**BBA – IV SEMESTER**

# SUBJECT- FINANCIAL MANAGEMENT

**(Topic-Meaning,Scope, Importance,Shares &Debentures)**

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## 1.1. Meaning, Nature and Scope of Finance:

Finance may be defined as the art and science of managing money. It includes financial service and financial instruments. Finance also is 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.

The concept of finance includes capital, funds, money, and amount. But each word is having unique meaning. Studying and understanding the concept of finance become an important part of the business concern.

Definition of Financial Management:

Howard and Upton: Financial management "as an application of general managerial Principles to the area of financial decision-making.

Weston and Brigham: Financial management "is an area of financial decision-making harmonizing individual motives and enterprise goals".

Joshep and Massie: Financial management "is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations. Thus, Financial Management is mainly concerned with the effective funds management in the business. In simple words, Financial Management as practiced by business firms can be called as Corporation Finance or Business Finance.

## 1.2. Financial goals or objectives:

Effective procurement and efficient use of finance lead to proper utilization of the finance of the business concern. It is the essential part of the financial manager. Hence, the financial manager must determine the basic objectives of the financial management.

Objectives of Financial Management may be broadly divided into two parts such as:

- Profit maximization
- Wealth maximization.

## 1.3. Profit maximization Vs wealth maximization

Profit Maximization

Main aim of any kind of economic activity is earning profit. A business concern is also functioning mainly for the purpose of earning profit. Profit is the measuring techniques to understand the business efficiency of the concern. Profit maximization is also the traditional and narrow approach, which aims at, maximizes the profit of the concern. Profit maximization consists of the following important features. Profit maximization is also called as cashing per share maximization. It leads to maximize the business operation for profit maximization.

Favourable Arguments for Profit Maximization

The following important points are in support of the profit maximization objectives of the business concern:

(i) Main aim is earning profit.

(ii) Profit is the parameter of the business operation.

(iii) Profit reduces risk of the business concern.

(iv) Profit is the main source of finance.

(v) Profitability meets the social needs also.

Unfavourable Arguments for Profit Maximization

The following important points are against the objectives of profit maximization:

(i) Profit maximization leads to exploiting workers and consumers.

(ii) Profit maximization creates immoral practices such as corrupt practice, unfair trade practice, etc.

(iii) Profit maximization objectives leads to inequalities among the sake holders such as customers, suppliers, public shareholders, etc.

Drawbacks of Profit Maximization

Profit maximization objective consists of certain drawback also:

(i) It is vague: In this objective, profit is not defined precisely or correctly. It creates some unnecessary opinion regarding earning habits of the business concern.

(ii) It ignores the time value of money: Profit maximization does not consider the time value of money or the net present value of the cash inflow. It leads certain differences between the actual cash inflow and net present cash flow during a particular period.

(iii) It ignores risk: Profit maximization does not consider risk of the business concern. Risks may be internal or external which will affect the overall operation of the business concern.

Wealth Maximization

Wealth maximization is one of the modern approaches, which involves latest innovations and improvements in the field of the business concern. The term wealth means shareholder wealth or the wealth of the persons those who are involved in the business concern. Wealth maximization is also known as value maximization or net present worth maximization. This objective is an universally accepted concept in the field of business.

Favourable Arguments for Wealth Maximization

(i) Wealth maximization is superior to the profit maximization because the main aim of the business concern under this concept is to improve the value or wealth of the shareholders.

(ii) Wealth maximization considers the comparison of the value to cost associated with the business concern. Total value detected from the total cost incurred for the business operation. It provides extract value of the business concern.

(iii) Wealth maximization considers both time and risk of the business concern.

(iv) Wealth maximization provides efficient allocation of resources.

(v) It ensures the economic interest of the society.

Unfavorable Arguments for Wealth Maximization

(i) Wealth maximization leads to prescriptive idea of the business concern but it may not be suitable to present day business activities.

(ii) Wealth maximization is nothing, it is also profit maximization, it is the indirect name of the profit maximization.

(iii) Wealth maximization creates ownership-management controversy.

(iv) Management alone enjoy certain benefits.

(v) The ultimate aim of the wealth maximization objectives is to maximize the profit.

(vi) Wealth maximization can be activated only with the help of the profitable position of the business concern.

**1.4. Functions of finance**

Finance function is one of the major parts of business organization, which involves the permanent and continuous process of the business concern. Finance is one of the interrelated functions which deal with personal function, marketing function, production function and research and development activities of the business concern. At present, every business concern concentrates more on the field of finance because, it is a very emerging part which reflects the entire operational and profit ability position of the concern. Deciding the proper financial function is the essential and ultimate goal of the business organization. Finance manager is one of the important role players in the field of finance function. He must have entire knowledge in the area of accounting, finance, economics and management. His position is highly critical and analytical to solve various problems related to finance. A person who deals finance related activities may be called finance manager.

