CHAPTER 1

Introduction to Financial Management

A Introduction

Money is invested for earning more more money *i.e.* money is required for begetting money. But money can beget money if and only if its proper management is possible. Financial management is an important area of the overall management, which helps in sound management of money. An amount of money which is used to run a business is called **Finance.** Finance is the life-blood of the business, because a business becomes weak due to inadequacy of finance and contrarily it becomes healthy due to adequacy of finance. So, Financial management is the most important area out of all the areas of the business management. In this chapter, we shall discuss about various basic theme of Financial management such as its definition, scope, objective etc.

B Definition of Financial Management

Financial Management is an integral part of overall management, which is concerned with the financial decision-making. Two important factors are involved with the financial decision-making—one is financing and the other is proper utilisation of the collected funds. Financing and its use are both necessary for maintaining the uninterrupted flow of the business activities. Financial management is such a discipline which selects the optimum source(s) of financing by appraising the potential sources, raises finance from the selected source(s) and ensures the optimum use of the finance. The term 'Financial Management' has been defined by various experts in different ways. A few definitions given by them, are given below :

*According to **I. M. Pandey** — Financial Management is that managerial activity which is concerned with the planning and controlling of the firm's financial resources.*

*According to **J. F. Bradley** — Financial Management is the area of business management devoted to the judicious use of capital and careful selection of resources of capital in order to enable a spending unit to move in the direction of reaching its goal.*

*According to **R. M. Srivastava** — In sum, Financial Management may appropriately be defined as the process of raising, providing and managing of all the money to be used inconnection with business activities.*

*According to **Joshep L. Mass** — Financial Management is an operational activities of the business that is responsible for obtaining and effectively utilising the funds necessary for efficient operation.*

*According to **Ezra Solomon** — Financial Management is concerned with the efficient use of an important economic resources, namely, capital funds.*

On the basis of above discussion, it can be said that the **Financial Management is an integral part of overall management, which is concerned with the financial planning, selection of sources of funds, financing, proper utilisation of funds and dividend policy in order to achieving the overall objectives of the business.**

Importance of Financial Management

As a man becomes weak if blood circulation is hampered in his / her body, Just like that also the financial condition of a firm becomes weak if cash flows are hampered in that firm. So, every firm should be managed by keeping in view in such a way so that the cash flows remain uninterrupted in the firm. The cash flows can be retained uninterrupted by proper management of the financial resources. For this, every firm requires proper financial management, because the financial managers remain engaged in the work of management of the financial resources. So, the importance of Financial management is unlimited to every firm. While giving the explanation that how much is the importance of Financial Management to a firm, **Collin Brooks** said—*Bad production management and bad sales management has slain in hundreds, but faulty financial management has slain in thousands.* It is clear from this speech that the Financial management performs many important activities, such as, it—

(i) *selects profitable investment projects,*
(ii) *determines the amount of investment into fixed and current assets,*
(iii) *determines optimum capital structure,*
(iv) *selects the sources of finance,*
(v) *raises finance from the selected sources,*
(vi) *expands the market of securities of the firm,*
(vii) *communicates with the investors,*
(viii) *determines dividend pay-out ratio,*
(ix) *ensures optimum use of retained earnings,*
(x) *evaluates the financial results and financial conditions of the firm,*
(xi) *determines the possibility of prosperity in future,*
(xii) *makes financial planning to execute financial activities effectively,*
(xiii) *helps to avoid the possibilities of over-capitalisation and under-capitalisation,* etc.

In order to perform the above important financial activities, sound and proper financial management is essential for every firm.

J Functions of Financial Management

The functions of financial management can be divided into seven broad categories, such as—

1. *Financing functions*, 2. *Investing functions*, 3. *Dividend distributing functions*, 4. *Liquidity maintaining functions*, 5. *Profit-earning functions*, 6. *Controlling functions* and 7. *Other functions*. These are discussed below :

1. **Financing functions** : The financing functions of the financial management are—
   (i) ***Making financial planning*** : Financial planning involves the estimation of the requirement of funds in future and to decide how these funds are to be utilised at the future time. Financial managers perform the work of making the financial planning. They perform this work through preparation of cash flow statement, cash budget and capital budget.
   (ii) ***Determination of optimum capital structure*** : Capital structure of a firm refers to the proportion of owned capital and Debt-capital in the total capital of that firm. A capital structure becomes optimum when the average cost of capital is minimum. So, in order to make optimum capital structure, the financial management determines the capital structure in such a way so that the average cost of capital is minimum.
   (iii) ***Selection of sources of financing*** : Finance can be raised from various sources, such as, by issuing shares or debentures, by taking public deposit, by taking loan from financial institution etc. Financial managers select the optimum source(s) by evaluating the various sources of financing.
   (iv) ***Raising of finance*** : After selecting the source(s) of financing, the financial managers raise the required finance from the selected source(s).
2. **Investing functions** : The investing functions are—
   (i) ***Investment of collected fund*** : The decision which is taken as to what would be the amount of investment in different assets in order to get benefits in future, is known as **Investment Decision**. The financial managers of the firm take such investment decision.

