UNIT I
INTRODUCTION

1. What is Financial Management? Explain the nature of financial management.

Ans. Financial Management is all about planning, organizing, directing, and controlling the economic pursuits such as acquisition and utilization of capital of the firm. To put it in other words, it is applying general management standards to the financial resources of the firm.

According to Guthman and Dougal, "Financial management is the activity concerned with planning, raising, controlling and administering of funds used in the business."

Nature or Features or Characteristics of Financial Management

Nature of financial management is concerned with its functions, its goals, trade-off with conflicting goals, its indispensability, its systems, its relation with other subsystems in the firm, its environment, its relationship with other disciplines, the procedural aspects and its equation with other divisions within the organisation.

1. Financial Management is an integral part of overall management. Financial considerations are involved in all business decisions. So financial management is pervasive throughout the organisation.

2. The central focus of financial management is valuation of the firm. That is financial decisions are directed at increasing/maximization/ optimizing the value of the firm.

3. Financial management essentially involves risk-return trade-off Decisions on investment involve choosing of types of assets which generate returns accompanied by risks. Generally higher the risk, returns might be higher and vice versa. So, the financial manager has to decide the level of risk the firm can assume and satisfy with the accompanying return.

4. Financial management affects the survival, growth and vitality of the firm. Finance is said to be the life blood of business. It is to business, what blood is to us. The amount, type, sources, conditions and cost of finance squarely influence the functioning of the unit.

5. Finance functions, i.e., investment, rising of capital, distribution of profit, are performed in all firms - business or non-business, big or small, proprietary or corporate undertakings. Yes, financial management is a concern of every concern.

6. Financial management is a sub-system of the business system which has other subsystems like production, marketing, etc. In systems arrangement financial sub-system is to be well-coordinated with others and other sub-systems well matched with the financial subsystem.

2. Explain the scope of financial management.

Ans. The scope of financial management can be divided in two approaches. Namely Under traditional approach and Modern Approach

Under Traditional Approach

In the traditional approach for corporate finance was the term used in place of financial management. The role of financial management was limited to measuring the funds required for the corporate body to meet its financial requirements. Thus the scope of financial management was narrow under the traditional approach of financial management. Financial Management under traditional approach covered the following aspects,

(i) Institutional sources of finance.

(ii) Issue of financial devices to collect refunds from the capital market.

(iii) Accounting and legal relationship between the source of finance and business.

In this approach, finance was required not for regular business operations but occasional events like reorganization, promotion, liquidation, expansion, etc. It was considered essential to have funds for such events and regarded as one of the crucial functions of a financial manager.

Under Modern Approach:
Under the modern approach of Financial Management is not concerned with the raising of funds instead it also includes making wise financial decisions of fund raising. It covers the following aspects

(i)Funds Requirement Decision: Here the decision is concerned with the forecasting or estimation of funds as per the need by the business. In business funds are very essential to carry out the smooth operations of the business activities. If proper fund requirement decision is not made then it will give rise to many problems and will affect the operations of the business and also will become a constraint in the development of business.
(ii)Financing Decision: Here the decisions are concerned with the procurement of the funds required at right time. After fund requirement decision is made then the financial manager has to explore various options available for financing and should choose the best and cost effect option for financing so that the business runs smoothly without any unnecessary obstacles such as inadequate fund.
(iii)Investment Decisions: The decisions are concerned with the allocation of funds to investment proposal. Many of the business today invest in the startups and also in other good investment deals to make profits and also to use the available funds for effective utilization.
(iv)Dividend Decision: Here the decision is concerned with the determination of the percentage of profit earned to be paid to the shareholders or dividend. Here financial manager makes decision regarding how much dividend is to be paid out and how much to retain as retain earning. Dividend payout decision is a critical decision to be made so that investors and shareholders are happy and even the firm has enough funds for the expansion of the business.

3. Explain the objectives of financial management.

Ans. The objectives or purposes of financial management have been broadly classified into the following:

1. Primary Objectives and 2.Secondary Objectives.

1. Primary Objectives: The primary objectives of financial management are:

(i) Profit maximization: Profit maximisation, as the name suggests, refers to maximising the profits earned by the business enterprise. It implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximised.

