
FINANCE
funding
saving
benefit
CASHBOOK
Business Company

MEANING OF FINANCE

Finance may be defined as an **art or a science of managing money**. It includes financial service and financial instruments.

Finance is also referred as the **provision of money at the time when it is needed.**

Finance function is the **procurement of funds and their effective utilization** in business concerns.

Webster's Ninth New Collegiate Dictionary defines finance as 'the Science on study of the management of funds' and the management of fund as the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of banking facilities.

MEANING OF BUSINESS FINANCE

- **According to the Wheeler,** *"Business finance is that business activity which concerns with the* ***acquisition and conversion of capital funds*** *in meeting* ***financial needs*** *and* ***overall objectives*** *of a business enterprise".*

- **According to the Guthumann and Dougall,** *"Business finance can broadly be defined as the activity concerned with planning, raising, controlling, administering of the funds used in the business".*

DEFINITION OF FINANCIAL MANAGEMENT

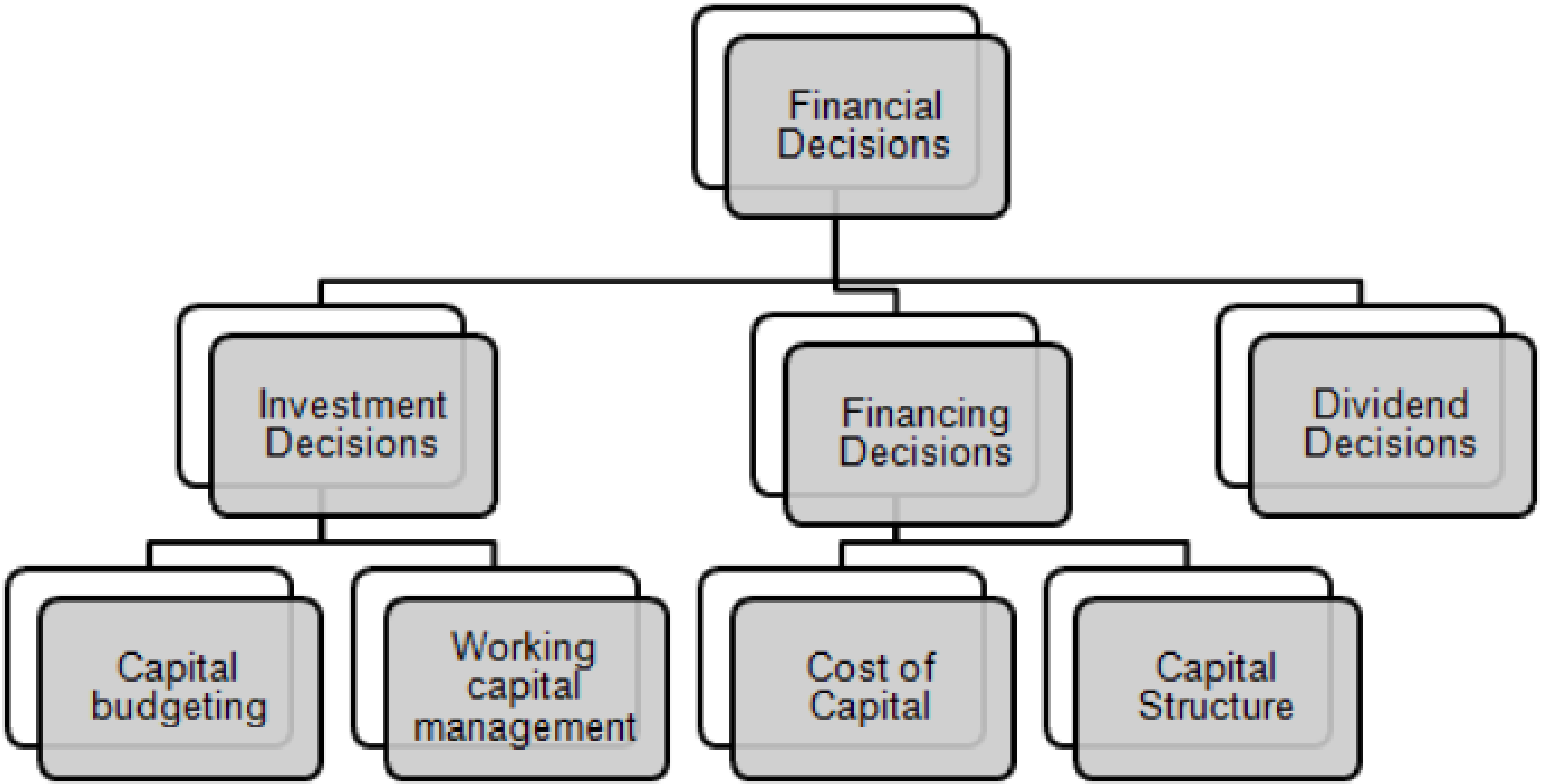
- Financial management is an integral part of overall management. It is concerned with the duties of the financial managers in the business firm.
- The term financial management has been defined by different experts as under :
- *"It is concerned with the efficient use of an important economic resource namely, capital funds".* – **Solomon**
- *Financial management "as an application of general managerial principles to the area of financial decision-making.* – **Howard and Upton**
- *Financial management "is an area of financial decision-making, harmonizing individual motives and enterprise goals".* – **Weston and Brigham**
- *Financial management "is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations.* – **Joseph and Massie**

DEFINITION OF FINANCIAL MANAGEMENT

Thus, financial management is broadly concerned with: **raising of funds, creating value to the assets of the business enterprise by efficient allocation of funds.**

It is the study of integration of the flow of funds in the most optimal manner to maximize the returns of a firm by taking proper decisions in utilizing the funds.

In other words, raising of funds should involve minimum cost and to bring maximum returns.



Types of Financial Decisions

1. INVESTMENT DECISIONS

- Investment ordinarily means **utilisation of money for profits or returns**.
- This could be done by **carrying on business or purchasing shares or debentures of a company or sometimes, though erroneously, purchasing a consumer durable like building.**
- **Capital budgeting** is a major aspect of investment decision making process.
- Investment decisions are concerned with the question whether adding to capital assets today will increase the revenue of tomorrow to cover costs.
- Thus, investment decisions are **commitments of monetary resources** at different times in expectation of **economic returns in future.**

1. INVESTMENT DECISIONS

- **Choice** is required to be made amongst **available resources and avenues for investment.**

- As such investment decisions are concerned with the choice of acquiring real assets, over the time period, in a productive process. In making such a choice consideration of certain aspects is essential viz., need for investment, factors affecting decisions, criteria for evaluating investment decisions and selection of a particular alternative from amongst the various options available.

- Investment decisions have, thus, become the most important area in the decision-making process of a company.

- Such decisions are essentially made after **evaluating the different proposals with reference to growth and profitability projections of the company.**

- The choice helps achieve the long-term objectives of the company i.e., **survival and growth, preserving market share of its products and retaining leadership** in its production activity.

1. INVESTMENT DECISIONS

The company likes to avail of the economic opportunity for which investment decisions are taken viz.,

(1) **expansion of the productive process** to meet the existing excessive demand in local market, exploit the global market, and to avail of the advantages and economies of the expanded scale of production.