(ii) ***Proper utilisation of the collected funds*** **:** It has to be noted especially by the financial managers that whether the collected funds are utilising properly or not. It is considered that the collected funds have been used properly when the financial needs of the firm will be satisfied fully and the firm will move towards on the way of prosperity through fair amount of profit-earning. So, the financial managers always attempt to fulfil the financial need and make wide the way of prosperity of the firm.

(iii) ***Investment of internal fund*** **:** Financial management makes suitable arrangement for the investment of the funds which are generated internally in the business by the reserves created out of profit, provision for depreciation etc.

3. **Dividend distributing function :** What portion of the divisible profit of the business will be distributed among the shareholders as dividend and what portion of the same will be retained in the form of unappropriated profit for ploughing back into the business are fixed through dividend policy. The financial managers determine such dividend policy of the business.

4. **Liquidity maintaining function :** The financial managers perform some functions so that the liquidity position of the firm can be maintained. These functions are—

   (i) ***Cash management*** **:** Proper cash management is required for maintaining consistency in inflows and outflows of cash. Financial management involves in cash management of the firm for ensuring the optimum use of cash.

   (ii) ***Inventory management*** **:** Financial management involves in inventory management of the firm. Financial managers perform this function by using various tools such as EOQ models, ABC Analysis, Fixation of stock level etc.

   (iii) ***Receivable management*** **:** Proper receivable management is required so that adverse effect may not be implied by the accounts receivable on the liquidity position of the firm. The financial managers involve in the receivable management of the firm.

   (iv) ***Working capital management*** **:** In order to maintain continuity in the production and sales, much quantity of raw materials and finished goods will have to be stored. Again, if the quantity of stock is very high, then the amount of cash in hand will be reduced. As a result of it, the capacity of meeting the short-term liabilities will be decreased. So, proper consistency is required in between these two contradictory items. A function of working capital management is to maintain such consistency. Financial management performs this function.

5. **Profit-earning functions :** Financial management has to perform vairous functions in order to increase the profitability and to keep intact the prof-earning capacity of the firm. These functions are—

   (i) ***Determination of expected profit*** **:** Whether a project will be accepted or not depends on the expected profit of that project. So, before accepting a project, the financial management takes decision regarding the acceptability of that project on the basis of its expected profit.

   (ii) ***Cost control*** **:** In order to increase the profitability of the business, financial management finds out the financial data having adverse effect on the profits by analysing the income statement for the purpose of controlling various costs and takes necessary remedial steps.

   (iii) ***Price fixation*** **:** Financial management helps in fixation of Price of the goods by using various pricing models.

6. **Controlling functions :** Financial management makes vairous financial planning in order to perform the financial activities such as financing, investing and dividend decisions etc. properly. Whether these activities have been performed according to the pre-determined plan after completing them and if not, then to develop necessary remedial steps is the **Financial Control**. Financial management performs the functions relating to the financial control by using various tools such as Financial Statement Analysis, Budgetory Control, Standard Costing, Cost-volume-profit Analysis, Ratio Analysis etc.
7. **Other functions :** In addition to the above functions, financial management performs some more functions, such as—
   (i) Takes decision relating to creation of reserves for development and expansion of the business,
   (ii) Maintains and preserves financial accounts and records,
   (iii) Co-ordinates financial activities of various departments,
   (iv) Ensures financial discipline,
   (v) Makes necessary arrangement for paying tax in time, and
   (vi) Ensures maximisation of shareholders' wealth.

