Finance Management

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Our Mission is to prepare the innovative and entrepreneurial leaders of the future with the capacity to anticipate and manage change in international business and the professional environment. At ISBM we ensure that our students become complete and successful managers in the shortest period and make a very bright future for better life.

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- Enhance the career of students in Business and Management sectors.
- Providing access of online study materials to access and learn anywhere with the matter of ease.
- Short duration programs in various faculties which enable the candidates/students to acquire value based and world-class Management qualifications while working.
- Offering need-based programs by giving professional and vocational orientation to the courses.
- Promoting and developing awareness of distance education.
- Setting and maintaining standards in distance education in the country as an apex body for the purpose.
- Transformation of students to working professional through education by industry level projects and practical’s.
- Students can learn through our state-of-art online learning portals and get qualified without disrupting current progression and earning.

We invite all those who share our vision, goals and purpose to join hands in hand in our efforts to build a new cadre of management professionals, who will participate actively in the growth of this era of economic, liberalization and globalization.

Accreditation & Awards:

ISBM has covered innumerable milestones at different levels of its expansion. What makes us an eminent brand is our youthful zest and enthusiasm to continuously reach new benchmarks. This reflects in the accreditations and recognitions bestowed on ISBM by leading institutions and certifying bodies, nationally and internationally.

- ISBM is an ISO 9001:2008 international B-School accreditated by United Kindgom Accreditation Services (UKAS)
- ISBM is channel partner with Richfield University, USA. ISBM also is an exclusive partner with Chartered management Institution, UK.
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- ISBM is an accreditated member of International Association for Distance Learning (Europe), National Human Resource Development (India), National Center for Higher Education Management Systems, U.S.A., Alnoor Charitable Society.
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And with all these, ISBM is also ranked amongst the Top B-Schools for correspondence education in India and abroad by various leading corporate business magazines like Business Baron, Business Today, Google.com etc.

ISBM – Awarded With:

- Most Innovative Distance Learning Institute in Mumbai from Writer, Diplomat and Politician Dr. Shashi Tharoor at New Delhi, 2012.
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- Mahatma Gandhi Samman Award, 2014
- Globally Assured Mark for “Quality Education” in Distance Education Service.
- ISBM is a registered patron member of “The Council of EU Chambers of Commerce in India”

Director's Message

Every moment of your life is infinitely creative and the universe is endlessly bountiful. Just put forth a clear enough request, and everything your heart desires must come to you.

~ Mahatma Gandhi (born: 1869-10-02 died: 1948-01-30 at age: 78)

I believe reading and writing doesn't make you literate but failing to learn and relearn makes you weak and illiterate. ISBM was incorporated with a strong vision to spread education across the globe.

ISBM sole motto is to enlighten the human mind and heart with excellent education so that he faces the world in much positive and confident way.

The pace of change in business and technology is accelerating. The last few decades have seen business be transformed from domestic, nationalistic enterprises and markets into Multinational enterprises.

ISBM wants to move ahead of the conventional classroom training and reach masses.

With the latest technology accelerating ISBM strives to completely be in synchronization with all generations giving education to them in their way. From classrooms to virtual classrooms, Offline to online exams the best study material ISBM believes in Quality education.

We have several ideas that we propose to present to the business community. We believe that walls that currently exist in the society between organizations that serves each other are a hindrance to overall social performance. We are looking forward to a positive response from business community to our programs and plans. Any guidance and suggestions towards this end would be most welcome.

ISBM wishes all aspirants to outshine in their respective lives.

Thank You,
Dr. Vinay Agrawal

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Table of Contents

Chapter 01

Nature, Scope and Objectives of Financial Management

Structure

- Introductory Case: Deloitte's New Financial Management System
- Introduction
- Structure of the Financial System
- Approaches to Financial Management
  - » Traditional Approach
  - » Modern Approach
- Concept of Financial Management
  - » Meaning of Financial Management
  - » A's of Financial Management
  - » Functions of Financial Management
  - » Scope of Financial Management
- Objectives of Financial Management
  - » Profit Maximization
  - » Wealth Maximization
- Functions of Finance Managers
- Importance of Financial Management
- Recall
- Important Terms
- Recall Test
- Answers

Notes

Introductory Case: Deloitte's New Financial Management System

Deloitte Consulting LLP (Deloitte Consulting) worked with the Chief Information Officer and Division of Budget of a Mid-Atlantic state's agency to complete a strategic assessment project. The collaborative effort was to implement a new financial management system.

The agency is known for employing more than 30 financial management systems throughout the state. The agency realised the importance of introducing a new, integrated system that could support every company. Deloitte helped the state in preparation for the implementation of this new system.