2. Wealth maximization: Wealth maximization (shareholders' value maximization) is also a main objective of financial management. Wealth maximization means to earn maximum wealth for the shareholders. So, the finance manager tries to give a maximum dividend to the shareholders. He also tries to increase the market value of the shares. The market value of the shares is directly related to the performance of the company. Better the performance, higher is the market value of shares and vice-versa. So, the finance manager must try to maximize shareholder's value.

2. Secondary Objectives: The other objectives of financial management are:

(i) Proper estimation of total financial requirements: Proper estimation of total financial requirements is a very important objective of financial management. The finance manager must estimate the total financial requirements of the company. He must find out how much finance is required to start and run the company. He must find out the fixed capital and working capital requirements of the company.

(ii) Proper mobilization: Mobilization (collection) of finance is an important objective of financial management. After estimating the financial requirements, the finance manager must decide about the sources of finance. He can collect finance from many sources such as shares, debentures, bank loans, etc. There must be a proper balance between owned finance and borrowed finance. The company must borrow money at a low rate of interest.

(iii) Proper utilization of finance: Proper utilization of finance is an important objective of financial management. The finance manager must make optimum utilization of finance. He must use the finance profitable. He must not waste the finance of the company. He must not invest the company's finance in unprofitable projects. He must not block the company's finance in inventories. He must have a short credit period.

(iv) Maintaining proper cash flow: Maintaining proper cash flow is a short-term objective of financial management. The company must have a proper cash flow to pay the day-to-day expenses such as purchase of raw materials, payment of wages and salaries, rent, electricity bills, etc. If the company has a good cash flow, it can take advantage of many opportunities such as getting cash discounts on purchases, large-scale purchasing, and giving credit to customers, etc. A healthy cash flow improves the chances of survival and success of the company.

(v) Survival of company: Survival is the most important objective of financial management. The company must survive in this competitive business world. The finance manager must be very careful while making financial decisions. One wrong decision can make the company sick, and it will close down.

(vi) Create goodwill: Financial management must try to create goodwill for the company. It must improve the image and reputation of the company. Goodwill helps the company to survive in the short-term and succeed in the long-term. It also helps the company during bad times.

(vii) Prepare capital structure: Financial management also prepares the capital structure. It decides the ratio between owned finance and borrowed finance. It brings a proper balance between the different sources of capital. This balance is necessary for liquidity, economy, flexibility and stability.

4. Explain profit maximisation and wealth maximisation objectives with their advantages and limitations. Which is superior in your opinion and why?

Ans.1. Profit Maximisation: Profit earning is the main aim of every economic activity. A business being an economic institution must earn profit to cover its costs and provide funds for growth. No business can survive without earning profit. Profit is a measure of efficiency of a business enterprise.

Profits also serve as a protection against risks which cannot be ensured. The accumulated profits enable a business to face risks like fall in prices, competition from other units, adverse government policies etc. Thus, profit maximisation is considered as the main objective of business.

The following arguments are advanced in favour of profit maximisation as the objective of business:
(i) When profit-earning is the aim of business then profit maximisation should be the obvious objective.

(ii) Profitability is a barometer for measuring efficiency and economic prosperity of a business enterprise, thus, profit maximisation is justified on the grounds of rationality.

(iii) Economic and business conditions do not remain same at all the times. There may be adverse business conditions like recession, depression, severe competition etc. A business will be able to survive under unfavourable situation, only if it has some past earnings to rely upon. Therefore, a business should try to earn more and more when situation is favourable.

(iv) Profits are the main sources of finance for the growth of a business. So, a business should aim at maximisation of profits for enabling its growth and development.

(v) Profitability is essential for fulfilling social goals also. A firm by pursuing the objective of profit maximisation also maximises socio-economic welfare.

However, profit maximisation objective has been criticised on many grounds. A firm pursuing the objective of profit maximisation starts exploiting workers and the consumers. Hence, it is immoral and leads to a number of corrupt practices. Further, it leads to colossal inequalities and lowers human values which are an essential part of an ideal social system.