Finance manager performs the following major functions:

1. Forecasting Financial Requirements

It is the primary function of the Finance Manager. He is responsible to estimate the financial requirement of the business concern. He should estimate, how much finances required to acquire fixed assets and forecast the amount needed to meet the working capital requirements in future.

2. Acquiring Necessary Capital

After deciding the financial requirement, the finance manager should concentrate how the finance is mobilized and where it will be available. It is also highly critical in nature.

3. Investment Decision

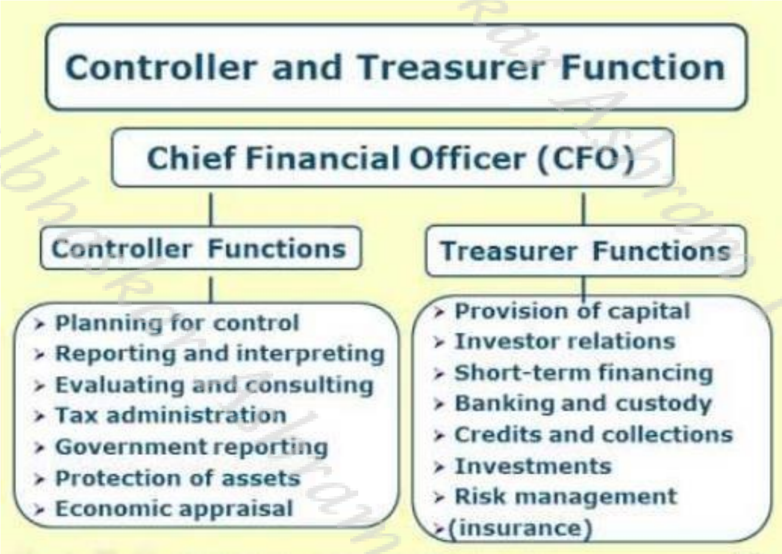
The finance manager must carefully select best investment alternatives and consider the reasonable and stable return from the investment. He must be well versed in the field of capital budgeting techniques to determine the effective utilization of investment. The finance manager must concentrate to principles of safety, liquidity and profitability while investing capital.

4. Cash Management

Present days cash management plays a major role in the area of finance because proper cash management is not only essential for effective utilization of cash but it also helps to meet the short-term liquidity position of the concern.

5. Interrelation with Other Departments

Finance manager deals with various functional departments such as marketing, production, personnel, system, research, development, etc. Finance manager should have sound knowledge not only in finance related area but also well versed in other areas. He must maintain a good relationship with all the functional departments of the business organization.




Importance of Financial Management:

Finance is the lifeblood of business organization. It needs to meet the requirement of the business concern. Each and every business concern must maintain adequate amount of finance for their smooth running of the business concern and also maintain the business carefully to achieve the goal of the business concern. The business goal can be achieved only with the help of effective management of finance. We can't neglect the importance of finance at any time at and at any situation. Some of the importance of the financial management is as follows:

Financial Planning

Financial management helps to determine the financial requirement of the business concern and leads to take financial planning of the concern. Financial planning is an important part of the business concern, which helps to promotion of an enterprise.

Acquisition of Funds

Financial management involves the acquisition of required finance to the business concern. Acquiring needed funds play a major part of the financial management, which involve possible source of finance at minimum cost.

Proper Use of Funds

Proper use and allocation of funds leads to improve the operational efficiency of the business concern. When the finance manager uses the funds properly, they can reduce the cost of capital and increase the value of the firm.

Financial Decision

Financial management helps to take sound financial decision in the business concern. Financial decision will affect the entire business operation of the concern. Because there is a direct relationship with various department functions such as marketing, production personnel, etc.

Improve Profitability

Profitability of the concern purely depends on the effectiveness and proper utilization of funds by the business concern. Financial management helps to improve the profitability position of the concern with the help of strong financial control devices such as budgetary control, ratio analysis and cost volume profit analysis.

Increase the Value of the Firm

Financial management is very important in the field of increasing the wealth of the investors and the business concern. Ultimate aim of any business concern will achieve the maximum profit and higher profitability leads to maximize the wealth of the investors as well as the nation.

Promoting Savings

Savings are possible only when the business concern earns higher profitability and maximizing wealth. Effective financial management helps to promoting and mobilizing individual and corporate savings.

Nowadays financial management is also popularly known as business finance or corporate finances. The business concern or corporate sectors cannot function without the importance of the financial management.

**1.5. Decisions in financial management**

The various decisions under financial management can be categorized under the following four heads.

- Investment Decisions
- Finance Decisions
- Dividend Decisions
- Liquidity Decisions

<u>Investment Decisions:</u>

The Investment Decision relates to the decision made by the investors or the top level management with respect to the amount of funds to be deployed in the investment opportunities. Capital Budgeting is the process of selecting the asset or an investment proposal that will yield returns over a long period.