K Financial Functions—Financing, Investment and Dividend Decisions

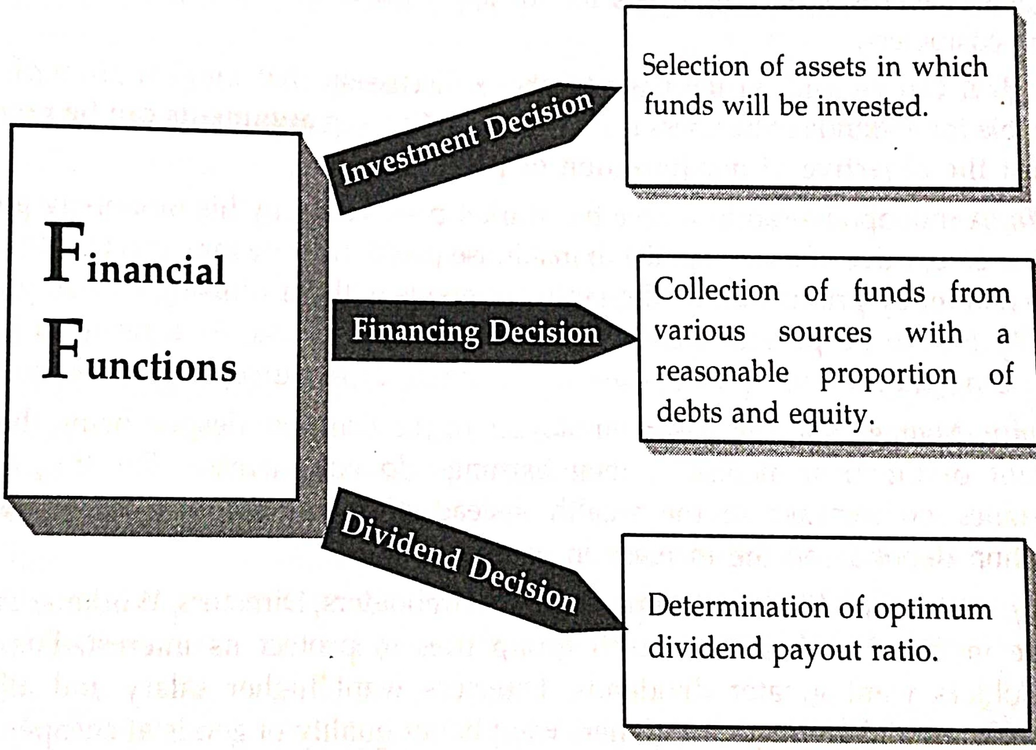
The financial manager is such a person who is responsible for performing the financial activities with utmost care. In ancient times, the activities of the financial manager was restricted to only procurement of funds. At that time, the main function of the financial manager was to procure adequate amount of money at a favourable terms and to supply it over to other managers and to keep proper accounts of expenditure of that money. In the middle of the 20th century, an unprecedented change took place in the business world through the emergence of large-scale business, technological development, expansion of marketing activities etc. As a result of it, the activities of the financial management are not confined to financing only, the scope of its activities is also spread extensively. At present the activities of the financial managers are involved with taking three important decisions, viz. *financing decision*, *investment decision* and *dividend decision*. These are discussed below :

A. **Investment Decision :** The most important activity of the financial management is to take investment decision. **The decision which is taken as to what would be the amount of investment in different assets in order to get benefits in the future, is known as Investment Decision.** The decision relating to investment in fixed assets is more important than the decision relating to investment in current assets. Because, if investment is done in fixed assets, the amount so invested remains blocked for a long period. Moreover, the amount of risk and uncertainty increases with the passage of time. So, the financial managers have to take decision for investment in fixed assets considering the future risk and uncertainty. At the time of taking decision for investment in current assets, the financial managers have to consider the inflows and outflows of cash, amount of trade debtors, amount of stock, time-limit for credit from creditors, time-limit for credit allowed to debtors etc. The decision relating to investment in fixed assets is known as capital budgeting and the decision relating to investment in current assets is termed as Working Capital Management.

B. **Financing Decision : The decision which is taken for selecting the sources from which the necessary funds can be collected for the amount required for investment, is called**

Financing Decision. The financial managers have to take this decision in such a way that formation of optimum capital structure is possible. The capital structure refers to the amount of owned capital (*i.e.*, equity capital) and debt capital in the total capital of the firm. The amount of owned capital and debt capital is determined by the debt-equity ratio. When the average cost of capital is least, the situation is called Optimum Debt-equity Ratio. So, the financial managers have to take financing decision in such a way so that the average cost of capital is minimum.

