MB202: FINANCIAL MANAGEMENT

UNIT 1

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MEANING 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

According to GUTHMANN and DOUGALL, business finance may be broadly defined as "the activity concerned with the planning, raising, controlling and administering the funds used in the business." Financial decisions refer to decisions concerning financial matters of a business firm. There are many kinds of financial management decisions that the firm makers in pursuit of maximizing shareholder's wealth, viz., kind of assets to be acquired, pattern of capitalization, distribution of firm's income etc.

We can classify these decisions into four major groups:

- Investment decisions
- Financing decision.
- Dividend decisions.
- Working capital decisions.

NATURE OF FINANCE FUNCTION:

I. In most of the organizations, financial operations are centralized. This results in economies.

II. Finance functions are performed in all business firms, irrespective of their sizes /legal form of organization.

III. They contribute to the survival and growth of the firm.

IV. Finance function is primarily involved with the data analysis for use in decision making.

V. Finance functions are concerned with the basic business activities of a firm, in addition to external environmental factors which affect basic business activities, namely, production and marketing.

VI. Finance functions comprise control functions also

VII. The central focus of finance function is valuation of the firm. Finance makes use of economic tools. From Micro economics it uses theories and assumptions. From Macroeconomics it uses forecasting models. Even though finance is concerned with individual firm and economics is concerned with forecasting of an industry.

EVOLUTION OF FINANCE FUNCTION:

Financial management came into existence as a separate field of study from finance function in the early stages of 20th century. The evolution of financial management can be separated into three stages:

1. Traditional stage (Finance up to 1940): The traditional stage of financial management continued till four decades. Some of the important characteristics of this stage are:

i) In this stage, financial management mainly focuses on specific events like formation expansion, merger and liquidation of the firm.

ii) The techniques and methods used in financial management are mainly illustrated and in an organized manner.

iii) The essence of financial management was based on principles and policies used in capital market, equipments of financing and lawful matters of financial events.

iv) Financial management was observed mainly from the prospective of investment bankers, lenders and others.

2. Transactional stage (After 1940): The transactional stage started in the beginning years of 1940‟s and continued till the beginning of 1950‟s. The features of this stage were similar to the traditional stage. But this stage mainly focused on the routine problems of financial managers in the field of funds analysis, planning and control. In this stage, the essence of financial management was transferred to working capital management.

3. Modern stage (After 1960): The modern stage started in the middle of 1960's and observed tremendous change in the development of financial management with the ideas from economic theory and implementation of quantitative methods of analysis. Some unique characteristics of modern stage are:

i) The main focus of financial management was on proper utilization of funds so that wealth of current shareholders can be maximized.

ii) The techniques and methods used in modern stage of financial management were analytical and quantitative. Since the starting of modern stage of financial management many important developments took place.

Some of them are in the fields of

- Capital budgeting,
- Valuation models,
- Dividend policy,
- Option pricing theory,
- Behavioural finance etc.

ORGANISATION OF FINANCE FUNCTION

Finance function is very vital for every type of organization, it is necessary to set up a sound and efficient organization. The organization varies depending upon the nature, size of the organization, though we cannot have a standard organization for all the enterprises, we can structure the basic aspects for a corporate as below:

Shareholders determine the following while approving the Articles of Association and the bye –laws:

- The amount and kind of capital
- Rules governing issue and transfer of stock
- Powers of directors to declare a dividend, choose a bank, create reserves
- Sale of firm's assets
- Plans for reorganization, liquidation, consolidation and mergers etc.

The board of directors of a limited company includes a managing director (or CEO – chief executive officer), and a number of functional executive directors and may include one or more professionally qualified accountants, one of which may be the finance director. The directors of the company necessarily delegate to middle managers and junior managers the responsibility for the day-to-day management of the business. It is certainly likely that this body of managers, who report to the board of directors, will include a further one or more qualified accountants responsible for managing the finance function.

The traditional structure of the finance function in a medium to large sized company (see Figure) splits responsibilities broadly between accounting and finance, both being the responsibility of the finance director (or CFO – chief financial officer). Accounting is managed by the financial controller (or chief accountant), and cash and corporate finance may be managed by a corporate treasurer (or financial manager), and they both report to the finance director. Historically, the IT function (information technology or data processing) has also been the responsibility of the finance director in the majority of companies. This is because the accounting function was the first major user of computers for payroll and then accounting ledgers, financial reporting, budgeting, financial information, etc.

Board of Directors approve the financial policy, declare dividends and translate the aspiration of shareholders into specific goals and objectives and select & appoint the senior officers. The Controller is concerned primarily with the Planning, Accounting and Control activities. The Treasurer is responsible mainly for financing, management of cash & receivables and investment activities. The organization of financial function depends on the needs of each organization. The financial needs of each organization vary from the other. In some organization working capital requirements may be more, as in the case of manufacturing

organizations as compared to service organizations. In some organization the gestation period may be longer before they start generating revenues and earn profits.