According to the Chief Information Officer of the agency, "*the objectives of the new system were to:*

- *Bring state agencies together to promote consensus about the functional requirements.*
- *Redesign the core business processes.*
- *Define the vision of the state's future financial system*."

The Deloitte team worked collaboratively with the state's team to conduct a comprehensive and structured analysis of the business and technical needs of users throughout the state. The Deloitte Consulting and the agency moderated a number of development sessions with agency representatives to assess the functional needs for the new system. These representatives performed financial management functions on a daily basis. According to Deloitte Consulting team, these sessions helped to:

- Build consensus among key stakeholders about how the system will function in the future environment.
- Facilitate the cataloguing and prioritisation of hundreds of functional requirements for the new system.
- Provide inputs to the redesign of key business processes to operate in the envisioned, Enterprise Resource Planning (ERP)-enabled environment.
- Develop a set of software scenarios to be used to test vendor's ability to meet the state's unique needs.

1.1 Introduction

Every company requires money to conduct its business operations and other activities. Every organisation requires finance in its various stages, be it incorporation stage where the organisation needs money to develop the infrastructure or during the developmental stage, where capital infusion is required to carry on business processes. Money is also spent in advertising. At the time of maturity, money is spent

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to ensure outreach of the company to its clients. All this use of money requires a good financial management. Financial management is concerned with judicious use of funds and availability of capital for operations to find various profitable avenues.

The chapter begins with explanation of the structure of financial management. The chapter also outlines the traditional and new approach to financial management. Next, you will understand the concept of financial management, with its meaning, functions, scope, objectives, and A's of financial management. In the end, chapter details the functions of finance managers and importance of financial management in business world.

Objectives

After going through this chapter, you will be able to:

- Explain the structure of the financial system
- Describe the approaches to financial management
- Explain the concept of financial management
- Analyse the objectives of financial management
- Examine the functions of finance managers
- Understand the importance of financial management

1.2 Structure of the Financial System

Financial system allows the transfer of money between savers or investors and borrowers. A financial system can exist on a global, regional or firm-specific level. According to Gurusamy, in *Financial Services and Systems*, financial system is "a set of complex and closely interconnected financial institutions, markets, instruments, services, practices, and transactions."

According to Franklin Allen and Douglas Gale, in *Comparing Financial Systems*:

"*Financial systems are crucial to the allocation of resources in a modern economy. They channel household savings to the corporate sector and allocate investment funds among firms; they allow inter-temporal smoothing of consumption by households and expenditures by firms; and they enable households and firms to share risks. These functions are common to the financial systems of most developed economies. Yet the form of these financial systems varies widely*."

They, *inter alia*, direct domestic savings to the corporate sector and apportion investment funds among firms; permit inter-temporal easing of consumption by domiciliaries and expenditure by firms, and enable the latter two to share risks. Although, these activities are common to the financial systems of most developed economies, yet, these financial systems differ extensively in their types.

Notes

The financial system is complex in structure. The financial system consists of the following markets:

1) **Primary market** is a market in which security, bond or stock, are sold to initial buyers by the corporate entities or a government agency. This market is not well known to the public because the selling of securities to purchasers is carried out in complete secrecy.

2) **Secondary market** is the market which provides a platform wherein the securities, that are issued, could be traded among the different buyers and the sellers. BSE (Bombay Stock Exchange) and NSE (National Stock Exchange) are the two most famous examples.

3) **Money market** is the one which deals in trading of short-term debt instruments by financial instruments and the organisations. Short-term securities are less prone to price fluctuations as compared to the long-term debt instruments. Therefore, banks use the money to garner extra interest quickly and efficiently.

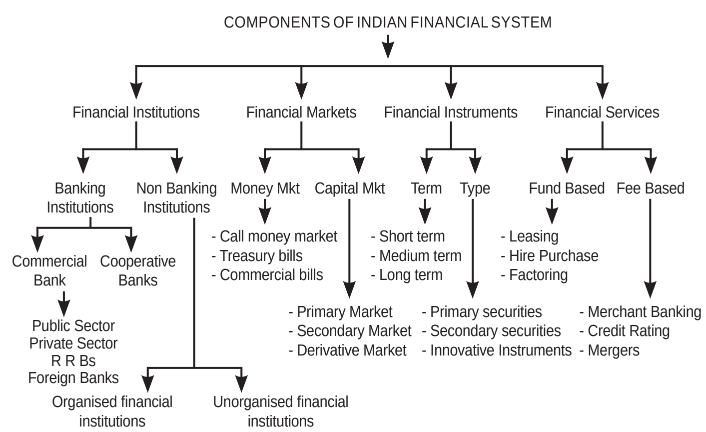
4) **Capital market** is the market for short-term and long-term debts along with equity which are traded in an impeccable manner. Insurance and pension funds are financial intermediaries that are being purchased or sold in the capital market. Some examples include treasury bonds, corporate bonds, and mortgage.