(2) **replacement of an existing asset**, plant and machinery or building, necessary for taking advantages of technological innovations, minimising cost of production by replacing obsolete and worn out plants, increasing efficiency of labour, etc.

(3) The choice of equipment establishes the need for investment decisions based on the question of **quality and latest technology.**

(4) **Re-allocation of capital** is another area of investment, to ensure asset allocation in tune with the production policy.

(5) **Mergers, acquisitions, re-organisations and rehabilitation** are all concerned with economic and financial involvement and are governed by investment decisions.

1. INVESTMENT DECISIONS

Two important Investment Decisions:

(1) **Capital budgeting**

(2) **Working Capital Management**

1. INVESTMENT DECISIONS – Capital Budgeting

Capital budgeting refers to **long-term planning** for **proposed capital outlays** and their **financing.**

The basic feature of capital budgeting decisions is:

- (1) current funds are exchanged for future benefits;
- (2) there is an investment in long-term activities; and
- (3) the future benefits will occur to the firm over series of years.

1. INVESTMENT DECISIONS – Capital Budgeting

PURPOSE OF CAPITAL BUDGTETING

The capital budgeting decisions are important, crucial and critical business decisions due to following reasons:

- **(i) Substantial expenditure:** Investment decisions are related with fulfilment of long-term objectives and existence of an organization. To invest in a project or projects, a substantial capital investment is required. Based on size of capital and timing of cash flows, sources of finance are selected. Due to huge capital investments and associated costs, it is therefore necessary for an entity to make such decisions after a thorough study and planning.

- **(ii) Long time period:** The capital budgeting decision has its effect over a long period of time. These decisions not only affect the future benefits and costs of the firm but also influence the rate and direction of growth of the firm.

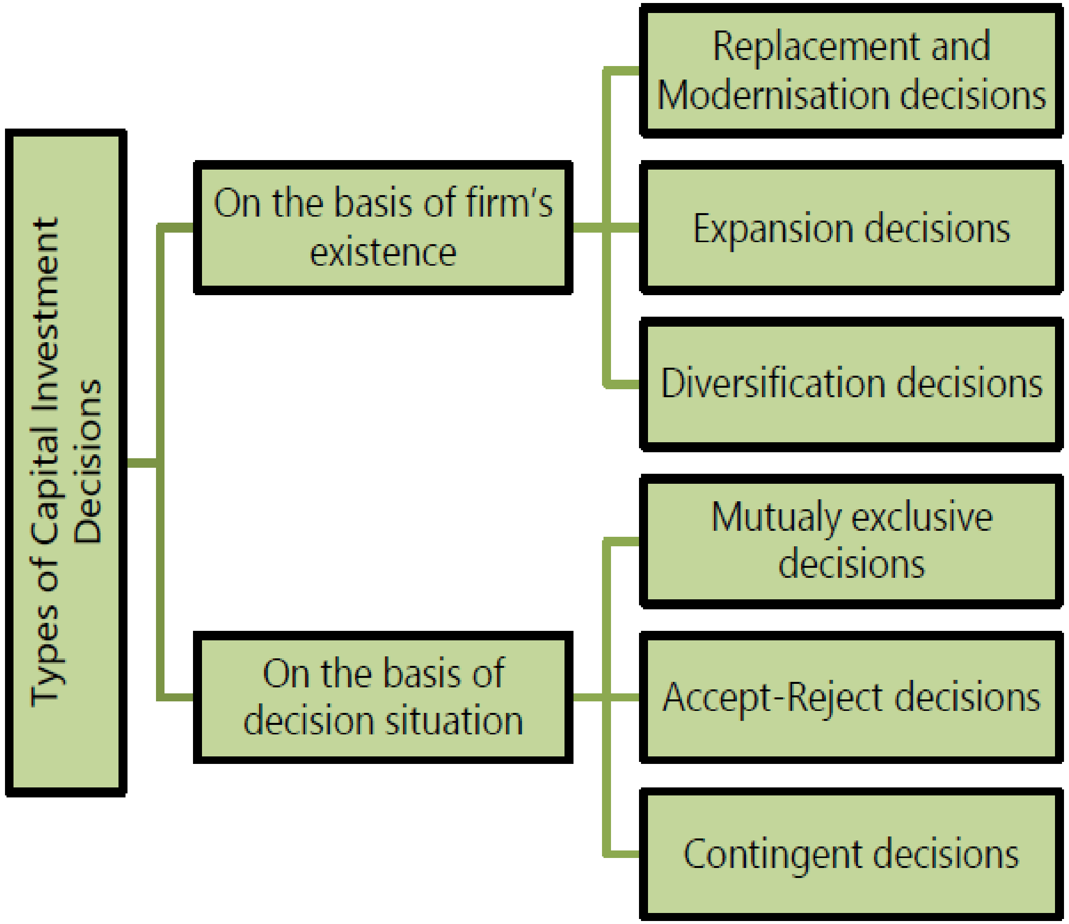
1. INVESTMENT DECISIONS – Capital Budgeting

PURPOSE OF CAPITAL BUDGTETING

- **(iii) Irreversibility:** Most of the investment decisions are irreversible. Once the decision implemented it is very difficult and reasonably and economically not possible to reverse the decision. The reason may be upfront payment of amount, contractual obligations, technological impossibilities etc.
- **(iv) Complex decisions:** The capital investment decision involves an assessment of future events, which in fact is difficult to predict. Further it is quite difficult to estimate in quantitative terms all the benefits or the costs relating to a particular investment decision.

1. INVESTMENT DECISIONS – Capital Budgeting

- TYPES OF CAPITAL INVESTMENT DECISIONS



1. INVESTMENT DECISIONS – Capital Budgeting

<u>TYPES OF CAPITAL INVESTMENT DECISIONS:</u>

- **<u>On the basis of firm's existence</u>**

The capital budgeting decisions are taken by both newly incorporated firms as well as by existing firms. The new firms may require taking decision in respect of selection of a plant to be installed. The existing firm may require taking decisions to meet the requirement of new environment or to face the challenges of competition. These decisions may be classified as follows:

(i) Replacement and Modernisation decisions: The replacement and modernisation decisions aim at to improve operating efficiency and to reduce cost. Generally, all types of plant and machinery require replacement either because of the economic life of the plant or machinery is over or because it has become technologically outdated. The former decision is known as replacement decisions and latter is known as modernisation decisions. Both replacement and modernisation decisions are called cost reduction decisions.

1. INVESTMENT DECISIONS – Capital Budgeting

TYPES OF CAPITAL INVESTMENT DECISIONS:

- **On the basis of firm's existence**

(ii) Expansion decisions: Existing successful firms may experience growth in demand of their product line. If such firms experience shortage or delay in the delivery of their products due to inadequate production facilities, they may consider proposal to add capacity to existing product line.

(iii) Diversification decisions: These decisions require evaluation of proposals to diversify into new product lines, new markets etc. for reducing the risk of failure by dealing in different products or by operating in several markets.