FINANCIAL MANAGEMENT

Financial Management is the process of planning and managing the Finances of an individual or organisation to achieve its goals and objectives. It involves optimising shareholder value, generating profit, reducing risk, and ensuring financial health from both short-term and long-term perspectives. For individuals, Financial Management may include retirement planning, college savings, and other personal investments.

Financial management is about controlling the flow of money in and out of the organization. Every business needs to sell products or services, pay expenses, balance the books, and file taxes. Financial management encompasses all of this, along with more complex processes, such as paying employees, buying supplies, and submitting reports to government agencies to show they're obeying applicable laws and regulations. The act of overseeing all these transactions for a business is what we mean when we talk about a company's financial management. In general, the bigger the company, the more complicated financial management becomes.

SCOPE OF FINANCIAL MANAGEMENT:

The main objective of financial management is to arrange sufficient finance for meeting short term and long term needs. A financial manager will have to concentrate on the following areas of finance function.

1. Estimating financial requirements: The first task of a financial manager is to estimate short term and long term financial requirements of his business. The amount required for purchasing fixed assets as well as needs for working capital will have to be ascertained.

2. Deciding capital structure: Capital structure refers to kind and proportion of different securities for raising funds. After deciding the quantum of funds required it should be decided which type of securities should be raised. A decision about various sources for funds should be linked to the cost of raising funds.

3. Selecting a source of finance: An appropriate source of finance is selected after preparing a capital structure which includes share capital, debentures, financial institutions, public deposits etc. If finance is needed for short term periods then banks, public deposits and financial institutions may be the appropriate. On the other hand, if long term finance is required then share capital and debentures may be the useful.

4. Selecting a pattern of investment: When funds have been procured then a decision about investment pattern is to be taken. A decision will have to be taken as to which assets are to be purchased? The funds will have to be spent first on fixed assets and then an appropriate portion will be retained for working capital and for other requirements.

5. Proper cash management: Cash management is an important task of finance manager. He has to assess various cash needs at different times and then make arrangements for arranging cash. Cash may be required to purchase of raw materials, make payments to creditors, meet wage bills and meet day to day expenses. The idle cash with the business will mean that it is not properly used.

6. Implementing financial controls: An efficient system of financial management necessitates the use of various control devices. They are ROI, break even analysis, cost control, ratio analysis, cost and internal audit. ROI is the best control device in order to evaluate the performance of various financial policies.

7. Proper use of surpluses: The utilization of profits or surpluses is also an important factor in financial management. A judicious use of surpluses is essential for expansion and diversification plans and also in protecting the interests of shareholders. A balance should be struck in using funds for paying dividend and retaining earnings for financing expansion plans.

ROLE OF FINANCIAL MANAGER IN THE CHANGING SCENARIO

The Indian financial system is currently undergoing a period of revolutionary changes to the extent that by the turn of millennium its face may be totally unrecognizable. In view of the strategy facts of a firm today should not be merely aiming at customer's satisfaction by meeting the current and contractual need but it should also be to delight the customer by meeting their intended needs In this changing scenario, the role of a finance manager has also changed. He has to be an active player and vociferous participant and not just a by-stander in the corporate world. The finance professional must now be conversant with both theoretical and analytical issues existing in the market, e.g. funding of investment channels, risk and rewards attached with a variety of financial instrument channels, legal and tax parameters. Globalisation has integrated the national financial market with the global financial market. This has brought new opportunities and challenges for the finance managers which are bound to influence the various financial decisions as explained in the following:

1. Financial decision: Globalisation has made possible for the corporate enterprises to raise funds at competitive rates from foreign markets. Foreign institutional investors and NRIs can be approached to have least cost capital structure.

2. Investment decision: Corporate enterprises now have the opportunity to invest money in both outside the country for the maximisation of wealth of their shareholders. However, investment made outside the country involves the following risks

- **Political risk:** Asset or easn`32ings in a foreign country may be frozen.
- **Regulatory risk:** Accounting procedures taxation provisions may be altered in the frozen country.
- **Economic risk:** Long term contracts with foreign suppliers or purchasers may be affected by change in exchange rates.