C. **Dividend Decision :** The part of the divisible profits of a company, which is distributed among its shareholders is called Dividend. Every shareholder expects such dividend on his investment. Again, a part of the divisible profit should be re-invested in order to expand the business in future. Re-investment of profit and dividend are contradictory to each other. Because, larger re-investment results in less dividend and less re-investment results in higher dividend. So, what portion of divisible profit will be distributed among the shareholders and what portion will be re-invested into the business for financing its long-term growth is an crucial problem in case of determining the dividend policy. Consistency is made between these two aspects through taking the dividend decision. The financial managers decide whether the firm should distribute all divisible profits, or retain them, or distribute a portion and retain the balance by taking proper dividend decision. So, it can be said briefly, **the decision which is taken in order to determine what portion of the divisible profit will be distributed among the shareholders and of what portion will be retained in the hand for ploughing them back into the business is known as Dividend Decision.**



L Objective of the Firm : Profit Maximisation vs. Wealth Maximisation

There are two broadly classified objectives of the business firm—one is profit maximisation objective and the other is wealth maximisation objective. These are discussed below :

1. **Profit Maximisation Objective :** According to the traditional approach, the basic objective of a firm is to maximise the amount of profit. Those who believe this approach Consider

that Profit is the yard-stick of efficiency and hence the overall efficiency of a firm is indicated through the earning of maximum profit. So, the managers manage the business by taking into consideration the profit maximisation objective in order to prove their efficiency. Because, as a result of maximisation of profit, the interests of both the business and the owners are protected. **The following arguments can be represented in favour of profit maximisation objective :**

Firstly, as Profit-earning is the main objective of the business firm, the objective of each business firm should be maximisation of profit.

Secondly, Profit is the yard-stick for measuring success and efficiency of management of the firm. So, maximisation of profit proves that the firm has been managed successfully and efficiently.

Thirdly, If there is a huge amount of accumulated profit created by past earnings in a firm, then it is not quite difficult for that firm to survive under unfavourable situation like recession, depression, severe competition etc. So, every firm should try to earn more and more profits when situation is favourable.

Fourthly, Profit is the main source of finance for the growth and expansion of a business firm. So, every business firm should aim at maximisation of profit for enabling its growth and expansion.

Fifthly, Profit maximisation objective is essential for fulfilling social goals. Because, if a firm can fulfil this objective, it is possible for that firm to pay dividend to the shareholders at higher rate, to settle the claims of the creditors timely, to pay wages at higher rate and other benefits to the employees and to supply better quality of goods at cheaper rate to the customers.

Though it can be said on the basis of above discussion that maximisation of profit is desirable for all kinds of business firms but **the following arguments can be represented against the objective of maximisation of profit :**

Firstly, A monopolist can influence the market price easily by his monopoly power. So, if it is the objective of a monopolist to maximise profit, then he may create artificial crisis in the market by producing small quantity of goods without utilising his full production capacity for the purpose of increasing the price of the goods. As a result of it, though profit is maximum but optimum use of the financial resources is not ensured.

Secondly, Managers are salarised employees of the firm. So, despite being the amount of profit of the firm increased, their earnings do not increase. For this, they give importance on increase in the wealth instead of increase in profit; because, their promotion depends on the increase in wealth.

Thirdly, Interests of different groups such as Shareholders, Directors, Workers, Customers etc. are involved with a firm. Each group tries to protect its interest. For example, Shareholders want greater dividends, Directors want higher salary and allowances, workers want higher wages, customers want better quality of goods at cheaper price etc. In such a situation, it is not possible for a firm to maximise anything because wherever something is maximised, interests of one group are maximised. As a result, interests of other groups will be neglected and they will oppose it. So, a firm can not run smoothly with the objective of maximisation of Profit.

Fourthly, The existing firms try to prevent the entry of new firm in the market for avoiding the uncertainty which may be created due to entrance of new firm in the market. For this, the existing firms sacrifice some amount of profit in the short run and they charge lower price for their products. Such pricing system is called **Entry Prevention Pricing.** According to such pricing system, it is not possible for a firm to maximise profit.

Fifthly, Profit may be of different types; such as short-term profit, long-term profit, rate of profit, amount of profit, before-tax profit, after-tax profit etc. So, if the objective of a firm is to maximise profit, there remains a problem that which profit should be maximised.

Sixthly, If the objective of maximisation of profit is considered, time value of money may be ignored.

Seventhly, If the objective of all the firms is to earn maximum profit, unexpected and undesirable competetion may be arised among-themselves, which is very harmful for the society.