Even as an operational criterion for maximising owner's economic welfare, profit maximisation has been rejected because of the following **drawbacks:**

(i) Ambiguity: The term 'profit' is vague and it cannot be precisely defined. It means different things for different people. Should we consider short-term profits or long-term profits? Does it mean total profits or earnings per share? Should we take profits before tax or after tax? Does it mean operating profit or profit available for shareholders?

(ii) Ignores Time Value of Money: Profit maximisation objective ignores the time value of money and does not consider the magnitude and timing of earnings. It treats all earnings as equal though they occur in different periods. It ignores the fact that cash received today is more important than the same amount of cash received after, say, three years.
The stockholders may prefer a regular return from investment even if it is smaller than the expected higher returns after a long period.

(iii) Ignores Risk Factor: It does not take into consideration the risk of the prospective earnings stream. Some projects are more risky than others. The earning streams will also be risky in the former than the latter. Two firms may have same expected earnings per share, but if the earning stream of one is more risky then the market value of its shares will be comparatively less.

(iv) Dividend Policy: The effect of dividend policy on the market price of shares is also not considered in the objective of profit maximisation. In case, earnings per share is the only objective then an enterprise may not think of paying dividend at all because retaining profits in the business or investing them in the market may satisfy this aim.

2. Wealth Maximisation: Wealth maximisation is the appropriate objective of an enterprise. Financial theory asserts that wealth maximisation is the single substitute for a stockholder's utility. When the firm maximises the stockholder's wealth, the individual stockholder can use this wealth to maximise his individual utility. It means that by maximising stockholder's wealth the firm is operating consistently towards maximising stockholder's utility.
A stockholder's current wealth in the firm is the product of the number of shares owned, multiplied with the current stock price per share.

The share's market price serves as a performance index or report card of its progress. It also indicates how well management is doing on behalf of the shareholder.

However, the maximisation of the market price of the shares should be in the long run. The long run implies a period which is long enough to reflect the normal market value of the shares irrespective of short- term fluctuations.

The following arguments are advanced in favour of wealth maximisation as the goal of financial management:

(i) It serves the interests of owners, (shareholders) as well as other stakeholders in the firm; i.e. suppliers of loaned capital, employees, creditors and society.

(ii) It is consistent with the objective of owners' economic welfare.

(iii) The objective of wealth maximisation implies long-run survival and growth of the firm.

(iv) It takes into consideration the risk factor and the time value of money as the current present value of any particular course of action is measured.

(v) The effect of dividend policy on market price of shares is also considered as the decisions are taken to increase the market value of the shares.

(vi) The goal of wealth maximisation leads towards maximising stockholder's utility or value maximisation of equity shareholders through increase in stock price per share.

Criticism of Wealth Maximisation: The wealth maximisation objective has been criticised by certain financial theorists mainly on following accounts:

(i) It is a prescriptive idea. The objective is not descriptive of what the firms actually do.

(ii) The objective of wealth maximisation is not necessarily socially desirable.

(iii) There is some controversy as to whether the objective is to maximise the stockholders wealth or the wealth of the firm which includes other financial claimholders such as debenture-holders, preferred stockholders, etc.

(iv) The objective of wealth maximisation may also face difficulties when ownership and management are separated as is the case in most of the large corporate form of organisations. When managers act as agents of the real owners (equity shareholders), there is a possibility for a conflict of interest between shareholders and the managerial interests.
The managers may act in such a manner which maximises the managerial utility but not the wealth of stockholders or the firm.

In spite of all the criticism, we are of the opinion that wealth maximisation is the most appropriate objective of a firm because profit maximization is a strictly short-term approach to managing a business, which could be damaging over the long term. Wealth maximization focuses attention on the long term, requiring a larger investment and lower short-term profits, but with a long-term payoff that increases the value of the business.

5. Distinguish between profit maximisation and wealth maximisation.
Ans.

Basis	Profit maximization	Wealth maximization
1.Based on	Profit Maximization is based on the increase of sales and profits of the organization.	Wealth Maximization is based on the cash flows into the organization.
2. Focused On	Profit Maximization emphasizes on short term goals.	Wealth Maximization emphasizes on long term goals.
3. Time Value of Money	Profit Maximization ignores the time value of money.	Wealth Maximization considers the time value of money.
4. Risk	Profit Maximization ignores the risk and uncertainty.	Wealth Maximization considers the risk and uncertainty.
5. Reliability	In the new business environment Profit maximisation is regarded as unrealistic, difficult, inappropriate and immoral.	Wealth maximisation objectives ensure fair return to the shareholders, reserve funds for growth and expansion, promoting financial discipline in the management.