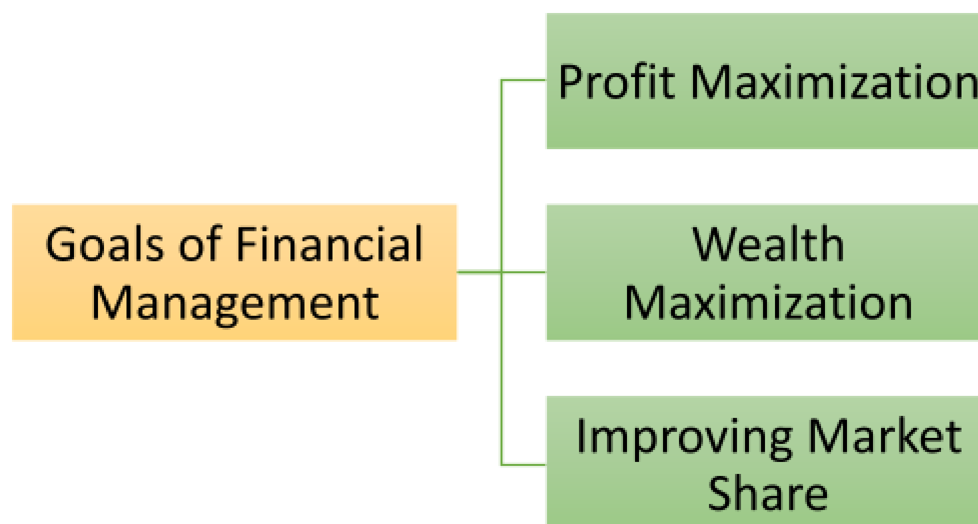
3. Dividend decision: The dividend decision has also to be taken by the finance manager in the overall global scenario, portfolio opportunities in and outside the country and internal financial needs of the business unit. The process of liberalisation and globalisation has led to

significant increase in the competition for the Indian industry which otherwise was functioning in a protected and sheltered environment. This has resulted into sickness of many industrial firms who could not keep up with the global competition in providing goods and services of the best quality at the lowest possible price to the consumers. However, globalisation has resulted into the following positive benefits to the Indian industry:

1. There has been boost in trade and commerce.
2. There has been sizeable increase in number of foreign collaborations resulting in transfer of latest technologies to the country.
3. Optimum utilization of financial, material and human resources which hassled to improvement in overall efficiency.
4. Larger capital inflows resulting in greater industrialisation besides strengthening the foreign exchange reserves position.
5. Development of infrastructural facilities and new financial instruments.

GOALS OF FINANCIAL MANAGEMENT

The goals of financial management can be grouped in many ways. However, most of those goals are overlapping and ultimately boils down to the following three goals.



1. Profit maximization

Profit is one of the most traditional yet popular goals of financial management. In economic terms, profit refers to an excess of revenues over the cost. Profit is considered as the fuel for a business which keeps the engine of a business active all the time.

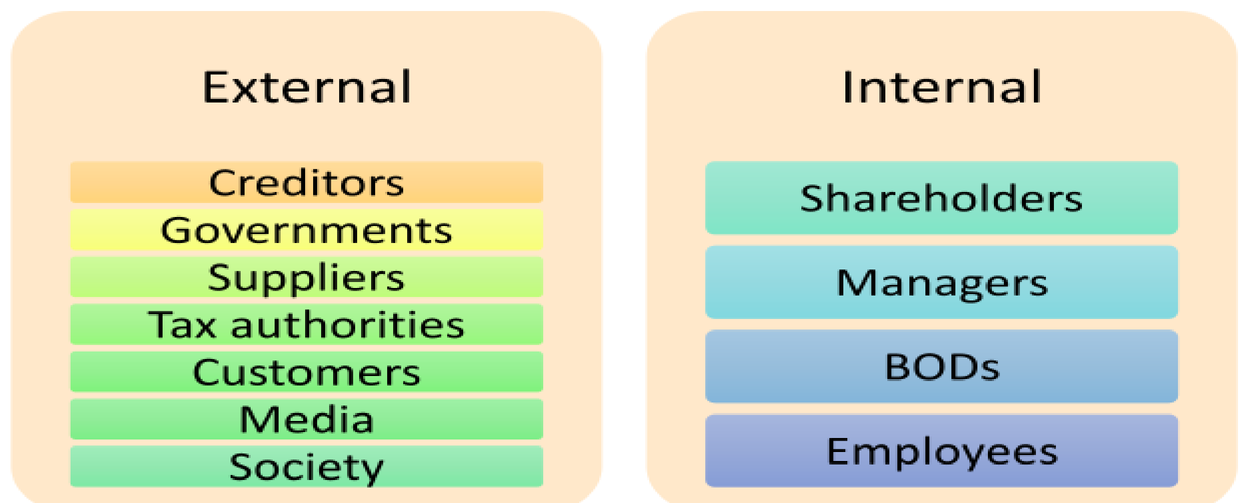
The term profit is subject to interpretation. There are different classes of profits we can observe in a business. For example,

- Profit before Tax (PBT)
- Profit after Tax (PAT)
- Earnings before Interest and Taxes (EBIT)
- Earnings before Tax Depreciation and Amortization (EBITDA) and many more of that categories.

