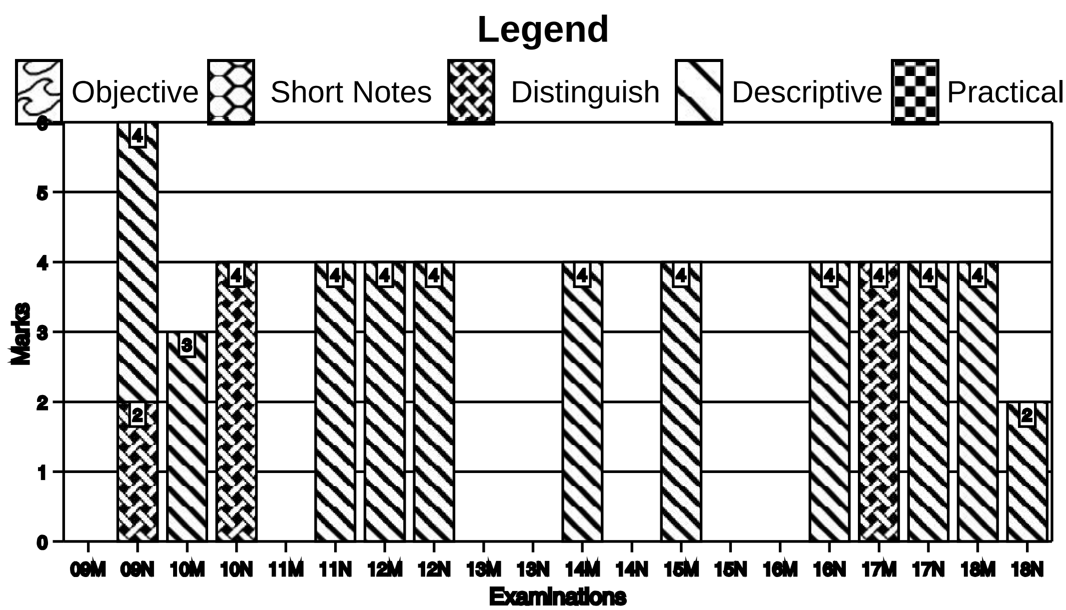
CHAPTER	
1	**Scope and Objectives of Financial Management**

This chapter covers: Study's Chapter: 1

☞ Meaning Evolution, Importance, Scope & Objectives of Financial Management ☞ Finance Functions/Finance Decisions ☞ Conflicts in Profit Versus Value Maximization Principle ☞ Role of Finance Executive ☞ Financial Distress and Insolvency ☞ Relationship of Financial Management with Related Disciplines ☞ Agency Problem and Agency Cost.

THE GRAPH . . . . ***Trend Analysis***

Marks of Objective, Short Notes, Distinguish Between, Descriptive & Practical Questions



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TIME MANAGER		. . . . *Plan and Manage your Time*						
Time	***First In-depth learning***	***Instant Revision (in hours)***		***Periodic Revision (in hours)***				
	i.e..... .... Day 1	Next day i.e.... .... Day 2	After 7 days i.e. on .... Day 8	After 30 days i.e. on .... Day 30	After 60 days i.e. on .... Day 60	After 90 days i.e. on .... Day 90	Fix as per your need.	
1. Budgeted								
2. Actual								
3. Variance (1-2)								

QUICK LOOK	. . . . *Weightage Analysis*	
Repeatedly Asked Questions	**Common Answered Questions**	**Must Try Question**
1.1	3.2, 4.1, 5.2, 5.3	1.1, 5.2, 5.3

1 *Meaning of Financial Management*

Q.1.1	**2002 - Nov [6] {C} (a), 2009 - Nov [8] (i), RTP**	**Descriptive**

Explain the two basic functions of Financial Management.

(3 marks each)

Answer :

The two basic functions of F.M. are	1. Procurement of funds 2. Effective use of these funds

1	**Procurement of fund**	**Procurement of funds includes :** (i) Identification of sources of finance (ii) Determination of finance mix (iii) Raising of funds (iv) Division of profit (v) Retention of profit **There are various sources of procurement of funds such as:** Share capital, debentures, bank, financial institution, ADR, GDR, FDI, FII etc. Every source has an element of risk, cost and control attached with it. Whatever be the source, the cost of the fund should be at the minimum, balancing the risk and the control function.
2	**Effective use of fund**	The funds once procured cannot be left to remain idle. The funds are to be invested in such a way that the business yields maximum return along with maintaining its solvency. Thus the effective use of the funds would require that adequate funds should be maintained to meet the working capital requirement and avoiding the blockage of funds in inventories, book debts, cash etc. **Aspects of Funds Utilisation** (i) Utilisation for fixed asset (ii) Utilisation for working capital

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Q.1.2	**2006 - May [6] {C} (b)**	**Descriptive**
Discuss the changing scenario of Financial Management in India. (6 marks)		