1. INVESTMENT DECISIONS – Capital Budgeting

TYPES OF CAPITAL INVESTMENT DECISIONS:

On the basis of decision situation

The capital budgeting decisions on the basis of decision situation are classified as follows:

(i) Mutually exclusive decisions: The decisions are said to be mutually exclusive if two or more alternative proposals are such that the acceptance of one proposal will exclude the acceptance of the other alternative proposals. For instance, a firm may be considering proposal to install a semi-automatic or highly automatic machine. If the firm installs a semi-automatic machine it excludes the acceptance of proposal to install highly automatic machine.

1. INVESTMENT DECISIONS – Capital Budgeting

TYPES OF CAPITAL INVESTMENT DECISIONS:

On the basis of decision situation

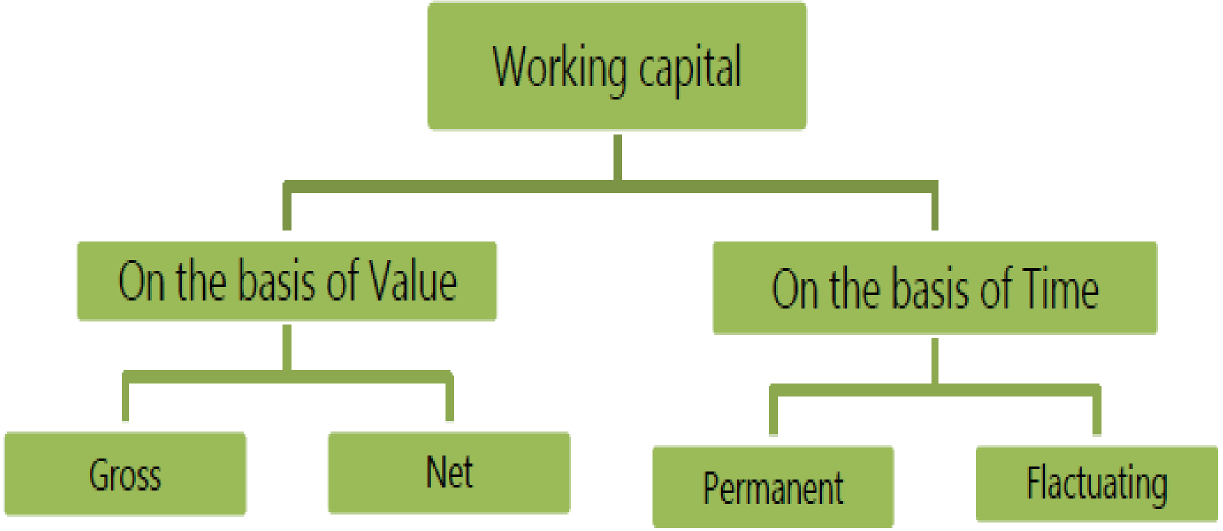
- **(ii) Accept-reject decisions:** The accept-reject decisions occur when proposals are independent and do not compete with each other. The firm may accept or reject a proposal on the basis of a minimum return on the required investment. All those proposals which give a higher return than certain desired rate of return is accepted and the rest are rejected.

- **(iii) Contingent decisions:** The contingent decisions are dependable proposals. The investment in one proposal requires investment in one or more other proposals. For example, if a company accepts a proposal to set up a factory in remote area it may have to invest in infrastructure also e.g. building of roads, houses for employees etc.

1. INVESTMENT DECISIONS – Working Capital Management

In accounting term working capital is the difference between current assets (cash, accounts receivable/customers' unpaid bills, inventories of raw materials and finished goods) and current liabilities accounts payable and debts.

Working Capital = Current Assets – Current Liabilities



1. INVESTMENT DECISIONS – Working Capital Management

(a) Value:

From the value point of view, Working Capital can be defined as Gross Working Capital or Net Working Capital.

- **Gross working capital** refers to the firm's investment in current assets.
- **Net working capital** refers to the difference between current assets and current liabilities.

A positive working capital indicates the company's ability to pay its short-term liabilities. On the other hand, a negative working capital shows inability of an entity to meet its short-term liabilities.

1. INVESTMENT DECISIONS – Working Capital Management

(b) Time:

From the point of view of time, working capital can be divided into two categories viz., Permanent and Fluctuating (temporary).

- **Permanent working capital** refers to the base working capital, which is the minimum level of investment in the current assets that is carried by the entity at all times to carry its day to day activities.

- **Temporary working capital** refers to that part of total working capital, which is required by an entity in addition to the permanent working capital. It is also called variable working capital which is used to finance the short-term working capital requirements which arises due to fluctuation in sales volume.

2. FINANCING DECISIONS

- Financing decision is the next step in financial management for executing the investment decision once taken.

- A look at the balance-sheet of a sample company indicates that it obtains finances from **shareholders, ordinary or preference, debenture holders on long-term basis, financial institutions as long-term loans, banks and others as short-term loans and the like.**

- There are variations in the provisions governing the issue of preference shares, debentures, loan papers, etc.

- Financing decisions are concerned with the **determination of how much funds to procure from amongst the various avenues available i.e. the financing mix or capital structure.**

2. FINANCING DECISIONS

- Efforts are made to obtain an **optimal financing mix** for a particular company. This necessitates study of the **capital structure** as also the **short and intermediate term financing plans** of the company.
- Financial decisions encompass **determination of the proportion of equity capital to debt** to achieve an optimal capital structure, and to balance the fixed and working capital requirements in the financial structure of the company.
- This important area of financing decision making, aims at maximising returns on investment and minimising the risk.
- The risk and return analysis is a common tool for investment and financing decisions for designing an optimal capital structure of a corporate unit.

2. FINANCING DECISIONS

Cost of Capital

Capital Structure

2. FINANCING DECISIONS – Capital Structure

Capital structure is the combination of capitals from different sources of finance. The capital of a company consists of equity share holders' fund, preference share capital and long term external debts. The source and quantum of capital is decided keeping in mind following factors:

1. **Control:** capital structure should be designed in such a manner that existing shareholders continue to hold majority stack.

2. **Risk:** Capital structure should be designed in such a manner that financial risk of the company does not increases beyond tolerable limit.

3. Cost: overall cost of capital remains minimum.

Practically it is difficult to achieve all of the above three goals together hence a finance manager has to make a balance among these three objectives.

However, the objective of a company is to maximise the value of the company and it is prime objective while deciding the optimal capital structure. Capital Structure decision refers to deciding the forms of financing (which sources to be tapped); their actual requirements (amount to be funded) and their relative proportions (mix) in total capitalisation.

1. Equity Financing

Equity (Owners Capital or Equity Capital) financing involves selling a portion of a company's equity in return for capital.

For example, the owner of Company ABC might need to raise capital to fund business expansion. The owner decides to give up 10% of ownership in the company and sell it to an investor in return for capital. That investor now owns 10% of the company and has a voice in all business decisions going forward.

Advantages of raising funds by issue of equity shares are:

- (i) It is a permanent source of finance. Since such shares are not redeemable, the company has no liability for cash outflows associated with its redemption.
- (ii) Equity capital increases the company's financial base and thus helps further the borrowing powers of the company.
- (iii) The company is not obliged legally to pay dividends (No financial burden). Hence in times of uncertainties or when the company is not performing well, dividend payments can be reduced or even suspended.