2. Wealth Maximisation

The second most popular goal of financial management is to increase the wealth of business. This is the most modern approach towards the goals of financial management. This is also called value maximization since this theory focuses on increasing the value of the business to increase the value of shares by creating wealth for the stakeholders. When we say stakeholders, there are two important categories of stakeholders we can see in any business.

Internal stakeholders and external stakeholders as shown below:



The term wealth is explained under two parameters. Wealth maximization in business mostly refers to improving the market price of the share and enabling the business to pay frequent dividends so that the investors are motivated enough to continue in the business. In simple terms, wealth in business refers to

NPV= Present value of the benefits-Present value of costs.

The wealth maximization theory takes care of the larger interest of the stakeholders. The wealth in this context is based on cash flows and not on profits. This theory emphasizes long term perspectives rather unlike profit maximization goal focusing on the short term. It is very

important to note that the wealth maximization analogy appreciates time factor, risk factors and uncertainty factors in the business; this helps board members of the business to create strategies that enhance the long term value for the stakeholders.

3. Improving market share

The business entities may start with a humble beginning but they dream to acquire market share. Market share gives a general idea of the size of a company about its market and its competitors. The market leader in an industry is the company with the largest market share. The calculation for market share is usually done for specific countries or regions.

For example, In Fast Moving Consumer Goods (FMCG) HUL is leading the industry with the highest market share followed by ITC and Britannia. Similarly, in the telecom industry, Jio has the largest market share followed by Airtel, Vodafone. In the automobile industry, Maruti Suzuki has the largest market share followed by Hyundai, Tata, M&M, and Honda.

The investors or the individuals who are interested in a business can access the market share details from various sources. For example,

- Published annual reports
- Television
- Newspapers
- Magazines
- Podcasts
- Social media etc.

It is important to note that when the business improves the market share, it can start enjoying economies of scale, reducing the competition resulting in the growth of revenues. A few important means to improve market share are listed below:

- Reducing cost
- Increase volume of sales
- Promotion
- Improving efficiency
- Introducing new products
- Customization and standardization
- Customer loyalty
- New technologies

- Talent retention
- Acquisitions

Nevertheless, the market improvement goal of financial management has also been criticized by several scholars. When the main goal of financial management is towards improving market share in an inconsistent manner that may lead to a monopoly where single-player rules the entire market leaving no scope for customers to choose between. Market share improvement may also lead to a duopoly where only two players rule the entire market by fixing the price that they are pleased with. When there are fewer alternatives, high prices, and unethical practices, the business would be off track from the mainstream of business where the business is expected to earn profit through legitimate routes.

FINANCIAL MANAGEMENT TOOLS & TECHNIQUES

1. Cash Flow Management: The lifeblood of any business, especially a wholesale one, is its cash flow. It is crucial to keep the inflow and outflow of cash well-balanced to sustain operations and maintain solvency. Implement a cash flow projection system that provides insights into future financial scenarios. This proactive approach enables you to make strategic decisions regarding purchases, sales, and investments. Regular reviews of accounts receivables and payables, effective credit control, and efficient inventory management also play pivotal roles in cash flow management.

2. Capital budgeting: It is a process that businesses use to evaluate potential major projects or investments. Building a new plant or taking a large stake in an outside venture are examples of initiatives that typically require capital budgeting before they are approved or rejected by management. As part of capital budgeting, a company might assess a prospective project's lifetime cash inflows and outflows to determine whether the potential returns it would generate meet a sufficient target benchmark. The capital budgeting process is also known as investment appraisal.

3. **Cost of capital**: is the minimum rate of return or profit a company must earn before generating value. It’s calculated by a business’s accounting department to determine financial risk and whether an investment is justified. Company leaders use cost of capital to gauge how much money new endeavours need to generate to offset upfront costs and achieve profit. They also use it to analyse the potential risk of future business decisions. Cost of capital is extremely important to investors and analysts. These groups use it to determine stock prices and potential returns from acquired shares.

4. Dividend Policy: The dividend policy of a company is the decision about the distribution of dividends to its shareholders. A dividend policy is a financial decision that involves deciding on the dividend pay-out ratio, the frequency of dividends and should they pay dividends at all or not. It is drafted by the company's board of directors and acts as a guideline for distributing dividends to the investors. The dividend decision of a firm depends on the profits, investment opportunities in hand, availability of funds, industry trends in dividend payment, and the company's dividend payment history.

