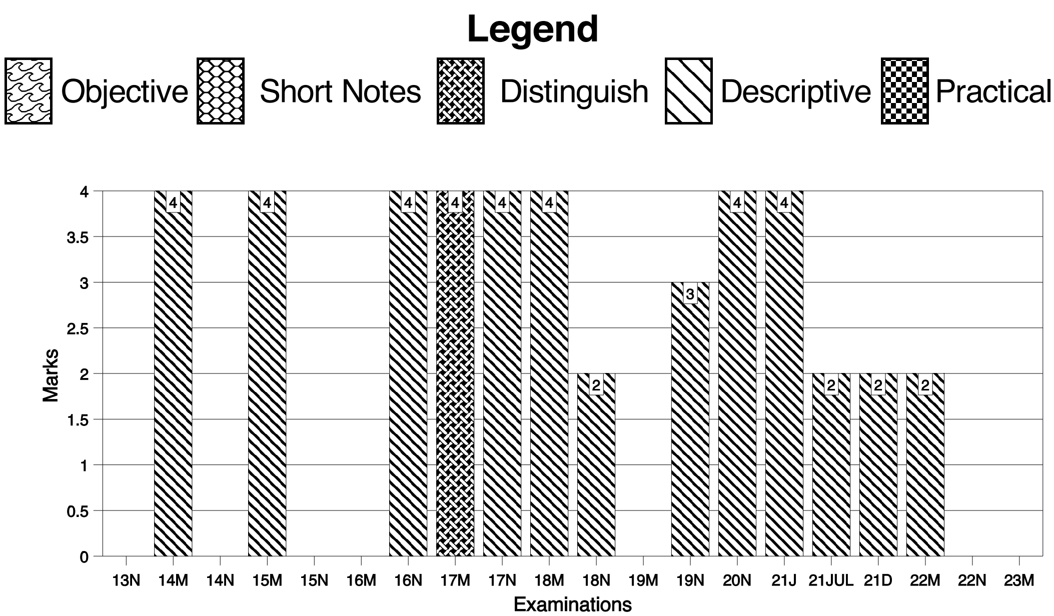
CHAPTER	
1	**Scope and Objectives of Financial Management**

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



For detailed analysis Login at *www.scanneradda.com*
for registration and password see first page of this book.

SCAN WITH CAMERA OF YOUR PHONE

Scan QR Code for Additional Material

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**
	6.1, 7.1, 7.2	6.1, 7.1, 7.2

1 Meaning of Financial Management

Q.1.1	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.

—— Space to write important points for revision ——

2 Evolution of Financial Management

Q.2.1	2021 - Dec [6] (c)	Descriptive

Explain in brief the phases of the evolution of financial management. (2 marks)

Answer:

Financial management evolved gradually over the past 50 years. The evolution of Financial management is divided into three phases. Financial management evolved as a separate field of study at the beginning of the century.

The three stage of its evolution are:

The Traditional phase	During this phase, financial management was considered necessary only during occasional events such as takeovers, mergers, expansion, liquidation, etc. Also when taking financial decisions in the organisation, the needs of outsiders to the business was kept in mind.
The Transitional phase	During this phase, the day to day problems that Financial managers faced were given importance. The general problems related to funds analysis, planning and control were given more attention in this phase.
The modern phase	Modern phase is still going on. The scope of Financial management has greatly increased now. It is important to carry out financial analysis for a company. This analysis helps in decision making. During this phase, many theories have been developed regarding efficient markets, capital budgeting option pricing, valuation models and also in several other important fields in financial management.

3 Finance Functions/Finance Decisions

Q.3.1	2017 - Nov [7] (e)	Descriptive
Explain 'Finance Function'.		(4 marks)

Answer:

Finance Function:

The finance function is most important for all business enterprises. It starts with the setting up of an enterprise and 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.

The basic finance function includes:

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

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.

—— Space to write important points for revision ——

Q.3.2	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)

—— Space to write important points for revision ——

Q.3.3	2019 - Nov [6] (a)	Descriptive
Briefly explain the three finance function decisions.		(3 marks)

Answer:

The three finance Function decisions:

(a) **Investment decisions (I):**
These decisions relate to the selection of assets in which funds will be invested by a firm. Funds procured from different sources have to be invested in various kinds of assets. Long term funds are used in a project for various fixed assets (PPE) and also for current assets. The investment of funds in a project has to be made after careful assessment of the various projects through capital budgeting. A part of long term

funds is also to be kept for financing the working capital requirements. Asset management policies are to be paid down regarding various items of current assets. The inventory policy would be determined by the production manager and the finance manager keeping in view the requirement of the production and the future price estimates of raw materials and availability of funds.