The first step involved in Capital Budgeting is to select the asset, whether existing or new on the basis of benefits that will be derived from it in the future.

The next step is to analyze the proposal's uncertainty and risk involved in it. Since the benefits are to be accrued in the future, the uncertainty is high with respect to its returns.

Finally, the minimum rate of return is to be set against which the performance of the long-term project can be evaluated.

Finance Decisions:

The second important decision which finance manager has to take is deciding source of finance. A company can raise finance from various sources such as by issue of shares, debentures or by taking loan and advances. Deciding how much to raise from which source is concern of financing decision. Mainly sources of finance can be divided into two categories:

1. Owners fund.
2. Borrowed fund.

Share capital and retained earnings constitute owners' fund and debentures, loans, bonds, etc. constitute borrowed fund. The main concern of finance manager is to decide how much to raise from owners' fund and how much to raise from borrowed fund. While taking this decision the finance manager compares the advantages and disadvantages of different sources of finance. The borrowed funds have to be paid back and involve some degree of risk whereas in owners' fund there is no fix commitment of repayment and there is no risk involved. But finance manager prefers a mix of both types. Under financing decision finance manager fixes a ratio of owner fund and borrowed fund in the capital structure of the company.

Dividend Decisions:

This decision is concerned with distribution of surplus funds. The profit of the firm is distributed among various parties such as creditors, employees, debenture holders, shareholders, etc.

Payment of interest to creditors, debenture holders, etc. is a fixed liability of the company, so what company or finance manager has to decide is what to do with the residual or left over profit of the company.

The surplus profit is either distributed to equity shareholders in the form of dividend or kept aside in the form of retained earnings. Under dividend decision the finance manager decides how much to be distributed in the form of dividend and how much to keep aside as retained earnings.

Working Capital:

Effective financial management will increase the range of opportunities open to an enterprise to pursue its strategic plan. A liquidity problem, apart from being expensive, reduces options and diverts the attention of management away from a longer-term perspective.

There are commonly three working capital issues on which a business would need to make a decision

· Whether to offer discounts to debtors for prompt settlement of accounts (Receivables Management)

· Whether to dispose of slow-moving stocks at reduced prices, and by how much to reduce them (Inventory Management)

· Whether to purchase by cash or on credit, allowing for discounts which might be on offer. (Cash Management)

**1.6. Types of shares and debentures**

Shares: Smallest division of the company's capital is known as shares. The shares are offered for sale in the open market, i.e. stock market to raise capital for the company. The rate on which the shares are offered is known as share price. It represents the portion of ownership of the shareholder in the company. The shareholders are entitled to the dividend (if any) declared by the company on the shares.

The shares are movable i.e. transferable and consist of a distinctive number. The shares are broadly divided into two major categories:

- Equity Shares: The shares which carry voting rights on which the rate of dividend is not fixed. They are irredeemable in nature. In the event of winding up of the company equity, shares are repaid after the payment of all the liabilities.
- Preference Shares: The shares which do not carry voting rights, but the rate of dividend is fixed. They are redeemable in nature. In the event of winding up of the company, preference shares are repaid before equity shares.

Debentures: A long-term debt instrument issued by the company under its common seal, to the debenture holder showing the indebtedness of the company. The capital raised by the company is the borrowed capital; that is why the debenture holders are the creditors of the company. The debentures can be redeemable or irredeemable in nature. They are freely transferable. The return on debentures is in the form of interest at a fixed rate.

Debentures are secured by a charge on assets, although unsecured debentures can also be issued. They do not carry voting rights. The debentures are of following types:

- Secured Debentures
- Unsecured Debentures
- Convertible Debentures
- Non-convertible Debentures
- Registered Debentures
- Bearer Debentures

## 1.7. Differences between shares and debentures

The following are the major differences between Shares and Debentures:

1. The holder of shares is known as a shareholder while the holder of debentures is known as debenture holder.
2. Share is the capital of the company, but Debenture is the debt of the company.
3. The shares represent ownership of the shareholders in the company. On the other hand, debentures represent indebtedness of the company.
4. The income earned on shares is the dividend, but the income earned on debentures is interest.
5. The payment of dividend can be made only out of current profits of the business and not otherwise. Unlike the interest on debentures which has to be paid by the company to debenture holders, no matter company has earned profit or not.
6. Dividend is not a business expense and so is not allowed as deduction. On the contrary, interest on debentures is a expense and so allowed as a deduction.
7. In the event of winding up, debentures get priority of repayment over shares.
8. Shares cannot be converted as opposed to debentures are convertible.
9. There is no security charge created for payment of shares. Conversely, security charge is created for the payment of debentures.
10. A trust deed is not executed in case of shares whereas trust deed is executed when the debentures are issued to the public.
11. Unlike debenture holders, shareholders have voting rights.
12. Shares are issued at a discount subject to some legal compliance. Debentures can be issued at a discount without any legal compliance.