Nature of Financial Management

Business Activities

- Production
- Marketing
- Finance

Finance Functions

- Investment or Long Term Asset Mix Decision
- Financing or Capital Mix Decision
- Dividend or Profit Allocation Decision
- Liquidity or Short Term Asset Mix Decision

Finance Manager's Role

- Raising of Funds
- Allocation of Funds
- Profit Planning
- Understanding Capital Markets

Financial Goals

- Profit maximization (profit after tax)
- Maximizing Earnings per Share
- Shareholder's Wealth Maximization

Profit Maximization

- Maximizing the Rupee Income of Firm
  - Resources are efficiently utilized
  - Appropriate measure of firm performance
  - Serves interest of society also

Objections to Profit Maximization

- It is Vague
- It Ignores the Timing of Returns
- It Ignores Risk
- Assumes Perfect Competition
- In new business environment profit maximization is regarded as
  - Unrealistic
  - Difficult
  - Inappropriate
  - Immoral.

Maximizing EPS

- Ignores timing and risk of the expected benefit
- Market value is not a function of EPS. Hence maximizing EPS will not result in highest price for company's shares
- Maximizing EPS implies that the firm should make no dividend payment so long as funds can be invested at positive rate of return—such a policy may not always work

Shareholders' Wealth Maximization

- Maximizes the net present value of a course of action to shareholders.
- Accounts for the timing and risk of the expected benefits.
- Benefits are measured in terms of cash flows.
- Fundamental objective—maximize the market value of the firm's shares.

Risk-return Trade-off

- Risk and expected return move in tandem; the greater the risk, the greater the expected return.
- Financial decisions of the firm are guided by the **risk-return trade-off**.
- The return and risk relationship: Return = Risk-free rate + Risk premium
- Risk-free rate is a compensation for time and risk premium for risk.

Managers Versus Shareholders' Goals

- A company has stakeholders such as employees, debt-holders, consumers, suppliers, government and society.
- Managers may perceive their role as reconciling conflicting objectives of stakeholders. This stakeholders' view of managers' role may compromise with the objective of SWM.
- Managers may pursue their own personal goals at the cost of shareholders, or may play safe and create satisfactory wealth for shareholders than the maximum.
- Managers may avoid taking high investment and financing risks that may otherwise be needed to maximize shareholders' wealth. Such "satisfying" behaviour of managers will frustrate the objective of SWM as a *normative guide*.

Financial Goals and Firm's Mission and Objectives

- Firms' primary objective is maximizing the welfare of owners, but, in operational terms, they focus on the satisfaction of its customers through the production of goods and services needed by them
- Firms state their vision, mission and values in broad terms
- Wealth maximization is more appropriately a *decision criterion*, rather than an *objective* or a *goal*.
- Goals or objectives are missions or basic purposes of a firm's existence

Financial Goals and Firm's Mission and Objectives

- The shareholders' wealth maximization is the second-level criterion ensuring that the decision meets the minimum standard of the economic performance.
- In the final decision-making, the judgement of management plays the crucial role. The wealth maximization criterion would simply indicate whether an action is economically viable or not.

Organisation of the Finance Functions

- Reason for placing the finance functions in the hands of top management
  - Financial decisions are crucial for the survival of the firm.
  - The financial actions determine solvency of the firm
  - Centralisation of the finance functions can result in a number of economies to the firm.

Status and Duties of Finance Executives

- The exact organisation structure for financial management will differ across firms.
- The financial officer may be known as the financial manager in some organisations, while in others as the vice-president of finance or the director of finance or the financial controller.

Role of Treasurer and Controller

- Two more officers—the **treasurer** and the **controller**—may be appointed under the direct supervision of CFO to assist him or her.
- The treasurer's function is to raise and manage company funds while the controller oversees whether funds are correctly applied.