1. Equity Financing

Disadvantages of raising funds by issue of equity shares are:

Apart from the above-mentioned advantages, equity capital has some disadvantages to the company when compared with other sources of finance. These are as follows:

- (i) The cost of ordinary shares is higher because dividends are not tax deductible and also the floatation costs of such issues are higher.
- (ii) Investors find ordinary shares riskier because of uncertain dividend payments and capital gains.
- (iii) The issue of new equity shares reduces the earning per share of the existing shareholders until and unless the profits are proportionately increased.
- (iv) The issue of new equity shares can also reduce the ownership and control of the existing shareholders.

2. Debt Financing

Debt financing involves the borrowing of money and paying it back with interest. The most common form of debt financing is a loan.

Loans, Bonds, debentures, leases, bills of exchange are examples of debt instruments.

Advantages:

- (i) Retain control. If a company agree to debt financing from a lending institution, the lender has no say in the management of the company. In other words, Debt financing does not result in dilution of control.
- (ii) Tax advantage. The cost of debt is much lower than the cost of preference or equity capital as the interest is tax-deductible.
- (iii) Easier planning. You know well in advance exactly how much principal and interest you will pay back each month. This makes it easier to budget and make financial plans.

2. Debt Financing

The disadvantages of debt financing are:

- (i) Debt interest and capital repayment are obligatory payments.
- (ii) Debt financing enhances the financial risk associated with the firm.
- (iii) Since debt need to be paid during maturity, a large amount of cash outflow is needed at that time.

2. FINANCING DECISIONS – Cost of Capital

- Cost of capital is the return expected by the providers of capital (i.e. shareholders, lenders and the debt-holders) to the business as a compensation for their contribution to the total capital. When an entity (corporate or others) procured finances from either sources as listed above, it has to pay some additional amount of money besides the principal amount. The additional money paid to these financiers may be either one off payment or regular payment at specified intervals. This additional money paid is said to be the cost of using the capital and it is called the cost of capital. This cost of capital expressed in rate is used to discount/ compound the cashflow or stream of cashflows. **Cost of capital is also known as 'cut-off' rate, 'hurdle rate', 'minimum rate of return' etc.**

- **It is used as a benchmark for:**

- Framing debt policy of a firm.

- Taking Capital budgeting decisions.

2. FINANCING DECISIONS – Cost of Capital

SIGNIFICANCE OF THE COST OF CAPITAL

The cost of capital is important to arrive at correct amount and helps the management or an investor to take an appropriate decision. The correct cost of capital helps in the following decision making:

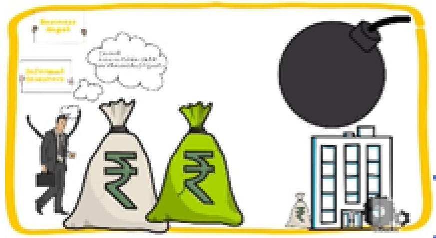
(i) Evaluation of investment options: The estimated benefits (future cashflows) from available investment opportunities (business or project) are converted into the present value of benefits by discounting them with the relevant cost of capital. Here it is pertinent to mention that every investment option may have different cost of capital hence it is very important to use the cost of capital which is relevant to the options available.

(ii) Financing Decision: When a finance manager has to choose one of the two sources of finance, he can simply compare their cost and choose the source which has lower cost. Besides cost he also considers financial risk and control.

2. FINANCING DECISIONS – Cost of Capital

SIGNIFICANCE OF THE COST OF CAPITAL

(iii) Designing of optimum credit policy: While appraising the credit period to be allowed to the customers, the cost of allowing credit period is compared against the benefit/ profit earned by providing credit to customer of segment of customers. Here cost of capital is used to arrive at the present value of cost and benefits received.

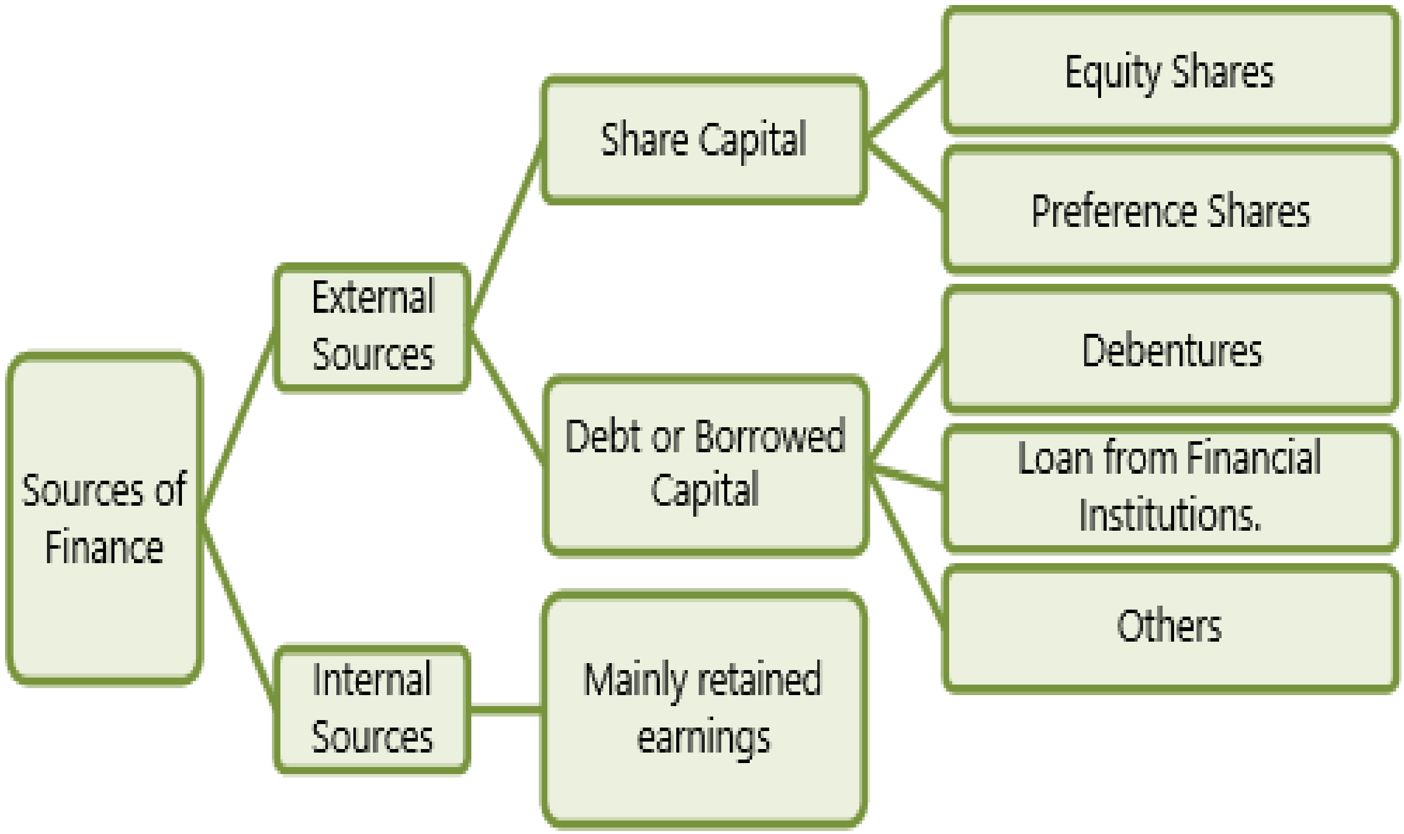


FINANCIAL SOURCES

There are mainly two ways of classifying various financial sources (Read yourself from the notes shared)