Eighthly, If the objective of a firm is to maximise profit, however the increased amount of profit may be, the owner of the firm will try to earn more and more profit because, there is no particular limit of profit that can be said maximum. So, the objective of maximisation of profit can never be fulfilled.

Ninthly, the directors of a firm like satisfactory profit, not maximum profit. Because, after earning maximum profit in a year, if it is not possible to maintain that level of profit in the next year, the shareholders may dissatisfy. In such a situation, they may consider that the firm is not managing efficiently. Because of this fear, the managers do not want to maximise profit.

Tenthly, Charging depreciation on fixed assets, valuation of unsold stock, making provision for doubtfull debts etc. depend on personal judgement of the Accountant. Again they have especial effect on the amount of profit of the firm. So, it can be said that there is effect of personal judgement on profits. Thus, if the objective of the firm is to maximise profit, there remains some doubt regarding the effectiveness of the profits even if sufficient profit is earned.

It is clear from the above discussion that there is various limitations of the objective of maximisation of profit. But it can be said with certainty that a firm can not run by neglecting profit altogether. Again it is also possible that only when profits are maximised, it would be easier to achieve other goals.

2. **Wealth Maximisation Objective :** According to the modern approach, the objective of a firm is maximisation of wealth. Here wealth refers to the wealth invested by the shareholders. Shares are issued for making investment in which project, if the Net Present Value of that project is maximum, the amount of wealth of the shareholders is maximum. Therefore, wealth maximisation refers to the maximisation of net present value of a project. The excess of present value of cash inflows from a project over the present value of cash outflows for that project is called **Net Present Value.** That is—

$$\text{Net Present Value} = \frac{A_1}{(1+K)^1} + \frac{A_2}{(1+K)^2} + \frac{A_3}{(1+K)^3} + \ldots + \frac{A_n}{(1+K)^n} - C$$

where—

$A_1, A_2, A_3, \ldots A_n$ represent the stream of cash inflows for the 1st, 2nd, 3rd .... nth year respectively.

The more the Net Present value, the more is the amount of wealth. So, according to the modern approach, the objective of a business firm is to maximise the net present value of the project. **The following arguments can be represented in favour of wealth maximisation objective :**

Firstly, According to the wealth maximisation objective, a proposed project is evaluated on the basis of its cashflows. In this case, at the time of forecasting inflows of cash, required provision is made for making the payment to the short-term lenders in time. So, the wealth maximisation objective ensures the settlement of claims to the short-term creditors timely.

Secondly, Wealth maximisation objective not only serves the interests of the short-term lenders but ensures security to long-term lenders also. The long-term lenders get a fixed rate of interest from the earnings and also have a priority over the shareholders in return of their invested funds. The claim to the shareholders' can never be settled until full payment is made to the lenders in settlement of their claims. Again, the objective of wealth maximisaiton is to maximise the shareholders wealth. Thus, it is clear that if the objective of wealth maximisation is fulfilled, the claims to the long-term lenders must be settled.

Thirdly, Productivity and efficiency of the employees is the primary consideration in raising firm's wealth. So, they may also try to acquire a share of the raising wealth of the firm through bargaining process. For this, if the objective of wealth maximisation is fulfilled, the employees share in the wealth of the firm gets increased.

Fourthly, Management is the elected body of the shareholders. The shareholders may not like to change a management if it is able to increase the value of their shares. As the objective of wealth maximisation is to maximise the value of the shares of the shareholders, it helps to keep intact the management of the firm.

Fifthly, According to the wealth maximisaiton objective, only those projects are accepted whose NPV is positive..So, the firm having the objective of maximisation of net wealth do not have to face financial distress.

Sixthly, There is no clear concept of profit in the profit maximisation objective. But the concept of wealth is clear in the wealth maximisation objective, because, in this case, wealth refers to the net present value of the project.

Seventhly, Time value of money is considered in the wealth maximisation objective. Because, in this case, the income-streams of the entire life of a project are discounted at cost of capital.

Eightthly, The aspect of risk and uncertainty is considered in wealth maximisation objective. Because, when a project is evaluated on the basis of this objective, the more the risk and uncertainty, the income streams are discounted at higher rate, and vise-versa.

Though the wealth maximisation objective is established on the basis of modern approach but inspite of that this objective is not completely flawless, it has been criticised in different ways. **The following arguments can be represented against the wealth maximisation objective :**

Firstly, Wealth maximisation refers to the maximisation of Net Present Value of a project. Therefore, if the objective of the business is to maximise wealth, the business firms will invest funds only into those projects whose Net Present Value will be maximum without giving importance to the taste, choice and demand of the customers. As a result of it, the social welfare will be obstructed due to lack of consumers' satisfaction. So, this objective is not desirable from the view-point of the society.