Answer :

Modern financial management has come a long way from traditional corporate finance. As the economy is opening up and global resources are being tapped, the opportunities available to a finance manager have no limits. Financial management is passing through an era of experimentation and excitement as a large part of finance activities are carried out today. A few instances of these are mentioned as below:

1. Interest rate freed from regulation treasury operation therefore have to be more sophisticated as interest rates are fluctuating.
2. The rupee has become fully convertible.
3. Optimum debt equity mix is possible.
4. Maintaining share prices is crucial. The dividend policies and bonus policies formed by finance managers have a direct bearing on the share prices.
5. Share buy backs and reverse book building.
6. Raising resources globally through ADRs./GDRs.
7. Risk Management due to introduction of option and future trading.
8. Free pricing and book building for IPOs, seasoned equity offering.
9. Treasury management.

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2 *Finance Functions/Finance Decisions*

Q.2.1	1999 - Nov [5] (a)	Descriptive
Inter-relationship between investment, financing and dividend decisions. (5 marks)		

Answer :

The basic finance function includes:

1. Investment decision.
2. Financing decision.
3. Dividend decision.

All the above three decisions are inter-related because the ultimate aim of all these is wealth maximisation. Moreover, they influence each other in one way or the other.

For e.g. Investment decision should be backed up by finance for which financing decisions are to be taken. The financing decision in turn influences and is influenced by dividend decision.

Let us examine the three decisions in relation to their inter-relationship.

Investment Decision : The funds once procured have to be allocated to the various projects. This requires proper investment decision. The investment decisions are taken after careful analysis of various projects through capital budgeting and risk analysis.

Only those proposals are excepted which yields a reasonable return on the capital employed.

Financing Decision : There are various sources of funds. A finance manager has to select the best source of finance from a large number of options available.

The financing decision regarding selection of source and internal financing depends upon the need, purpose, object and the cost involved .

The finance manager has also to maintain a proper balance between long term and short term loan. He has also to ensure a proper mix of loans fund and owner's funds which will yield maximum return to the shareholders.

Dividend Decision : A finance manager has also to decide whether or not to declare dividend. If dividends are to be declared then what portion is to be paid to the shareholder and what portion is to be retained in the business.

Thus, we see that investment, financing and dividend decisions are all inter-related.

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Q.2.2	**2017 - Nov [7] (e)**	**Descriptive**
Explain 'Finance Function'.		(4 marks)

Answer :

Finance Function:

The finance function is most important for all business enterprises. It remains a focus of all activities. It starts with the setting up of an enterprise. It is concerned with raising of funds, deciding the cheapest source of finance, utilization of funds raised, making provision for refund when money is not required in the business, deciding the most profitable investment, managing the funds raised and paying returns to the providers of funds in proportion to the risks undertaken by them. Therefore, it aims at acquiring sufficient funds, utilizing them properly, increase the profitability of the organisation and maximizing the value of the organisation and ultimately the shareholder's wealth.

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Q.2.3	2018 - May [6] (Or) (c)	Descriptive
What are the two main aspects of the Finance Function? (2 marks)		

Answer:

Two main aspects of the Finance Function

1. **Long term Finance Function Decisions**
   (i) Investment decisions (I)
   (ii) Financing decisions (F)
   (iii) Dividend decisions (D).
2. **Short-term Finance Function Decision**
   Working Capital Management (WCM)

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3 *Objectives of Financial Management*

Q.3.1	2003 - Nov [8] (b)	Descriptive
Discuss the 'Profit maximisation' and 'Wealth maximisation' objective of a firm. (6 marks)		

Answer:

Financial management is basically concerned with procurement and use of funds. In the light of these the main objectives of financial management are:

1. Profit Maximisation.
2. Wealth Maximisation.

1. **Profit Maximisation :**
   Profit Maximisation is the main objective of business because :
   (i) Profit acts as a measure of efficiency and
   (ii) It serves as a protection against risk.

Agreements in favour of profit maximisation :

(i) When profit earning is the main aim of business the ultimate objective should be profit maximisation.

(ii) Future is uncertain. A firm should earn more and more profit to meet the future contingencies.

(iii) The main source of finance for growth of a business is profit. Hence, profits maximisation is required.

(iv) Profit maximisation is justified on the grounds of rationality as profits act as a measure of efficiency and economic prosperity.

Arguments against profit maximisation :

(i) It leads to exploitation of workers and consumers.

(ii) It ignores the risk factor associated with profit.

(iii) Profit in itself is a vague concept and means differently to different people.

(iv) It is a narrow concept at the cost of social and moral obligations.

Thus, profit maximisation as an objective of financial management has been considered inadequate.