- (i) Based on basic Sources
- (ii) Based **on Maturity of repayment period**

Sources of Finance based on Basic Sources



Sources of Finance based on Maturity of Payment

Sources of Finance

Long-term

1. Share capital or Equity shares
2. Preference shares
3. Retained earnings
4. Debentures/Bonds of different types
5. Loans from financial institutions
6. Loans from State Financial Corporations
7. Loans from commercial banks
8. Venture capital funding
9. Asset securitisation
10. International financing like Euro-issues, Foreign currency loans

Medium-term

1. Preference shares
2. Debentures/Bonds
3. Public deposits/fixed deposits for duration of three years
4. Medium term loans from Commercial banks, Financial Institutions, State Financial Corporations
5. Lease financing/Hire-Purchase financing
6. External commercial borrowings
7. Euro-issues
8. Foreign Currency bonds

Short-term

1. Trade credit
2. Accrued expenses and deferred income
3. Short term loans like Working Capital Loans from Commercial banks
4. Fixed deposits for a period of 1 year or less
5. Advances received from customers
6. Various short-term provisions

FINANCIAL NEEDS OF A BUSINESS

(i) Long-term financial needs: Such needs generally refer to those requirements of funds which are for a period exceeding 5-10 years. All investments in plant, machinery, land, buildings, etc., are considered as long-term financial needs. Funds required to finance permanent or hard-core working capital should also be procured from long term sources.

(ii) Medium- term financial needs: Such requirements refer to those funds which are required for a period exceeding one year but not exceeding 5 years. For example, if a company resorts to extensive publicity and advertisement campaign then such type of expenses may be written off over a period of 3 to 5 years. These are called deferred revenue expenses and funds required for these are classified in the category of medium-term financial needs.

(iii) Short- term financial needs: Such type of financial needs arises to finance current assets such as stock, debtors, cash, etc. Investment in these assets is known as meeting of working capital requirements of the concern. The main characteristic of short-term financial needs is that they arise for a short period of time not exceeding the accounting period. i.e., one year.

3. DIVIDEND DECISIONS

- The dividend decision is another major area of financial management.

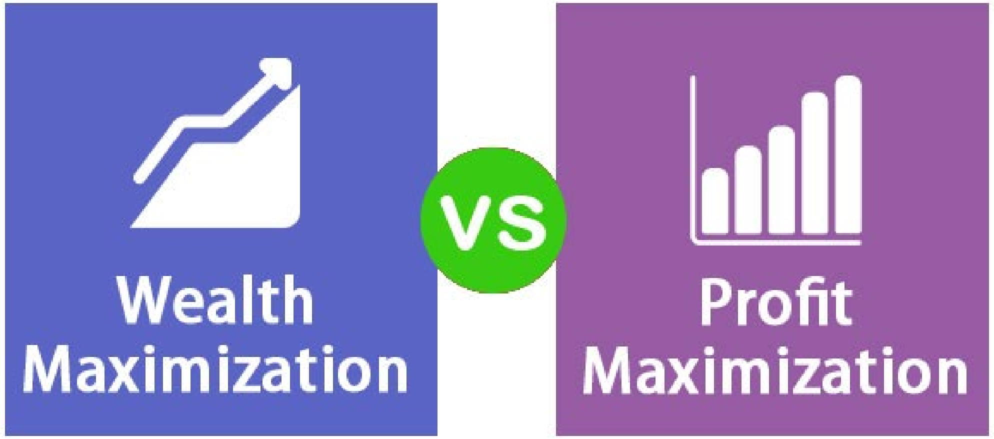
- The financial manager must decide whether the firm should **distribute all profits or retain them or distribute a portion and retain the balance.**

- Theoretically, this decision should depend on whether the company or its shareholders are in the position to better utilise the funds, and to earn a higher rate of return on funds. However, in practice, a number of other factors like the market price of shares, the trend of earning, the tax position of the shareholders, cash flow position, requirement of funds for future growth, and restrictions under the Companies Act etc. play an important role in the determination of dividend policy of business enterprise.

- The finance manager has to take a decision regarding optimum dividend pay-out ratio, he also has to take decisions relating to bonus issue and interim dividend.

OBJECTIVES OF FINANCIAL MANAGEMENT

- Financial management of any business firm has to set goals for itself and to interpret them in relation to the objective of the firm.
- Broadly, there are only two alternative objectives a business firm can pursue viz.
- **(a) Profit maximisation;**
- **(b) Wealth maximisation.**



(a) Profit Maximisation

- The **traditional approach** of financial management was all about **profit maximization.**
- The process of **increasing the profit earning capability** of the company is referred to as Profit Maximization.
- It is mainly a **short-term goal** and is primarily restricted to the **accounting analysis of the financial year**. It ignores the **risk and avoids the time value of money.**
- It is primarily concerned as to **how the company will survive and grow in the existing competitive business environment.**
- Profit maximization means that a firm either **produces maximum output for a given amount of input, or uses minimum input for producing a given output.**
- **The underlying rationale of profit maximization is efficiency.**
- Profit maximisation is considered as an important goal in financial decision-making in an organisation. It ensures that firm utilizes its available resources most efficiently under conditions of competitive markets.

(The time value of money (TVM) is the concept that a sum of money has greater value now than it will in the future due to its earnings potential)

(a) Profit Maximisation (Contd.)

- But in recent years, under the changed corporate environment, profit maximisation is regarded as **unrealistic, difficult, inappropriate and socially not much preferred goal for business organisation.**
- It is argued that the **objective of profit maximisation as a business objective developed in the 19th century** when the business activity was **self financing** and based on assumption of **private property and single entrepreneurship.** The **only aim of the entrepreneur then was to maximize his profit** and enhance his **own wealth,** this objective could be easily satisfied by profit maximisation objective.
- The modern **business environment is characterised by limited liability and a distinction between management and ownership**. The **various stakeholders of the firm are shareholder, lenders, customers, employees, government and society**. In practice the objectives of all these stakeholders may differ and may even conflict with each other. The manager has a difficult task of reconciling and balancing these conflicting objectives.
- The goal of profit maximization overlooks the interest of other parties than the shareholders and is therefore crticised and considered as unrealistic, inappropriate and immoral.

(a) Profit Maximisation (Contd.)

Profit maximisation as corporate goal is criticised by scholars mainly on the following grounds:

- (i) It is **vague c**onceptually. (Terms like "Profit" or "maximum" ambiguous)
- (ii) It ignores **timing of returns.**
- (iii) It ignores **the risk** factor.
- (iv) It may tempt to make such decisions which may in the **long run prove disastrous**.
- (v) Its emphasis is generally on **short run** projects.
- (vi) It may cause **decreasing share prices.**
- (vii) The **profit is only one of the many objectives** and variables that a firm considers.
- (viii) Many other objectives are there: **Larger market share, high sale, etc.**

(b) Wealth Maximisation

Wealth maximization is a modern approach to financial management.