The other four basic components of the financial system are:

- Financial Institutions
- Financial Markets
- Financial Instruments (Assets or Securities)
- Financial Services

These components can be depicted as follows:

Figure 1: Components of Financial System



Source: http://www.indianmba.com/Faculty_Column/FC1063/fc1063.html

Notes

Let us discuss each in detail.

Financial Institutions

Financial institutions are financial intermediaries as they are middlemen between savers and borrowers.They facilitate smooth functioning of the financial system by bridging the gap between investors and borrowers. They use different financial instruments and process to mobilize the savings of investors either via financial markets, directly or indirectly. These institutions use diverse financial instruments and processes to mobilise the savings of investors either directly, by way of financial markets, or indirectly. They also make use of the services of numerous financial services providers.

Financial Markets

A financial market basically deals with creation or transfer of financial assets. Financial markets are divided into into money markets and capital markets. The key functions of this type of market are to:

- Assist in creation and allocation of credit and liquidity.
- Serve as intermediaries for mobilisation of savings.
- Help achieve balanced economic growth.
- Offer financial convenience.

Financial Instruments

Financial instruments are an important part of financial system. Financial instruments are the products traded in a financial market.. They can be financial assets, securities, or other types. Equity shares, debentures, bonds, etc. are some examples.

Financial Services

Financial services are services provided by Asset Management and Liability Management Companies. These companies provide a range of services, such as:

- Getting necessary funds and making sure they are efficiently deployed.
- Assisting in determining the financing combination.
- Borrowing, selling, purchasing, lending and investing securities.
- Making and allowing payments and facilitating settlements.
- Dealing with risk exposures in financial markets.
- Providing a host of financial services, such as credit rating, venture capital financing, mutual funds, merchant banking, depository services, and book building.

Financial institutions and financial markets help in the working of the financial system by means of financial instruments.

Notes

Section Questions

Q1. Which of the following markets is not well known to the public as the selling of securities to purchasers is carried out in complete secrecy?

A. Primary market

B. Secondary market

C. Money market

D. Capital market

Q2. In which of the following markets, short-term debt instruments are traded?

A. Primary market

B. Secondary market

C. Money market

D. Capital market

Q3. Which of the following act as middlemen between savers and borrowers?

A. Financial Institutions

B. Financial Markets

C. Financial Instruments

D. Financial Services

Application Based Questions

Watch the video from the link given below to learn more about the four components of financial system, and the very important, fifth component.

http://www.youtube.com/watch?feature=player_embedded&v=mnFtjsaWSCg

Find out about various financial services mentioned in the section above.

1.3 Approaches to Financial Management

Financial management is divided into two approaches which divide the scope and functions of financial management — traditional and modern approach.

Let us talk about each in detail.

Notes

1.3.1 Traditional Approach

Traditional approach dates back to the period 1920-1950. This approach is marked as an initial stage of financial management. It is based on the past experience and the traditionally accepted methods. According to the traditional approach, financial management just involves raising of funds. Traditional approach emphasizes on the procurement of funds by the corporate organizations. Traditional approach consists of the following important areas:

- Arrangement of funds from lending body.
- Arrangement of funds through various financial instruments.
- Finding out the various sources of funds.

The traditional approach is not free from criticism. Some of its drawbacks are:-

- The traditional approach revolved around the viewpoint of the suppliers of funds. Thus, the approach was the outsider-looking-in approach as it considered views of investors, financial institutions, investment bankers, etc., i.e., outsiders.
- The approach lacked internal financial decision-making.
- Traditional approach was narrow in the sense that it was limited to only episodic events such as mergers, acquisitions, reorganisations, and consolation.

Traditional approach lacked focus on immediate needs and failed to consider the routine managerial finance problems. Thus, the approach ignored working capital management aspect of finance. It only concerns the long-term financial problems.