6.Explain the functions of Financial Management

Ans. Functions of Financial Management:

(i)Estimation of capital requirements: A finance manager has to make estimation with regards to capital requirements of the company. This will depend upon expected costs and profits and future programmes and policies of a concern. Estimations have to be made in an adequate manner which increases earning capacity of enterprise.

(ii)Determination of capital composition: Once the estimation have been made, the capital structure have to be decided. This involves short- term and long- term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.

(iii)Choice of sources of funds: For additional funds to be procured, a company has many choices like-

a. Issue of shares and debentures
b. Loans to be taken from banks and financial institutions
c. Public deposits to be drawn like in form of bonds.

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

(iv)Investment of funds: The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.

(v)Disposal of surplus: The net profits decisions have to be made by the finance manager. This can be done in two ways:
(a) Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
(b)Retained profits - The volume has to be decided which will depend upon expansion, innovation, diversification plans of the company.

(vi)Management of cash: Finance manager has to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintenance of enough stock, purchase of raw materials, etc.

(vii)Financial controls: The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.

7. What is Time Value of Money? Explain the significance of Time Value of Money or explain the reasons for time preference of money.

Ans. Time value of money is defined as "the value derived from the use of money over time as a result of investment and reinvestment". Time value of money means that "worth of a rupee received today is different from the worth of rupee to be received in future". The preference for money now, as compared to future money is known as time preference of money.

In other words, the value of a sum of money received today is more than its value received after some time, conversely the sum of money received in future is less valuable than it is to-day.

Importance/Significance of Time Value of Money or Reasons for Time Preference of Money:
In the financial decisions, the time value of money holds great importance. It is now the most significant principle in finance and economics. There are certain valid reasons for time preference for money:

(i) Inflation: Because of inflationary conditions, the rupee today has a higher purchasing power than rupee in future. As a result, those who have to receive the money prefer to receive the same as early as possible, while those who have to pay the money try to delay the payment.

(ii) Uncertainty: Since the future is characterised by uncertainty, individuals/business concerns prefer to have current income rather than having the same payment at a later date. They have an apprehension that the party making the payment may default due to insolvency or other reasons.

(iii) Preference for Present Consumption: Both due to uncertainty and inflationary conditions, individuals prefer the consumption to future consumption. They do not wish to save for the future by curtailing current consumption.

(iv)Opportunities for reinvestment: Money can be employed to generate real returns. Individual's business concerns reinvest the money at a certain rate so as to have some yield on it.

As such a financial manager of any business concern cannot ignore the concept of time value of money while making any financial decisions, otherwise his decisions will be invalid and incorrect also.

8. Name and explain the different techniques of time value of money.

Ans. There are two techniques of estimating time value of money which are:

(i) Discounting or Present Value Method: The current value of an expected amount of money to be received at a future date is known as Present Value. If we expect a certain sum of money after some years at a specific interest rate, then by discounting the Future Value we can calculate the amount to be invested today, i.e., the current or Present Value.
Hence, Discounting Technique is the method that converts Future Value into Present Value. The amount calculated by Discounting Technique is the Present Value and the rate of interest is the discount rate.

(ii)Compounding or Future Value Method: Compounding is just the opposite of discounting. The process of converting Present Value into Future Value is known as compounding.

Future Value of a sum of money is the expected value of that sum of money invested after n number of years at a specific compound rate of interest.

9. What is Risk? Explain the different types of risk.

Ans. Risk implies future uncertainty about deviation from expected earnings or expected outcome. Risk measures the uncertainty that an investor is willing to take to realize a gain from an investment.

Types of Risk: Risk can be classified under two main groups:

A. Systematic Risk: Systematic risk is due to the influence of external factors on an organization. Such factors are normally uncontrollable from an organization's point of view.
It is a macro in nature as it affects a large number of organizations operating under a similar stream or same domain. It cannot be planned by the organization.