It is a superior goal compared to profit maximization as it takes broader arena into consideration.

Wealth or Value of a business is defined as the market price of the capital invested by shareholders.

The primary goal of financial management is shareholder wealth maximization, which translates into **maximizing the price of the firm's common stock (In other words, it implies maximisation of market value of equity shares.)**

It is a **long-term goal** and involves **multiple external factors like sales, products, services, market share, etc.** The ultimate goal of the concern is to **improve the market value of its shares.**

(b) The Concept of Wealth Maximisation

It simply means maximization of shareholder’s wealth.

It is a combination of two words viz**. wealth and maximization**.

A **wealth of a shareholder maximizes when the net worth** of a company maximizes.

To be even more meticulous, a shareholder holds share in the company/business and his wealth will improve if the share price in the market increases which in turn is a function of net worth.

This is because wealth maximization is also known as net worth maximization.

(b) How to Calculate Wealth?

Wealth is said to be generated by any financial decision if the **present value of future cash flows relevant to that decision is greater than the costs** incurred to undertake that activity.

Increase in wealth is equal to the present value of all future cash flows less the cost/investment.

In essence, it is the net present value (NPV) of a financial decision.

In other words, Shareholder wealth maximization **means maximizing** the **net present value of a course of action to shareholders.**

Net present value (NPV) or Increase in wealth = **Present value of Future Cash Inflows - Present value of costs**

(b) Wealth Maximisation

This goal for the maximum present value is generally justified on the following grounds:

(i) Firstly, the wealth maximization is based on **cash flows and not on profits**.

(ii) It focuses on the **long run** picture.

(iii) It takes into account **time value of money** –

It is important as we all know that a rupee today and a rupee one-year latter do not have the same value. In wealth maximization, the future cash flows are discounted at an appropriate discounted rate to represent their present value. Suppose there are two projects A and B, project A is more profitable however it is going to generate profit over a long period of time, while project B is less profitable however it is able to generate return in a shorter period. In a situation of an uncertainty, project B may be preferable. So**, timing of returns** is ignored by profit maximization, it is considered in wealth maximization.

DISCOUNT RATE

In corporate finance, a discount rate is the rate of return used to discount future cash flows back to their present value. This rate is often a company's Weighted Average Cost of Capital (WACC), required rate of return, or the hurdle rate that investors expect to earn relative to the risk of the investment.

Present Value of Discounted Cash Flows

$$PV = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_3}{(1+r)^3} \cdots \frac{CF_n}{(1+r)^n}$$

CF equals cash flow for a period,

r equals the discount rate, and

n equals the number of periods.

(b) Wealth Maximisation

- **However, profit maximisation can be part of a wealth maximisation strategy.** Quite often two objectives can be pursued simultaneously but the maximisation of profit should never be permitted to overshadow the objectives of wealth maximisation.
- The objective of the firm provides a framework for optimal decision making in the area of business management.
- **The objective of shareholder wealth maximisation is an appropriate and operationally feasible criterion to choose among the alternative financial actions.**
- It provides an unambiguous measure of what financial management should seek to maximise in making investment and financing decisions on behalf of shareholders.

PROFIT MAXIMISATION VERSUS WEALTH MAXIMISATION

- Profit maximisation is basically a single-period or, at the most, a short-term goal. It is usually interpreted to mean the maximisation of profits within a given period of time. A firm may maximise its short-term profits at the expense of its long-term profitability and still realise this goal.
- In contrast, shareholder wealth maximisation is a long-term goal and shareholders are interested in future as well as present profits.
- Wealth maximisation is generally preferred because it considers
- (1) wealth for the long-term,
- (2) risk or uncertainty,
- (3) the timing of returns, and
- (4) the shareholders' return.

PROFIT MAXIMISATION VERSUS WEALTH MAXIMISATION

- *The key difference between Wealth and Profit Maximization is that*
- *Wealth maximization is the long term objective of the company to increase the value of the stock of the company thereby increasing shareholders wealth to attain the leadership position in the market,*
- *whereas, profit maximization is to increase the capability of earning profits in the short run to make the company survive and grow in the existing competitive market.*

Profit Maximisation Vs. Shareholder Wealth Maximisation

Goal	***Objective***	***Advantages***	***Disadvantages***
Profit maximisation	Large amount of profits	1. Easy to calculate profits 2. Easy to determine the link between financial decisions and profits	1. Emphasizes the short term 2. Ignores risk or uncertainty 3. Ignores the timing of returns 4. Requires immediate resources
Shareholder wealth maximisation	Highest market value of common stock	1. Emphasizes the long term 2. Recognizes risk or uncertainty 3. Recognizes the timing of returns 4. Considers return	1. Offers no clear relationship between financial decisions and stock price 2. Can lead to management anxiety and frustration

Wealth Maximization VS Profit Maximization

#1. Definition

Wealth Maximization

It is defined as the management of financial resources aimed at increasing the value of the stakeholders of the company.

Profit Maximization

It is defined as the management of financial resources aimed at increasing the profit of the company.

#2. Focus

Wealth Maximization	Profit Maximization
Focuses on increasing the value of the stakeholders of the company in the long term.	Focuses on increasing the profit of the company in the short term.

#3. Risk

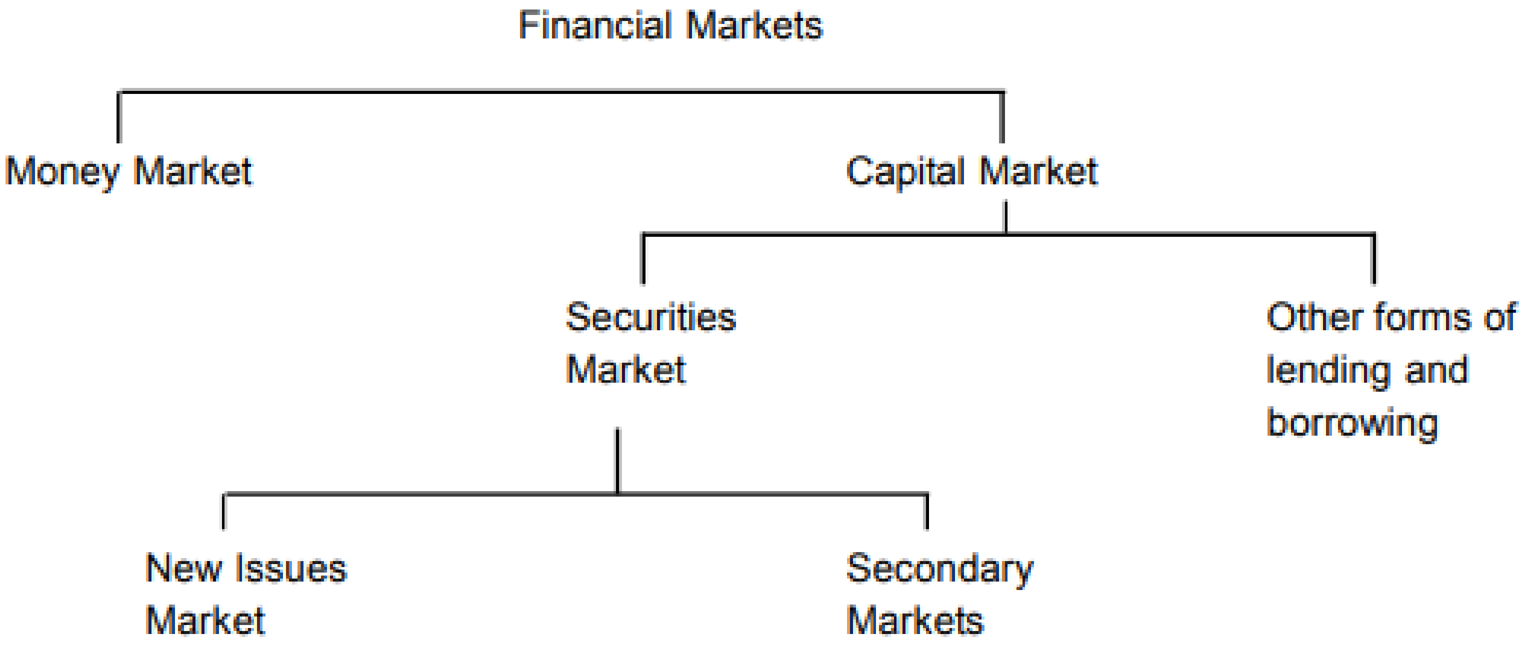
Wealth Maximization	Profit Maximization
It considers the risks and uncertainty inherent in the business model of the company.	It does not consider the risks and uncertainty inherent in the business model of the company.