5. Receivable management or accounts receivable management is the strategic process of ensuring customers make timely payments. It is paramount in maintaining a healthy working capital for businesses and preventing overdue or unpaid customer invoices. Accounts receivable management is the process by which a business oversees and administers the collection of outstanding payments from its customers. Accounts receivable (AR) refers to the sale of products or services for which payment has not yet been received from the customer.

6. Budgeting and Forecasting: Budgeting is more than an annual exercise it's a continuous process of tracking actual versus projected numbers. An effective budget gives you control over your financial situation, helps you set realistic goals, and provides a benchmark to measure performance. Equally important is forecasting, which gives you a glimpse into the future based on historical trends and current market conditions. This information can be leveraged to anticipate changes and plan accordingly.

7. Inventory Management: Wholesalers often face the challenge of overstocking or understocking. Implement a robust inventory management system that utilizes real-time data and predictive analytics. This helps you maintain an optimal inventory level, reducing holding costs and mitigating the risk of stock outs. Techniques like Just-in-Time (JIT) can significantly improve your inventory efficiency and positively impact your financial health.

8. Working Capital Management: Efficient working capital management ensures that you have enough resources to meet short-term obligations and operational expenses. Techniques include effective receivables and payables management, inventory control, and maintaining a suitable cash reserve. Leveraging supplier credit and negotiating favourable payment terms can significantly improve your working capital situation.

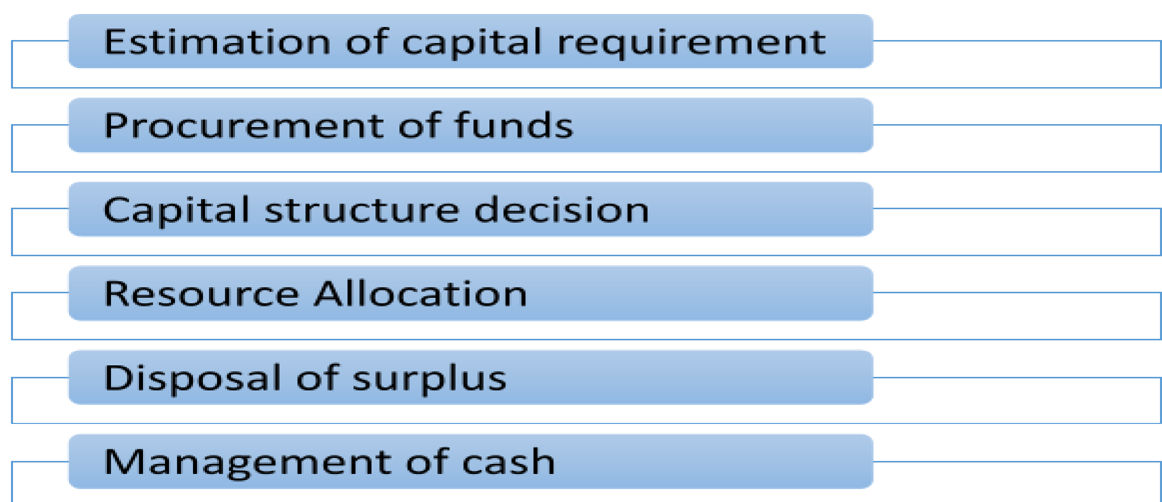
9. Financial Ratio Analysis: Regularly conduct financial ratio analysis to monitor the health of your business. Ratios like Current Ratio (liquidity), Debt-Equity Ratio (leverage), Gross Profit Margin (profitability), and Inventory Turnover (efficiency) provide insights into different aspects of your business. Tracking these ratios over time helps identify trends, pinpoint issues, and devise corrective measures.

10. Tax Planning: Wholesale businesses often operate across jurisdictions, making tax planning complex. Understand the tax implications of your business decisions. Leverage available tax incentives, credits, and deductions to minimize your tax liability. Engage with a tax professional to ensure you are compliant with all regulations and optimize your tax situation.

11. Investing in Human Capital: Your finance team plays a vital role in managing your business finances. Invest in their training and development. Encourage them to stay updated with the latest financial management practices, accounting standards, and technological advancements. An informed and competent finance team is a valuable asset that contributes significantly to your business's success.

FUNCTIONS OF FINANCIAL MANAGER

It is important to continue understanding the functions of a financial manager since it is interconnected. Some of the most common functions performed by a financial manager are briefly discussed below:



1. Estimation of capital requirement: A finance manager has to make an approximation about the capital requirements of the company. This will depend upon expected expenditures, expenses for future projects. The capital estimation is done two ways

- Funds required to buy long term assets, maintain long term assets and expand business
- Funds required to take care of working capital requirements

2. Procurement of funds: Once the requirement capital estimation is done, now it's time to find out the right source of funds from the market. There are a series of options available out of which finance needs to handpick the source of funds considering the cost and

benefits. Finance managers need to analyses each of the options available carefully to understand inherent limitation of each source of capital.