The types of systematic risk are listed below:
(i)Interest rate risk: Interest-rate risk arises due to variability in the interest rates from time to time. It particularly affects debt securities as they carry the fixed rate of interest.

(ii)Market risk: Market risk is associated with consistent fluctuations seen in the trading price of any particular shares or securities. That is, it arises due to rise or fall in the trading price of listed shares or securities in the stock market.

(iii)Purchasing power or inflationary risk: Purchasing power risk is also known as inflation risk. It is so, since it emanates (originates) from the fact that it affects a purchasing power adversely. It is not desirable to invest in securities during an inflationary period.

B. Unsystematic Risk: Unsystematic risk is due to the influence of internal factors prevailing within an organization. Such factors are normally controllable from an organization's point of view.
It is a micro in nature as it affects only a particular organization. It can be planned, so that necessary actions can be taken by the organization to mitigate (reduce the effect of) the risk.

The types of systematic risk are listed below:

(i) Business or liquidity risk: Business risk is also known as liquidity risk. It is so, since it emanates (originates) from the sale and purchase of securities affected by business cycles, technological changes, etc.

(ii) Financial or credit risk: Financial risk is also known as credit risk. It arises due to change in the capital structure of the organization. The capital structure mainly comprises of three ways by which funds are sourced for the projects.

(iii) Operational risk: Operational risks are the business process risks failing due to human errors. This risk will change from industry to industry. It occurs due to breakdowns in the internal procedures, people, policies and systems.

10. Distinguish between Systematic Risk and Unsystematic Risk.

Ans.

Basis	Systematic Risk	Unsystematic Risk
Meaning	Risks that are uncontrollable in nature and arise out of external factors like political, economic, and sociological are regarded as systematic risks.	Risks that are controllable in nature and arise out of organizational (or internal) factors are regarded as unsystematic risks.
Nature	Systematic risks are the risks that are uncontrollable in nature.	Unsystematic risks are totally controllable in nature
Factors responsible	Systematic risks take place due to external factors or macro-economic factors. These external factors can be sociological, economical, or even political too	Unsystematic risks take place due to internal or organizational or micro-economic factors.
Measurement	Systematic risks are measured by Beta.	Unsystematic risks are not measured or indicated with the help of any tool. However, unsystematic risks can be measured by subtracting
Examples	Systematic risk are inflation, rise in unemployment rates, the higher rate of poverty, corruption, changes in the interest rates, change in price rates, etc	Unsystematic risk are high rate of employee turnover, employee strike, higher costs of operational activities, manipulation of financial statements, etc.

11. What do you mean by return?

Ans. Return may be defined as the total gain or loss expected on the investment made in a particular project. Returns are the stream of benefits expected from an investment decision over a given future period.

12. What do you mean by Risk Return Trade-Off?

Ans. Higher risk is associated with greater probability of higher return and lower risk with a greater probability of smaller return. This trade off which an investor faces between risk and return while considering investment decisions is called the risk return trade off.

13. Explain the capital asset pricing model (CAPM) with its limitations.

Ans. The capital asset pricing model (CAPM), as the name suggests, is a theory that explains how asset prices are formed in the market place. It is a logical and major extension of the portfolio theory of Markowitz by William Sharpe (1964).

The capital asset pricing model provides the framework for determining the equilibrium expected return for risky assets. It uses the results of capital market theory to derive the relationship between expected return and systematic risk of individual assets/securities and portfolios. Capital market theories, also referred to as asset pricing theories, deal with how asset prices are determined if investors behaved the way Markowitz's portfolio theory suggests. A price reflects the expected return and risk associated with an asset.