(b) **Financing decisions(F):**

These decisions relate to acquiring the optimum finance to meet financial objectives and seeing that fixed and working capital are effectively managed. The financial manager needs to possess a good knowledge of the sources of availability of funds and their respective costs and needs to ensure that the company has a sound capital structure, i.e. a proper balance between equity capital and debt such managers also need to have a very clear understanding as to the difference between profit and cash flow, bearing in mind that profit is of little avail unless the organization is adequately supported by cash to pay for assets and sustain the working capital style. Financing decisions also call for a good knowledge of evaluation of risks, eg. excessive debt carried high' risk for an organization's equity because of the priority rights of the lenders. A major area for risk-related decisions is in overseas trading, where on organisation is vulnerable to currency fluctuations, and the manager must be well aware of the various protective procedures, such as hedging (it is a strategy designed to minimize, reduce or cancel out the risks in another investment) available to him. For example, someone who has a shop, takes care of the risk of the goods being destroyed by fire by hedging it via a fire insurance contract.

(c) **Dividend decisions (D)**:

These decisions relate to the determination as to how much and how frequently cash paid out of the profits of an organisation as income for its owners/shareholders. The owner of any profit making organization looks for reward for his investment in two ways, the growth of the capital invested and the cash paid out as income; for a sole trader this income would be termed as drawings and for a limited liability company the term is dividends.

The dividend decision thus has two elements – the amount to be paid out and the amount to be retained to support the growth of the organisation, the latter being also a financing decision; the level and regular growth of dividends represent a significant factor in determining a profit-making company's market value, i.e. the value placed on its shares by the stock market.

Space to write important points for revision

4 *Importance of Financial Management*

Q.4.1	2021 - Jan [6] (a)	Descriptive
State four tasks involved to demonstrate the importance of good Financial Management. (4 marks)		

Answer:

The best way to demonstrate the importance of good financial management is to describe some of the tasks that it involves:

- **Taking care** not to over-invest in fixed assets
- **Balancing** cash-outflow with cash-inflows
- **Ensuring** that there is a sufficient level of short-term working capital
- **Setting** sales revenue targets that will deliver growth
- **Increasing** gross profit by setting the correct pricing for products or services
- **Controlling** the level of general and administrative expenses by finding more cost efficient ways of running the day-to-day business operations, and
- **Tax planning** that will minimize the taxes a business has to pay.

Space to write important points for revision

5 Objectives of Financial Management

Q.5.1	2018 - Nov [6] (c)	Descriptive

Write two main objectives of Financial Management. (2 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.

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.

Space to write important points for revision

Q.5.2	2021 - July [6] (c)	Descriptive

List out the steps to be followed by the manager to measure and maximize the Shareholder's Wealth. (2 marks)

Answer:

We will first like to define what is Wealth/Value Maximization Model. Shareholders wealth are the result of cost benefit analysis adjusted with their timing and risk. i.e time value of money.

So, wealth = Present value of benefits-Present value of costs.

It is important that benefits measured by the finance manager are in terms of cash flow. Finance manager should emphasis on cash flow for investment or financing decisions are not on accounting profit. The shareholder value maximization model holds that the primary goals of the firm is to maximize its market value and implies that business decisions should seek to increase the net present value of the economic profits of the firm.

So for measuring and maximising shareholders wealth finance manager should follow:

1. Cash flow approach not Accounting profit
2. Cost benefit analysis
3. Application of time value of money.

—— Space to write important points for revision ——

Q.5.3	2022 - May [6] (c)	Descriptive
State advantages of "Wealth Maximization" goals in Financial Management (2 marks)		

Answer:

Advantages of "Wealth Maximization" goals in Financial Management:

(i) Emphasizes the long term gains.
(ii) Recognises risk or uncertainty.
(iii) Recognises the timing of returns.
(iv) Consider shareholders' return.

—— Space to write important points for revision ——

6 *Conflicts in Profit Versus Value Maximisation Principle*

Q.6.1	2015 - May [7] (d)	Descriptive
Answer the following: Discuss the conflicts in Profit versus Wealth maximization principle of the firm. (4 marks)		

OR	2017 - May [5] (d)	Distinguish Between
Distinguish between "Profit maximisation vs Wealth maximisation objective" of the firm. (4 marks)		

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.

(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 factors 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 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.

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 share of employees in the wealth gets increased.

(iv) The various resources are put to economical and efficient use.

Arguments against Wealth Maximisation :

(i) It is socially undesirable.

(ii) It is not a descriptive idea.

(iii) Only stockholder'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.

Space to write important points for revision

7 *Role of Finance Executive*

Q.7.1	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.

Space to write important points for revision

Q.7.2	**2018 - May [6] (c)**	**Descriptive**
What are the roles of Finance Executive in Modern World?		(2 marks)

OR	2020 - Nov [6] (a)	Descriptive
List out the role of Chief Financial Officer in today's World. (4 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.

Space to write important points for revision

8 *Relationship of Financial Management with Related Disciplines*

Q.8.1	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.