2. Wealth Maximisation : Wealth maximisation is considered as the appropriate objective of an enterprise. When the firms maximises the stock holder's wealth, the individual stockholder can use this wealth to maximise his individual utility. Wealth maximisation is the single substitute for a stock holder's utility.

A stock holder's wealth is shown by :

Stock holder's wealth = No. of share owned × Current stock price per share

Higher the stock price per shares, the greater will be the stock holder's wealth, the greater will be the stock price per share.

Maximum Utility

↓ Refers to

Maximum stock holder's wealth

↓ Refers to

Maximum stock price per share

Arguments in favour of wealth maximisation:

(i) Due to wealth maximisation, the short term money lenders get their payments in time.

(ii) The long time lenders too get a fixed rate of interest on their investments.
(iii) The employees share in the wealth gets increased.
(iv) The various resources are put to economical and efficient use.

Argument against wealth maximisation :

(i) It is socially undesirable.
(ii) It is not a descriptive idea.
(iii) Only stock holder's wealth maximisation does not lead to firm's wealth maximisation.
(iv) The objective of wealth maximisation is endangered when ownership and management are separated.

In spite of the arguments against wealth maximisation, it is the most appropriative objective of a firm.

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Q.3.2	2007 - Nov [8] (ii)	Descriptive
Explain the limitations of profit maximization objective of Financial Management. (3 marks)		
OR	2012 - May [7] (a), RTP	Descriptive
Answer the following: "The profit maximization is not an operationally feasible criterion." Comment on it. (4 marks)		

Answer:

Arguments against Profit Maximisation	1. It leads to exploitation of workers and consumers 2. It ignores the risk factor associated with profit. 3. Profit in itself is a vague concept and means differently to different people. 4. It is a narrow concept at the cost of social and moral obligations.

Limitation of Profit Maximization objectives	1. It ignores the risk factor as well as timing of returns. 2. The concept of profit maximisation is vague and narrow. 3. It emphasizes the short-run profitability and short-term projects. 4. It may cause decrease in share price. 5. It fails to consider the social responsibility of business. 6. It may allow decisions to be taken at the cost of long run stability and profitability of the concern. 7. The profit is only one of the many objectives of a modern firm. 8. It ignores the time and risk factors

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Q.3.3	**2018 - Nov [6] (c)**	**Descriptive**
Write two main objectives of Financial Management.		(2 marks)

4 *Conflicts in Profit Versus Value Maximisation Principle*

Q.4.1	**1999 - Nov [2] (c)**	**Descriptive**
Explain as to how the wealth maximisation objective is superior to the profit maximisation objective.		(5 marks)
OR	**2006 - Nov [6] {C} (b), 2009 - Nov [5] (iv)**	**Descriptive**
Answer the following : (iv) Discuss conflict in profit versus wealth maximisation objective.		(4 marks each)
OR	**2010 - Nov [5] (b) (i), 2017 - May [5] (d)**	**Distinguish Between**
Distinguish between "Profit maximisation vs Wealth maximisation objective" of the firm.		(4 marks each)

OR	2012 - Nov [7] (a), 2015 - May [7] (d)	Descriptive

Answer the following:
Discuss the conflicts in Profit versus Wealth maximization principle of the firm. (4 marks each)

Answer:

1. **Profit Maximisation :**

   Profit Maximisation is the main objective of business because profit acts as a measure of efficiency and it serves as a protection against risk.

   Arguments in favour of Profit Maximisation :

   (i) When profit earning is the main aim of business the ultimate objective should be profit maximisation.

   (ii) Future is uncertain. A firm should earn more and more profit to meet the future contingencies.

   (iii) The main source of finance for growth of a business is profit. Hence, profits maximisation is required.

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   Wealth maximisation is considered as the appropriate objective of an enterprise. When the firms maximises the stockholder's wealth, the individual stockholder can use this wealth to maximise his individual utility. Wealth maximisation is the single substitute for a stockholder's utility.

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(iv) The objective of wealth maximisation is endangered when ownership and management are separated.

Space to write important points for revision

5 *Role of Finance Executive*

Q.5.1	2000 - Nov [3] (c)	Descriptive
"The information age has given a fresh perspective on the role of finance management and finance managers. With the shift in paradigm it is imperative that the role of Chief Financial Officer (CFO) changes from a controller to a facilitator." Can you describe the emergent role which is described by the speaker/author? (6 marks)		

Answer :

It is true that the information age has given a fresh perspective on the role of financial management and finance managers.

The job of the financial manager in India today has become more important, complex, and demanding due to :

— Global competition

— Technological development

— Volatile financial prices

— Economic uncertainty

— Tax law changes etc.

The key challenges before a financial manager is following areas :

- Investment planning
- Corporate governance
- Risk management
- Financial Structure
- Working capital management
- Performance management
- Mergers
- Acquisitions
- Restructuring
- Investors relations etc.