Secondly, The wealth of the shareholders is maximum only at that time when the market value of the shares is maximum. The market value of the shares is not maximum if only the Net Present Value of the concerned project is maximum; because, the market value of the shares remarkably depends also on the economic and political environment of the country. So, it can not always be said that the amount of wealth of the shareholders must be maximum if the wealth maximisation objective is fulfilled.

Thirdly, a firm may manufacture such a goods or service that can meet the requirements of a few peoples of the society. In such a case, despite being maximisation of wealth, the social welfare is not performed. Because, the concerned goods or service can not fulfil the wants of the majority people of society.

Fourthly, wealth maximisation is neither an objective nor a goal, it is a criterion. According to this criterion, financial decisions are taken in such a way so that the amount of wealth of the shareholders is maximum. Thus, it is a decision-making criterion.

Fifthly, wealth can not be generated without earning profit. So, it is not possible to fulfil the wealth maximisation objective by ignoring the objective of earning profit. Besides, the qualitative changes in profit maximisation criterion is the wealth maximisation criterion. So, profit must be maximised in order to fulfil the wealth maximisation objective. Thus, profit maximisation is the primary objective and wealth maximisation is the secondary objective.

Sixthly, Minority shareholders always expect dividend at higher rate on their investment. So, the wealth maximisation objective is not much important to them. As the amount of dividend depends on earning capacity and dividend policy of the firm, the profit maximisation objective is more important than wealth maximisation objective from the view-point of the minority shareholders.

M Profit Maximisation Criterion

All the business concerns are profit-seeking concerns. Profit seeking concerns refer to those concerns which are formed for earning profit. So, profit maximisation is an important goal of the financial management. According to profit maximisation approach, those activities are accepted which maximise profit and those are rejected which reduce profit. So, according to profit maximisation criterion, the activities relating to financing, investing and dividend decisions of the financial management should be managed in such a way so that the amount of profit is maximum. It can be mentioned in this regard that the term 'Profit' is used in two senses, such as, owner-oriented concept and profitability concept. According to owner-oriented concept, profit refers to the amount of earnings which is paid to the suppliers of the equity capital. On the other hand, according to profitability concept, if the value of resources, which is generated by using an input is more than the value of that input, then the excess is known as profit. According to profit maximisation criterion, the second concept is accepted. So, according to profit maximisation criterion, the activities of the financial management is conducted in such a way so that the value of the output is more than the value of the input.

The basic opinion of profit maximisation criterion is to earn maximum profit by optimum use of the economic resources. Profit is the yardstick of measurement of efficiency. For this, the activities of the financial management are managed in such a way that sufficient profit is earned by efficient use of the important economic resource like capital. So, the profit maximisation criterion is very important in case of financial management. But inspite of that this criterion has been criticized from different angles, such as —

(i) **Indistinct concept of Profit :** The basic opinion of profit maximisation criterion is to maximise profit. But profit may be of different types, such as, short-term profit, long-term profit, rate of profit, amount of profit, before-tax profit, after-tax profit, etc. But it is not clearly stated in the profit maximisation criterion which profit is to be maximised.

(ii) **Ignoring time value of Money :** Time value of money is not considered in profit maximisation theory. When different amount of cash inflows take place in different times, the approach considers only the total value of money without considering the times of inflows. If the total inflows of cash of different projects for the different periods are same, all the projects are considered identical according to the profit maximisation criterion. For example, suppose we have two projects — 'A' and 'B' with equal life of 5 years. A return of ₹ 10,000 p.a. will obtain from the first project and ₹ 50,000 from the second one at the end of fifth year. Since the total return of both the projects is ₹ 50,000, both of them are equally likely projects according to the profit maximisation criterion. But this concept is not correct. Because one rupee of today is not equal to the one rupee of tomorrow. As for example, return is to be obtained in the second year on the re-investment of the first year's return if it is re-invested. Similarly, returns are to be obtained in the subsequent years on the re-investment of the second, third and fourth year's returns if these are re-invested. So, naturally, the first project is more acceptable than the second one. But both the projects are equally likely acceptable according to the profit maximisation criterion.