3. Capital structure decision: Creating the right mix of sources in the capital structure is critical for a business. Once the requirement of capital funds is finalized, a decision with regards to the kind and proportion of various sources of funds has to be taken. For this, the financial manager needs an adequate mix of equity and debt and short-term and long-term debt proportion. This is done to accomplish the minimum cost of capital and maximize shareholders wealth.

4. Resource Allocation: Once the funds are acquired, the manager must allocate funds appropriately within the organization and ensure the funds are effectively utilized to create long term value for the business.

Nevertheless, there are three guiding principles for the allocation of funds within the organization.

- Safety
- Liquidity
- Profitability

5. Disposal of surplus: The financial manager should decide on how much to preserve for reinvesting and how much to distribute as dividends to shareholders out of the profits of the company. The factors which impact these decisions include the trend of earnings of the company, the trend of the market price of its shares, the necessities of funds for self-financing the future projects and so on.

6. Management of cash: Management of cash and other liquid assets is an imperative task of a financial manager. It encompasses projecting the cash inflows and outflows to confirm that there is neither shortage nor surplus of cash with the organisation. Adequate funds must be accessible for the acquisition of materials, payment of salaries, wages and meeting day-to-day expenses.

7. Agency theory: Agency theory is also referred to as agency problem or agency dilemma. Agency theory is an idea used to elucidate the central associations between principal and their relative agent. In the fundamental sense, the principal is somebody who profoundly depends on an agent to execute specific financial decisions and transactions that can result in changeable outcomes. Since the principal depends so profoundly on the agent to make the accurate decision, there may be a variety of conflicts or differences Agency theory bars into such relationships.

IMPORTANCE OF FINANCIAL MANAGEMENT

Financial Management is the process of planning, managing, and controlling the Finances of a company to achieve its goals and objectives. It helps the company to avoid bankruptcy and cope with various challenges, such as loss of revenue, natural disasters, strikes, wars, etc. Thus, Financial Management becomes paramount.

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1. Achieving financial goals: It provides a framework and necessary techniques to plan, allocate resources and make informed decisions to achieve these goals. Financial Management also helps set clear and well-defined goals and assess the potential risks that might arise while following these goals. With a proper management plan, businesses and individuals can attain the desired financial outcome and secure a stable financial future.

2. Informed decision: Financial Management ensures that individuals and businesses make informed decisions considering the financial condition of the business and individual. The process of making an informed decision includes collecting the right information and analysing the possible outcomes using Financial Management techniques.

3. Cost control: Financial Management helps businesses and individuals identify unnecessary cost expenditures and suggest the best possible way to achieve cost-effectiveness. It involves a systematic approach to managing and reducing expenses and focusing on providing stability and profitability. Financial Management also enables businesses and individuals to identify the areas of inefficiency and implement measures to optimise costs by effectively using the available resources.

4. Stakeholder confidence: Good Financial Management boosts the confidence of stakeholders in the company and attracts more opportunities to grow and scale the business. It also helps make the financial system of a business more transparent and honest. One of the

most significant importance of good stakeholder confidence is the trust of the investors. This helps in attracting more investments and business opportunities. With the right Financial Management, businesses can make sure that the employees are aligned with the financial goals of the business.

5. Liquidity management: Having an adequate amount of liquidity is of crucial importance for a business. Financial Management enables businesses to maintain the optimum cash flows and resources to meet short-term financial obligations. This also enables businesses to cover immediate expenditures and focus on opportunities and stability. By managing cash flows and liquidity, businesses can remain agile and equip themselves to navigate through the uncertainties that might arise in the future.

6. Financial security: One of the paramount benefits of Financial Management is ensuring financial security for businesses and individuals. With the help of rigorous planning, resource allocations, and effective decision-making, organisations can secure their financial cycles. This also offers a strategy against financial instabilities and other financial uncertainties and ensures that businesses achieve long-term success.

7. Debt Management: Financial Management allows businesses to manage debt in the most effective ways. It also helps in making informed decisions for borrowing, structuring debt, and avoiding unnecessary fundraising. By effectively managing debt, businesses can achieve financial stability and improve their capacity to achieve their financial goals.

MAXIMIZING VS SATISFYING

As shareholders are the real owners of the organization, they appoint managers to take important decisions with the objective of maximizing shareholder's wealth. Though organizations have many more objectives, but maximizing stock price is considered to be an important objective of all for many firms.