#4. Usage

Wealth Maximization	Profit Maximization
It helps in achieving a larger value of a company's worth, which may reflect in the increased market share of the company.	It helps in achieving efficiency in the company's day-to-day operations to make the business profitable.

FINANCIAL MARKETS

- **Efficient transfer of resources** from those having idle resources to others who have a pressing need for them is achieved through financial markets.
- The financial markets have two major components; the money market and the capital market.



I. MONEY MARKET

- The money market refers to the market where **borrowers and lenders exchange short-term funds** to solve their **liquidity** needs.
- The money market in India is an **important source of finance to industry, trade, commerce and the government sector** for both national and international trade through bills–Call/ Notice Money, treasury Bills, commercial Bills, commercial papers and other financial instruments and provides an opportunity to the banks to deploy their surplus funds so as to reduce their cost of liquidity.
- The money market also provides **leverage to the Reserve Bank of India to effectively implement and monitor its monetary policy.**
- Money market instruments are generally **financial claims** that have **low default risk, maturities under one year and high marketability.**

MONEY MARKET INSTRUMENTS

1. Call/Notice money:

- Call money market, or inter-bank call money market, is a segment of the money market where **scheduled commercial banks lend or borrow on call** (i.e., overnight) or at short notice (i.e., for periods upto 14 days) to manage the day-to-day surpluses and deficits in their cash-flows.

2. Treasury Bills (TBs):

- Treasury Bills are one of the most popular money market instruments issued by the Reserve Bank of India on behalf of the Government of India.
- T- Bills are generally issued to ward off short-term mismatches in receipts and expenditure. Therefore, the purpose of issuing Treasury Bills is to tackle short term liquidity problems.
- Treasury bills are generally issued at discount and redeemed at par.
- The difference between the issued amount and the redemption amount is the amount of interest which is to be paid to the holder of the treasury bills. Thus, the TBs are short-term promissory notes issued by Government of India at a discount. More relevant to the money market is the introduction of 14 days, 28 days, 91 days and 364 days TBs on auction basis.

MONEY MARKET INSTRUMENTS

3. Commercial Bills

- A commercial bill is one which arises out of a genuine trade transaction, i.e. credit transaction. When the goods are sold, the seller draws a bill of exchange (BOE) on the buyer to pay a certain amount on a particular date. The buyer then accepts the BOE, signs it and sends it to the seller. The seller on the maturity date presents the BOE to the buyer and collects its payment. It is a basically a negotiable instrument and issued for a short period generally ranging from 3 to 6 months.

4. Commercial Paper (CP)

- At present CP provides the cheapest source of funds for corporate sector and has caught the fancy of corporate sector and banks. Its market has picked up considerably in India due to interest rate differentials in the inter-bank and commercial lending rates.
- CPs are unsecured instruments issued by high rated corporate entities to raise short-term funds for meeting working capital requirements directly from the market instead of borrowing from banks. Its period ranges from 7 days to 1 year.

II. CAPITAL MARKET

- A capital market is a financial market in which long-term debt or equity-backed securities are bought and sold, in contrast to a money market where short-term debt is bought and sold.
- In other words, the Capital Market comprises the complex of institutions and mechanisms through which intermediate term funds and long - term funds are pooled and made available to business, government and individuals.

Functions of the capital market:

The main functions of Capital Market are:

- 1. Allocation Function
- 2. Liquidity Function
- 3. Other Function

Functions of the capital market:

1. Allocation Function

- Capital Market allows for the channelization of the saving of innumerable investors into various productive avenues of investments. Accordingly, the current savings for a period are allocated amongst the various users and uses. The market attracts new investors who are willing to make new funds available to business.

2. Liquidity Function

- Capital Market provides a means whereby buyers and sellers can exchange securities at mutually agreed prices. This allows better liquidity for the securities that are traded.

Functions of the capital market:

3. Other Functions:

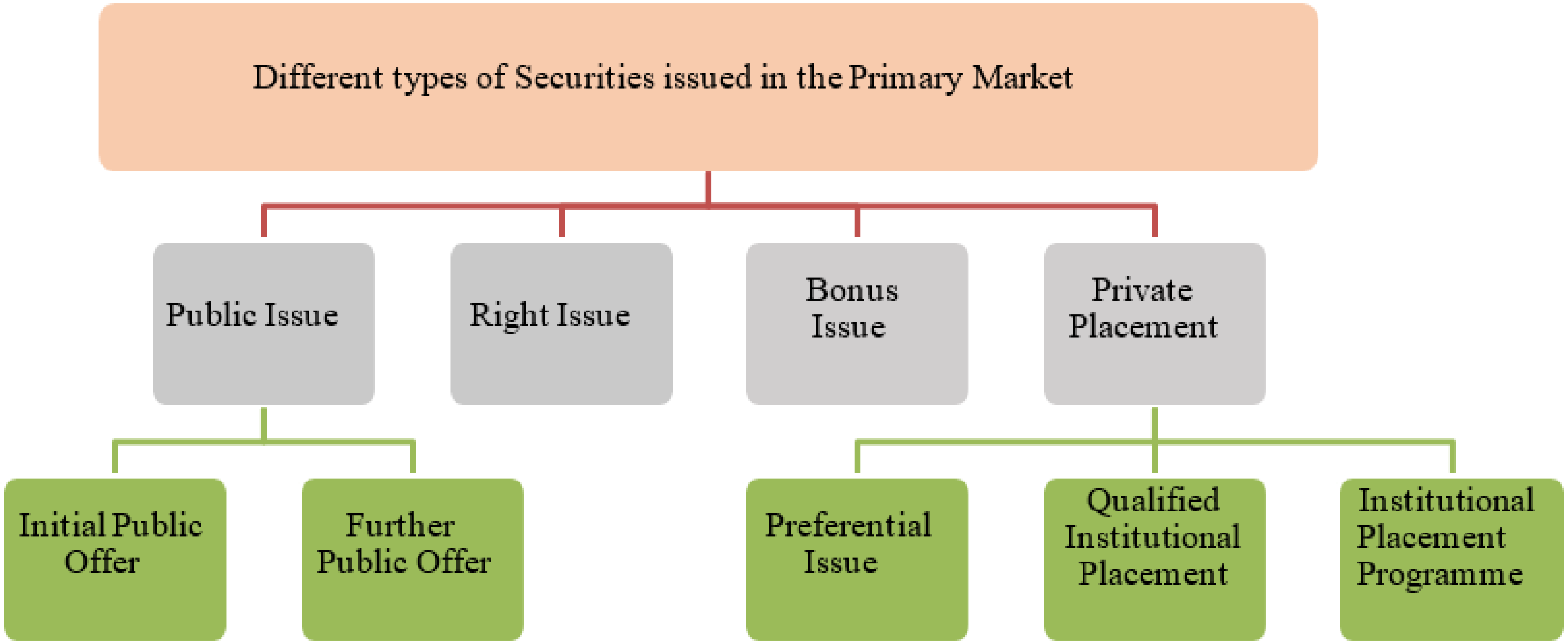
- In addition to the functions of funds allocation and liquidity, Capital Market also renders the following functions:
- 1. Indicative Function– A Capital Market acts as a barometer showing not only the progress of a company, but also of the economy as a whole through share price movements.
- 2. Savings & Investment Function– Capital Market provides a means of quickly converting long-term investment into liquid funds, thereby generating confidence among investors and speeding up the process of saving and investment.

