years should be valued more highly than equivalent benefits in later years. The assumption of equal value is inconsistent with the real world situation.

Quality of Benefits. Probably the most important technical limitation of profit maximistion as an operational objective, is that it ignores the quality aspect of benefits associated with a financial course of action. The term quality here refers to the degree of certainty with which benefits can be expected. As a rule, the more certain the expected return, the higher is the quality of the benefits. Conversely, the more uncertain/ fluctuating is the expected benefits, the lower is the quality of the benefits. An uncertain and fluctuating return implies risk to the investors. It can be safely assumed that the investors are risk-averters, that is they want to avoid or at least minimise risk. They can, therefore, be reasonably expected to have a preference for a return which is more certain in the sense that it has smaller variance over the years.

The problem of uncertainty renders profit maximisation unsuitable as an operational criterion for financial management as it considers only the size of benefits and gives no weight to the degree of uncertainty of the future benefits. This is illustrated in Table 1.2.

[illegible]

State of Economy	Alternative A	Alternative B
Recession (Period I)	9	0
Normal (Period II)	10	10
Boom (Period III)	11	20
Total	**30**	**30**

It is clear from Table 1.2 that the total returns associated with the two alternatives are identical in a normal situation but the range of variations is very wide in case of alternative B, while it is narrow in respect of alternative A. To put it differently, the earnings associated with alternative. B are more uncertain (risky) as they fluctuate widely depending on the state. of the economy. Obviously, alternative A is better in terms of risk and uncertainty, The profit maximisation criterion fails to reveal this,

To conclude, the profit maximisation criterion is inappropriate and unsuitable as an operational objective of investment, financing and dividend decisions of a firm. It is not only vague and time value of money. It follows from the above that an appropriate operational decision criterion for financial management should (i) be precise and exact, (ii) be based on the 'bigger the better' principal, (iii) consider both quantity and quantity dimensions of benefits, and (iv) recognise the time value of money. The alternative to profit maximisation, that is wealth maximisation is one such measure.

Wealth Maximisation Decision Criterion

This is also known as value maximisation or net present worth maximisation. In current academic literature value maximisation is almost universally accepted as an appropriate operations decision criterion for financial management decisions as it removes the technical limitations which characterise earlier profit maximisation criterion Its operational features satisfy all the three requirement of a suitable operation objective of financial courses of action, namely, exactness, quality of benefits and the time value of money.

The value of an asset should be viewed in terms of the benefits it can produce. The worth of a course of action can similarly be judged in terms of the value of the benefits it produces less the cost of undertaking it. A significant element in computing the value of a financial course of action, is the precise estimation of the benefits associated with it. The wealth maximisation criterion is based on the measurement of benefits in the case of the profit maximisation criterion. Cash flow is a precise concept with a definite connotation. Measuring benefits in terms of case flow avoids the ambiguity associated with accounting profits. This is the first operational feature of the net present worth maximisation criterion.

The second important feature of the wealth maximisation criterion is that it considers is that it considers both the quantity and quality dimensions of benefit. At the same, it also incorporates the time value of money. The operational implication of the uncertainty and timing dimensions of the benefits emanating from a financial decision is that adjustment should be made in the cash flow pattern, firstly, to incorporate risk and, secondly, to make an allowance for differences in the timing of benefits. The value of a course of action must be viewed in teams of its worth to those providing the resources necessary for its undertaking. In applying the value maximisation criterion, the term value is used in terms of worth to the owners, that is, ordinary shareholders. The capitalisation (discount) rate that is employed is, therefore, the rate that reflects the time and risk preferences of the result of higher risk longer time period. Thus, a stream of case flows that is quite certain might be associated with a rate a 5 per cent, while a very risky stream may carry a 15 per cent discount rate.

For the above reason the net present value maximisation is superior to the profits maximisation as an operational objective. As a decision criterion, it involves a comparison of value to cost. An action that has a discounted value – reflecting both time and risk that exceeds its cost can be said to create value. Such actions should be undertaking. Conversely, actions, with lees value than cost, reduce wealth and should be alternative with the greatest net present value should be selected. In the words of Ezra Solomon,

> *"The gross present worth of a course of action is equal to the capitalised value of the flow of future expected benefit, discounted (or capitalised) at a rate which reflects their certainty or uncertainty. Wealth or net present worth is the difference between gross present worth and the amount of capital investment required to achieve the benefits being discussed. Any financial action which creates wealth or which has a net present worth above zero is a desirable one and should be undertaken. Any financial action which does not meet this test should be rejected.*