1) Stock price maximization and social welfare: It is advantageous for society, if firm maximize its stock price. But, firm must not have any intentions of forming monopolistic market, creating pollution and avoiding safety measures. When stock prices are maximized, it benefits society by:

i) To greater extent the owners of stock are society: In past, ownership of stock was with wealthy people in society. But now, with the tremendous growth of pension funds, life insurance companies and mutual funds, large group of people in society have

ownership of stock either directly or indirectly. Hence, when stock price is increased, it ultimately improves the quality of life for many people in society.

ii) Consumers benefit: It is necessary to have effective low-cost businesses which manufacture good quality of goods and services at the cheapest cost possible to maximize stock price. Companies which are interested in maximizing stock price must satisfy all requirements of customers, provide good services and innovate new products finally; it must increase its sales by creating value for customers. Some people believe that firms increase the prices of goods while maximizing stock price. But it is not true; in order to survive in competitive market firms does not increase prices otherwise they may lose their market share.

iii) Employees benefit: In past years, it was an exception that decreases in level of employees lead to increase in stock price, but now a successful company which can increase stock price can develop and recruit more employees which ultimately benefits the society. Successful companies take advantage of skilled employees and motivated employees are an important source of corporate success.

2) Managerial Actions to Maximize Shareholder's Wealth: In order to identify the steps taken by managers to maximize shareholder's wealth, the ability of the organization to generate cash must be known. Cash flows can be determined in three ways, they are:

i) Unit Sales: In first determinant, managers can increase the level of their sales either by satisfying customers or by luck, but which will not continue in long run.

ii) After Tax Operating Margins: In second determinant, managers can generate cash flows by increasing operating profit which is not possible in competitive environment or by decreasing direct expenses.

iii) Capital Requirements: In third determinant, managers can increase cash flows by decreasing assets requirements which ultimately results in increase of stock price. Investment and financing decisions have an impact on level, timing and risk of the cash flow of firm and finally on stock price. It is necessary for manager to make decisions which can maximize the stock price of the firm.

3) Maximizing Earnings Per Share is Beneficent or Not: In order to maximize stock price, many analyst focus on cash flows by evaluating the performance of the company and also focus of EPS as an accounting measure. Along with cash flow, EPS also plays an important role in identifying stockholder's value.

PROFIT MAXIMISATION VS. WEALTH MAXIMISATION:

Details	Wealth Maximisation	Profit Maximisation
Principle	The definition of this term is the management of financial resources to raise the value of the company's stakeholders.	It is described as the management of financial resources to boost the company's profit.
Puts more emphasis on	Emphasises long-term stakeholder value growth for the business.	Prioritises short-term profit growth for the company.
Risk	It takes into account the risks and ambiguity that the business model of the organisation implies.	The company's business model's inherent risks and unpredictability are not taken into account.
Application	It contributes to increasing a firm's value, which could result in the company gaining more market share.	It assists in achieving efficiency in the day-to-day operations of the firm to maximise profitability.
Understanding Time Patterns of Returns	Yes	No

PROFIT VS. WEALTH VS. WELFARE

S.No	PROFIT MAXIMIZATION	WEALTH MAXIMIZATION	WELFARE MAXIMIZATION
1	Profits are earned, maximised, so that firm can over-come future risks which are uncertain.	Wealth is maximized, so that wealth of share-holders can be maximized.	Welfare maximization is done with the help of micro economic techniques to examine locative distribution.
2	Profit maximization is a yards stick for calculating efficiency and economic prosperity of the concern	In wealth maximisation stockholders current wealth is evaluated in order to maximize the value of shares in the market	In welfare maximization social welfare is evaluated by calculating economic activities of individuals to the society
3	Profit is measured in terms of efficiency of the firm.	Wealth is measured in terms of market price of shares.	Welfare can be measured in two ways, either by comparing to efficiency in units or money.
4	Profit maximization Involves problems of uncertainty because profits are uncertain.	Wealth maximization involves problems related to maximising shareholders wealth or wealth of the firm	Wealth maximization involves problems of combining the utilities of different people

AGENCY RELATIONSHIP AND COST:

The relationship that exists in an organization between shareholders and management known as agency relationship. Agency relationship results when a principal hires an agent to perform part of his duties.

Agency Problem: In this type of relationship there is a chance of conflicts to occur between the principal and the agent. This conflict is termed as agency problem.

Agency Costs: The costs incurred by stockholders in order to minimize agency problem and maximize the owner's wealth are called agency costs.