SEGMENTS OF CAPITAL MARKET

1. Primary Market

- Primary market is a market where buying and selling of new securities are taken place for the first time.
- In other words, the market, where the first public offering of equity shares or convertible securities by a company take place which is followed by the listing of a company's shares on a stock exchange is called a primary market.
- It is also known as 'initial public offering' (IPO).
- Issue of further capital by companies whose shares are already listed on the stock exchange also comes within the ambit of Primary market.
- There are different types of intermediaries operating in this segment of capital market by providing a variety of services. For example, merchant bankers, brokers, bankers to issues, portfolio managers, registrars to issues and share transfer agents, etc. They are also regulated by SEBI. Their contribution is immense in the development of capital market.

ASPECTS OF PRIMARY MARKET (NEW ISSUE MARKET)



ASPECTS OF PRIMARY MARKET (NEW ISSUE MARKET)

(a) **Public Issue:** When shares or convertible securities are issued to new investors, it is called a public issue. Public issue can be further sub-divided into Initial Public Offer (IPO) and Further Public Offer (FPO). The significant features of each type of public issue are illustrated below:

- Initial Public Offer (IPO): When the shares and debentures of a company are issued to the public for the first time, it is called an IPO. It then set the stage for listing and trading of the issuer's shares or convertible securities on the Stock Exchanges.
- Further Public Offer (FPO) or Follow on Offer: When an already listed company makes either a fresh issue of shares or convertible securities to the public, it is called a FPO.

ASPECTS OF PRIMARY MARKET (NEW ISSUE MARKET)

- **(b) Right Issue (RI):** When an issue of shares or convertible securities is made by an issuer to its existing shareholders as on a particular date fixed by the issuer (i.e. record date), it is called a right issue. The rights are offered in a particular ratio to the number of shares or convertible securities held as on the record date.

- **(c) Composite Issue:** When the issue of shares or convertible securities by a listed issuer on public cum-rights basis, wherein the allotment in both public issue and rights issue is proposed to be made simultaneously, it is called composite issue.

- **(d) Bonus Issue:** When an issuer makes an issue of shares to its existing shareholders without any consideration based on the number of shares already held by them as on a record date, it is called a bonus issue. In Bonus Issue, the shares are issued out of the Company's free reserve or share premium account in a particular ratio.

- **(e) Private Placement:** When an issuer makes an issue of shares or convertible securities to a select group of persons not more than 50 but can extend upto 200, it is called a private placement. It should not either be a right issue or a public issue.

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2. Secondary Market

- Secondary Market refers to a market where securities are traded after being initially offered to the public in the Primary Market and/or listed on the Stock Exchange.
- Majority of the trading is done in the Secondary Market.
- Secondary Market comprises of equity markets and the debt markets.
- The Secondary Market enables participants who hold securities to adjust their holdings in response to changes in their assessment of risk and return. They also sell securities for cash to meet their liquidity needs.
- The Secondary Market has further two components, namely the over-the-counter (OTC) market and the exchange traded market.

2. Secondary Market

(i) OTC markets are essentially informal markets where trades are negotiated. An over-the-counter (OTC) market is a decentralized market in which market participants trade stocks, commodities, currencies or other instruments directly between two parties and without a central exchange or broker. Most of the trades in government securities are in the OTC market.

(ii) A stock exchange is a place where stockbrokers and trades trade stocks and other securities. Usually each country will have at-least one national stock exchange. For example, in the USA, the two major stock exchanges are: the American Stock Exchange (AMEX) and the New York Stock Exchange (NYSE). Apart from that there are several regional exchanges which deal in small local companies.

Functions of Secondary Market

- **(i) Economic Indicator –** Every major change in the economy either due to government policy or any major international event has a bearing on the secondary/stock market. So, if the stock market is doing well, it is an indicator that economy is more or less in a stable position.
- **(ii) Valuation of Securities** –Secondary market helps in the valuation of securities through its demand and supply. The securities of those companies which are growth oriented and doing well will surely have higher demand in comparison to securities of companies which are not doing well. Consequently, the share prices of growth-oriented companies will be high.
- **(iii) Transaction in securities is safe in the secondary market** –Transactions executed in the secondary market are safe because all the trading taking place in an electronic system which is highly secure.

Functions of Secondary Market

- **(iv) Contributes to economic growth –**It contributes to economic growth through allocation of funds to the most efficient sector through the process of disinvestment to reinvestment. This leads to capital formation and economic growth.
- **(v) Motivating people to invest in equity shares**–Efficient secondary market motivate people to invest in the securities market. The reason is that the people would be less apprehensive about the riskiness of the stock market.
- **(vi) It ensures safety and measure of fair dealing to protect investor' interest.**

Primary Market vs. Secondary Market

- 1. The Primary market refers to the market in which new securities are issued by the company to the public for the first time while the secondary market refers to the market where new securities which are already issued are traded. Stocks, bonds, options and futures are usually traded on the secondary market.
- 2. There is direct involvement of the company in the primary market. Whereas, in the secondary market, the company has virtually no involvement since the transactions takes place between investors.
- 3. The primary markets deal with new securities, that is, securities, which were not previously available and are, therefore, offered to the investing public for the first time while the secondary market is a market for already issued securities.
- 4. Primary market provides additional funds to the issuing companies either for starting a new enterprise or for the expansion or diversification of the existing business. On the other hand, the secondary market can in no circumstance supply additional funds since the company is not involved in the transaction.