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Q.5.2	**2004 - May [7] (b)**	**Descriptive**
Discuss the functions of a Chief Financial Officer. (3 marks)		
OR	**2007 - May [8] (iii)**	**Descriptive**
Answer the following: What are the main responsibilities of a Chief Financial Officer of an organisation? (3 marks)		
OR	**2010 - May [8] (ii)**	**Descriptive**
Answer the following: (ii) State the role of a Chief Financial Officer. (3 marks)		
OR	**2011 - Nov [7] (a)**	**Descriptive**
Answer the following : (a) Elucidate the responsibilities of Chief Financial Officer. (4 marks)		
OR	**2018 - May [6] (c)**	**Descriptive**
What are the roles of Finance Executive in Modern World? (2 marks)		

Answer :

The finance manager occupies an important position in the organisational structure. Earlier his role was just confined to raising of funds from a number of sources. Today his functions are multidimensional.

The functions performed by today's finance managers are as below:

1	**Forecasting the financial requirement**	A financial manager has to make an estimate and forecast accordingly the financial requirements of the firm.
2	**Planning**	A finance manager has to plan out how the funds will be procured and how the acquired funds will be allocated.
3	**Procurement of fund**	A finance manager has to select the best source of finance from a large number of options available. The finance manager's decisions regarding the selection of source is influenced by the need, purpose object and the cost involved.
4	**Investment/ Allocation of fund**	A finance manager has also to invest or allocate funds in best possible ways. In doing so a finance manager cannot but ignore the principles of safety profitability and liquidity.
5	**Maintaining proper liquidity**	A finance manager plays an important role in maintaining proper liquidity. He determines the need for liquid assets and then arrange them in such a way that there is no scarcity of funds.
6	**Cash management**	A finance manager has also to manage the cash in an efficient way. Cash is to be managed in such a way that neither there is scarcity of it nor does it remains idle earning no return on it.

7	**Dividend decision**	A finance manager has also to decide whether or not to declare a dividend. If dividends are to be declared, then what amount is to be paid to the shareholders and what amount is to be retained in the business.
8	**Evaluation of financial performance**	A finance manager has to implement a system of financial control to evaluate the financial performance of various units and then take corrective measures wherever needed.
9	**Financial negotiations**	In order to procure and invest funds a finance manager has to negotiate with the various financial institutions, banks, public depositors in a meticulous way.
10	**To ensure proper use of surplus**	A finance manager has to see to the proper use of surplus fund. This is necessary for expansion and diversification plan and also for protecting the interest of shareholders.

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Q.5.3	**2014 - May [5] (c)**	**Descriptive**
Discuss emerging issues affecting the future role of Chief Financial Officer (CFO). (4 marks)		
OR	**2016 - Nov [5] (c)**	**Descriptive**
List the emerging issues (any four) affecting the future role of CFO. (4 marks)		

Answer:

Emerging issues affecting the future role of Chief Financial Officer (CFO)		
1	**Regulation**	Regulation requirements are increasing and CFOs have an increasingly personal stake in regulatory adherence.

2	**Globalisation**	The challenges of globalisation are creating a need for finance leaders to develop a finance function that works effectively on the global stage and that embraces diversity.
3	**Technology**	Technology is evolving very quickly, providing the potential for CFOs to reconfigure finance processes and drive business insight through 'big data' and analysis.
4	**Risk**	The nature of the risk that organisation face is changing, requiring more effective risk management approaches and increasingly CFOs have a role to play in ensuring an appropriate corporate ethos.
5	**Transformation**	There will be more pressure on CFOs to transform their finance functions to drive a better service to the business at zero cost impact.
6	**Stakeholder Management**	Stakeholder management and relationship will become important as increasingly CFOs become the face of the corporate brand.
7	**Strategy**	There will be a greater role to play in strategy validation and execution, because the environment is more complex and quick changing, calling on the analytical skills CFOs can bring.
8	**Reporting**	Reporting requirements will broaden and continue to be burdensome for CFOs.
9	**Talent and capability**	A brighter spotlight will shine on talent, capability and behaviour in the top finance role.

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6 Relationship of Financial Management with Related Disciplines

Q.6.1	2009 - Nov [5] (iv)	Distinguish Between

Differentiate between Financial Management and Financial Accounting. (2 marks)

Answer:

Difference between Financial Management and Financial Accounting

S. No.	Basis of Difference	Financial Management	Financial Accounting
1	**Decision-making**	Financial Management's primary responsibility relates to financial planning, controlling and decision making.	The chief focus of Financial Accounting is to collect data and present the data.
2	**Treatment of funds**	In financial management it is based on cash flows. The revenues are recognised only when cash is actually received (i.e. cash inflow) and expenses are recognised on actual payment (i.e. cash outflow).	In Financial Accounting, the measurement of funds is based on the accrual principle of funds.

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