(iii) **Risk and uncertainty :** The aspect of risk and uncertainty has been ignored in profit maximisation criterion. The future earnings of different projects are subject to different degree of risk. So, if the earning capacity of different projects is same, the value of their earning never may be identical. The more fluctuating the income of a project, the more is the degree of risk. The investors want to be risk-free or take low risk. So, they prefer risk-free certain income to more risk-related maximum income. Moreover, future is uncertain. So, the objective of profit maximisation is meaningless as what amount of profit can be earned in future is not certain.

N Wealth Maximisation Criterion

The profit maximisation criterion is not consistent with the operational activities of the firm because it ignores the time value of money and the degree of risk and uncertainty and it has no clear concept of profit. The wealth maximisation criterion is considered the best criterion in case of financial decisions-making as it takes into consideration the time value of money and the degree of risk and uncertainty and it has a clear concept of wealth. Wealth maximisation means maximisation of Net Present Value of a project. If the present value of cash inflows of a project is more than the present value of cash outflows for undertaking the project, the excess is known as Net Present Value. Thus—

$$\text{Net Present Value} = \frac{A_1}{(1+K)^1} + \frac{A_2}{(1+K)^2} + \frac{A_3}{(1+K)^3} + \ldots\ldots + \frac{A_n}{(1+K)^n} - C.$$

where A_1, A_2, A_3 ...... A_n represent the stream of cash inflows for the 1st, 2nd, 3rd ..... *n*th year respectively. '*K*' represents the rate of discount and '*C*' represents the initial outlay for undertaking the project.

The more the net present value, the more is the amount of wealth. So, the more the net present value of a project, the more it is acceptable in financial decisions-making. It can be mentioned in this regard that if the net present value of a project is less than zero *i.e.*, negative, it is not acceptable according to the wealth maximisation criterion as it reduces the amount of wealth.

O Why is the Wealth Maximisation Criterion Superior to the Profit Maximisation Creterion?

The wealth maximisation creiterion is more acceptale than profit maximisation criterion in case of taking ivestment decisions in financial management, because—

Firstly, it is not clearly mentioned in the profit maximisation criterion that which profit is to be maximised. In wealth maximisation criterion, wealth refers to the net present value. So, wealth maximisation refers to the maximisation of net present value of a project.

Secondly, the profit maximisation criterion does not take into consideration the time value of money. But it is considered in wealth maximisation criterion as income streams of the entire life of a project are discounted in such a case.

Thirdly, the aspect of risk and uncertainty is ignored in profit maximisation criterion. But it is considered in wealth maximisation criterion as in this case the more the risk and uncertainty, the incomes are discounted at higher rate, and the less the risk and uncertainty, the incomes are discounted at low rate.

P Difference between Profit Maximisation Criterion and Wealth Maximisation Criterion

Profit Maximisation Criterion	Wealth Maximisation Criterion
(i) It is traditional approach of the financial management.	(i) It is modern approach of the financial management.
(ii) According to this criterion, the financial activities of a firm is conducted in such a way so that the amount of profit of that firm is maximum.	(ii) According to this criterion, the financial activities of a firm is conducted in such a way so that the net wealth of the firm is maximum.
(iii) The concept of profit is not clear in the profit maximisation criterion.	(iii) The concept of wealth is clear in the wealth maximisation criterion. In this case wealth refers to the net present value of a project.
(iv) The aspects of risk and uncertainty are ignored in profit maximisation criterion.	(iv) The aspects of risk and uncertainty are considered in wealth maximisation criterion.
(v) In this case, it is not necessary to know the rate of discount for determining the profit.	(v) In this case, it is necessary to know the rate of discount for determining the net wealth.
(vi) Time value of money is not considered in this criterion.	(vi) Time value of money is considered in this criterion.

Q Role of Chief Financial Officer

A chief financial officer is such a person who is responsible to carry out the finance function of the firm smoothly. His traditional role was confined just to the raising finance from various sources. But the recent development in the socio-economic and political scenario throughout the world has placed him in a central position in the business organisation. At present, his role is confined not only to the raising finance. The increasing pace of industrialisation, raise of large-scale units, innovations in information processing technique etc. have increased the need for financial planning and control. For this, his role, day-by-day, is becoming more and more pervasive and significant.

In his new role, he needs to have a broader and far-sight outlook and he must ensure that the funds of the firm are utilised in the most efficient way. Because, he is now responsible for shaping the fortunes of the firm and is involved in the most vital decision of the allocation of capital. He must have the flexibility to adapt the external factors such as economic uncertainty, technological change, global competetion, volatility of interest and exchange rate and changes in law and regulations. Thus, in today's changing environment, the Chief financial officer plays a vital leadership role in a firm's overall efforts to achieve its objective. He must realise that his action would have far-reaching consequence for the firm because they influence the size, growth, risk, profitability and survival of the firm, and as a consequence, affect the overall value of the firm.