Assumptions

To grapple with the complexities of the real world, the CAPM makes certain simplifying assumptions. Some of these may be

1. All investors are price-takers. Their number is so large that no single investor can affect prices.

2. All investors use the mean-variance portfolio selection model of Markowitz.

3. Assets/securities are perfectly divisible.

4. All investors plan for one identical holding period.

5. Homogeneity of expectation for all investors results in identical efficient frontier and optimal portfolio.

6. Investors can lend or borrow at an identical risk-free rate.

7. There are no transaction costs and income taxes.

The Model

The CAPM assumes that total risk of a portfolio or an asset can be divided into two parts – systematic risk and unsystematic risk. Systematic risk is the risk which cannot be eliminated through investing in well-diversified market portfolio. Systematic risk is represented by beta (B). On the other hand, unsystematic risk is that type of risk which can be eliminated through diversification. Since the unsystematic risk can be eliminated, there is no reward for it and hence it has no impact on the return of securities. Market will pay premium only for systematic risk as it cannot be avoided. However, CAPM can be expressed as follows:

Expected Return = Risk-free return + (Beta x Risk premium of market).

Limitations of the CAPM

The CAPM is subject to theoretical and practical limitations:

(i) It prices only systematic risk or beta risk which makes it restrictive and inflexible.

(ii)It does not consider multi-period implications. Hence, it cannot capture factors that vary over time and span several periods.

(iii)CAPM defines a true market portfolio as including assets, financial and nonfinancial. Since many assets are not investable, CAPM-defined market portfolio cannot be created. This is why CAPM cannot be tested.

(iv)The assumption that there is homogeneity in investor expectations does not hold in reality.

14. Name and explain the different methods of valuation of equity shares.

Ans. The different methods of valuation of equity shares are:

(i)Net Asset Value (NAV) Method: Net Asset represents Net worth of the Company. After reduction of preference share Capital value from net worth of the Company we get value of company to the Equity share holders.

(ii)Discounted Cash Flow Method (DCF): Discounted Cash Flow Method (DCF) is a complex calculation however it considers not just Companies present situation but also take in to figure, future of the Company. DCF also works for start-up Companies Valuations which do not have track records but has valuation based on business idea & current resources.

Value of firm derived by discounting future cash flows to the company by expected rate of return of Equity & Debt holders. Valuation through DCF imbibes expectation of owners & lenders by considering expected rate of return of both Equity & Debt holders.

DCF becomes more relevant since any decision related to investment is taken considering future return on its & DCF figures out valuation based on future cash flows of the Company.

(iii)Profit OR Divided Yield Method: Profit after tax or dividend is divided by Normal rate of return to derive Capitalized Value & the same is divided by number of shares to get value per share.

Capitalize Value = $\frac{Profit/Dividend}{Normal\ Rate\ of\ Return}$

Value per Share = $\frac{Capitalise\ Value}{Number\ of\ shares}$

Preference Share Dividend to be subtracted from profit to find profit attributable to equity share holders.

(iv)Price-Earnings Ratio Method: This method is generally used to calculate listed Company Share Value. It uses Earning Per Share (EPS) & Market Price of Share (MPS) to calculate value of share.

PE Ratio is determined as follow- $\frac{MPS}{EPS}$

Investor can average out PE Ratio Companies in same sector to rule out higher or lower side valuation based on one company data.

Value per share – EPS x P/E Ratio

Whenever Company declare its Quaterly results & EPS, Investor by using particular sector PE Ratio can find Value of Share to take investment decision.

15. What is Security Market Line (SML)?

Ans. Security market line or SML is a graphical representation of the returns expected to be provided by security given the amount of systematic risk taken in by it. The securities market line is used by investors to determine whether to include security in their portfolio or not.

The graph’s X-axis has systematic risk, which is measured by beta, while the expected returns are on the Y axis. SML starts on Y axis at the risk-free returns value (in the market).

16. What is Capital Market Line (SML)?

Ans. The Capital Market Line is a graphical representation of all the portfolios that optimally combine risk and return. CML is a theoretical concept that gives optimal combinations of a risk-free asset and the market portfolio. The CML is superior to Efficient Frontier in the sense that it combines the risky assets with the risk-free asset.

17. What is Bond? Name the different types of bonds for the purpose of valuation.

Ans. A Bond or a Debenture is a debt instrument. It is an acknowledgement of debt given by an investor. Being a financial asset, a bond or a debenture is valued by taking the Present Value of future inflows from the bond or debenture.

For valuation purposes, bonds or debentures are classified into the following types:
(a) Coupon Bonds or Plain Vanilla Bonds.
(b) Zero Coupon Bonds.
(c) Irredeemable Bonds.
(d) Self-amortising Bonds.