The two primary agency relationships exists in a business concern are:

1) Agency conflict-I (Shareholders Vs Bondholders): Shareholders are the real owners of the concern, they pay fixed and agreed amount of interest to bondholders till the duration of bond is finished but bondholders have a proceeding claim over the assets of the company. Since equity investors are the owners of the company they possess a residual claim on the cash flows of the company. Bondholders are the only sufferers if decisions of the company are not appropriate. When a company invest in project by taking amount from bondholders and if the project is successful, fixed amount is paid to bondholders and rest of the profits are for shareholders and suppose if project fails then sufferers will be the bondholders as their money have been invested.

2) Agency conflict-II (Managers Vs Shareholders): Profits generated from investments in projects can be utilized for reinvestment or provided back to shareholders as dividends. If dividends are increased, it may leads to decrease in the resources which are under the managers control and also strict its growth. As managers are evaluated on the basis of growth they might go for unproductive projects which cannot generate appropriate returns, which make the shareholders, feel shocked. This is the main cause of conflicts between managers and shareholders.

RISK RETURN TRADE-OFF

The risk-return trade-off is a fundamental concept in financial management and investment theory that illustrates the relationship between the potential return on an investment and the level of risk associated with it.

1. Risk: In the context of financial management, risk refers to the uncertainty or variability associated with the returns on an investment. It represents the chance that an investment may not perform as expected or could result in a loss of capital.

2. Return: Return, on the other hand, represents the gain or profit an investor expects to earn from an investment. It is typically expressed as a percentage and includes dividends, interest, and capital appreciation.

The risk-return trade-off is summarized as follows:

Risk return trade-off is used in investment decisions to describe the relationship between the risks of an investment versus the returns that it can fetch.

Higher Risk, Higher Potential Return: Generally, investments with higher levels of risk are expected to offer the potential for higher returns. Investors are typically willing to take on more risk if they believe they can earn a greater reward.

Lower Risk, Lower Potential Return: Conversely, investments with lower risk levels tend to offer lower potential returns. Safer investments, such as government bonds or certificates of deposit, typically have lower returns but are associated with less uncertainty.

This relationship is based on the principle that investors require compensation for taking on higher levels of risk. They expect a higher return as a reward for the possibility of incurring losses. The risk-return trade-off is essential for investors and financial managers to consider when making investment decisions, as it helps them determine their risk tolerance and choose investments that align with their financial goals and risk preferences. The risk-return trade-off is a fundamental concept in finance that highlights the relationship between the potential for return and the level of risk. Investors and financial managers must carefully consider this trade-off when making investment decisions to align their portfolios with their financial objectives and risk tolerance.

TIME VALUE OF MONEY

The Time Value of Money (TVM) is a financial concept that describes the idea that money available today is worth more than the identical sum in the future due to its potential earning capacity. This core principle of finance holds that money can be used to earn more money: it can be invested in interest-bearing financial instruments, such as stocks, bonds, or a savings account, which can provide returns over time.

The time value of money means that a sum of money's value is more now than what it is expected to be soon, which is because of its earnings potential in the interim. The time value of money mainly acts on the principle of finance. Money today is worth more than what the worth of the money will be in the future. This is because money today can be invested to earn interest and grow in value. The concept that a dollar today is worth more than a dollar tomorrow is the time value of money. The time value of money states that a dollar today is worth more than a dollar tomorrow due to option costs and inflation. This principle is used to accurately compare and evaluate cash flows that occur at different times. Present worth and future value calculations help apply the time value of money in finance.

The time value of money could be understood from the points said below.

- Money today is better than money tomorrow.
- Money today can earn interest and grow.
- Money tomorrow lost time to earn interest.
- Inflation makes money lose value over time.
- So Rs 100 today is worth more than Rs 100 tomorrow.
- We compare money at different times using the following
    - Present value: Value now of money in future
    - Future value: Value in the future of money now

Time Value of Money Formula

The present Value Formula is as follows.

PV = Future Value / (1 + Interest Rate)^Number of Periods

Enter the following.

- Future value = amount you'll receive in future
- Interest Rate = Rate of return or discount rate
- Number of Periods = Years until you get the future cash flow

The Future Value Formula is as follows.

FV = Present Value * (1 + Interest Rate)^Number of Periods

Enter the following.

Present value = amount you have now

Interest Rate = rate of return you'll earn

Number of Periods = Years until the future date

1. What is the future value of $2,000 invested today if it earns 10% interest for one year?

Investment = 2,000

Rate =10%

Time period = 1 year

SOLUTION:

Future value = investment $(1 + r)^{t}$

= 2000 * $(1+0.10)^{1}$

Future value = 2,200

2. What is the present value of $2,000 to be received 2 years from today when the annual discount rate is 10%

Future value = 2,000

Rate =10% per year

Time period = 2 year Compounding=yearly

SOLUTION:

Present value = Future value / $(1 + r)^{t}$

=2000 / $(1+0.10)^{2}$

Present value = 1,653