Globalisation has integrated the national financial market with the global financial markets. Emergence of financial services industry and recent innovation and development of financial tools, techniques and instruments have extended the scope of finance function wide-spreadly. As a result of it, at present, the responsibilities of the Chief financial officer have been increased many times than previous. His main responsibilities are—

1. **Making Financial Planning :** The main responsibility of the chief financial officer is to make financial planning properly. His responsibilities relating to making the financial planning are—
   (i) *To forecaste the needs and sources of finance;*
   (ii) *To ensure the adequate supply of fund at proper time;*
   (iii) *To make necessary arrangement of raising finance as and when they are required;*
   (iv) *To ensure the optimum use of the surplus fund.*

   In order to fulfil the above responsibilities properly, he has to maintain control on the inflows and outflows of funds in such a way so that the necessary funds may be available as and when they are required and it is possible to use the surplus funds properly in order to avoid idle cash.

2. **Financing :** The second important responsibility of the Chief financial officer is to make necessary arrangement for raising finance. For this purpose, he has :
   (i) *to determine the nature of the required finance for determining whether the finances are required for long-terms or for short-terms, because the terms and sources of finance depends on the nature of the finance.*
   (ii) *to find out the sources of raising finance on the basis of the nature of financial needs and to select the optimum sources by making a comparative study among the various sources in relation to the profitability and cost of raising finance.*
   (iii) *to see that the selected sources must not be opposite to the interest of the shareholders and other investors or they must not hamper the flexibility of the capital structure.*

3. **Controlling the use of funds :** The chief financial officer is also responsible for the proper utilisation of funds. For this, he has to maintain proper control on the use of funds. In order to control the use of funds properly—
   (i) *he has to invest the collected funds into different assets of the firm in such a way so that it is possible to earn higher profits;*

(ii) *Inflows and outflows of cash have to be controlled in such a way so that it is possible to meet the current as well as the future obligations timely ;*

(iii) *Unnecessary expenditure should be curtained;*

(iv) *Misappropriation of funds should be prevented;* and

(v) *Consistency should be maintained in the investment of funds into fixed and working capital.*

4. **Appropriation of profits :** Appropriation of profits is one of the important responsibilities of the chief financial officer. At the time of taking decisions relating to the appropriation of profits, the chief financial officer has to take the following two contradictory decisions mainly—

   (i) *How much amount of profits should be retained in hands as reserves for future expansion of the business;* and

   (ii) *How much amount of profits should be distributed among the shareholders as dividend.*

5. **Supervision of the functions of treasurer and controller :** The main responsibility of the treasurer is to provide, protect and manage the capital of the firm whereas the Financial controller is responsible to check that whether the capital is used efficiently or not. The chief financial officer supervises the functions of these two financial executives.

R Relation of Financial Management with other branches of Management

Financial management is an integral part of overall management. So, the financial management has a close relation with the other branches of management. Such relationships are discussed below :

(i) **Financial Management and Marketing Management :** Every firm has to charge an appropriate price for its products. The market management and the financial management have a joint role in the determination of such price, because, the marketing manager provides information as to how different prices will affect the demand for the firm's product and the financial manager provides information as to how the cost of production will be changed at different level of production.

(ii) **Financial Management and Assets Management :** The acquisition of assets and their proper maintenance involve finances. Again, the firm's finances are affected by the effective utilisation of assets. Hence, the financial management is concerned with both acquisition and utilisation of the firm's assets.

(iii) **Financial Management and Personnel Management :** Recruitment, Training, Placement and Promotion of the staffs etc. are the responsibilities of the personnel department. All these require finance. So, the personnel department can not take decisions regarding these aspects by isolating the finance department.

(iv) **Financial Management and Production Management :** Production function involves heavy investment in fixed assets and working capital. Financial management determines the amount of investment in fixed assets and working capital through capital budgeting decision and working capital forecasting respectively. Thus, it is clear that the production management has to depend on financial management in order to perform the production function smoothly without the problem of over-capitalisation and under-capitalisation.

(v) **Financial Management and Cash Management :** Proper cash management is required for maintaining consistency in inflows and outflows of cash. Financial management involves in cash management of the firm for ensuring the optimum use of cash.