1.3.2 Modern Approach

Financial decisions have a great impact on all other areas of business activities. As such, the finance manager needs to broaden his/her outlook and view the financial problems of a firm in an analytical way. Here, came the modern approach, where the financial managers estimated the size and nature of the technology and set the direction and growth of the business. They paid attention towards shaping the profitability, calculating the amount of risk taking, selecting the asset mix, and determining the optimum capital structure. According to the new approach, the financial management aimed to solve each and every problem in the areas of investment, financing, and dividend decisions. The modern approach expects the financial manager to take financial decisions in the most rational way, use the funds of the firm optimally and take special care in executing their administrative duties, management responsibilities and decision-making techniques. The modern approach to financial management is enumerated below:

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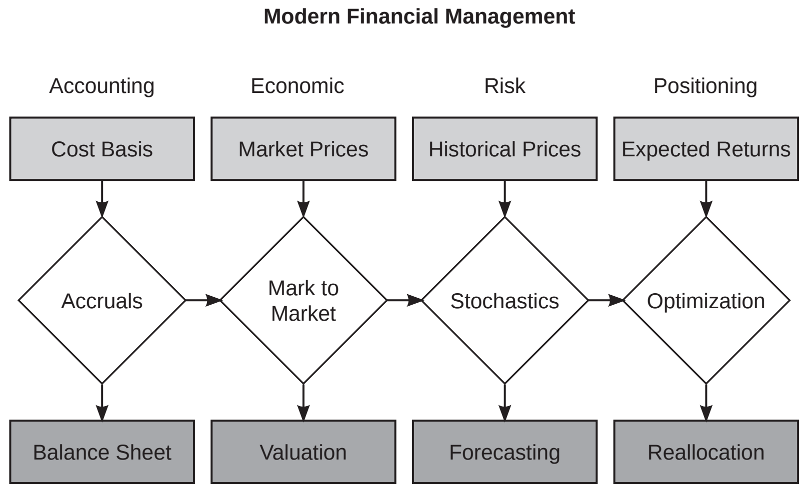
Figure 2: Modern Approach to Financial Management



Source: wjmc.blogspot.com

Section Questions

Q4. Finding out the various sources of funds is an important area under the modern approach of financial management. (True/False)

1.4 Concept of Financial Management

Financial management is an essential component of overall management. It emphasises the duties and responsibilities of the financial managers in the business firm. Financial management encompasses cash management, planning and forecasting, and financial reporting.

Let us study about financial management in detail.

1.4.1 Meaning of Financial Management

Financial management is the art of managing money. It consists of corporate and business finance. Corporate finance is related to the wealth that an organisation needs to acquire for generating profits. Business finance pertains to the capital raised from the market to fund the business operations.

In the words of Solomon, the term financial management has been defined as, "I*t pertains to effective employment of a vital economic resource, viz. capital funds.*"

Notes

According to S.C. Kuchal, "*Financial management deals with procurement of funds and their effective utilisation in the business.*"

Howard and Upton define financial management in the following terms: "*It is putting to use the general managerial principles to the area of financial decision-making*."

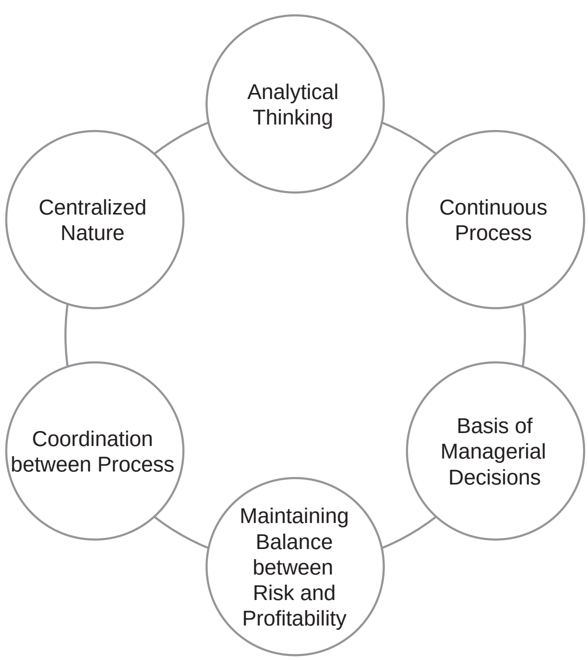
For Weston and Brigham, financial management may be described as "*a field of financial decision-making which brings in line individual purposes and enterprise objectives*"."*is an area of financial decision-making, harmonizing individual motives and enterprise goals.*"

Joshep and Massie, define financial management as "*the operational functions of an enterprise that are responsible for obtaining and making effective use of the finances essential for its efficient operations.*"

According to J. F. Bradley, "*Financial management is the area of business management devoted to the judicious use of capital and careful selection of sources of capital in order to enable a spending unit to move in the direction of reaching its goals.*"

On the basis of the above definitions, the following are the main characteristics of the financial management:

Figure 3: Characteristics of financial management



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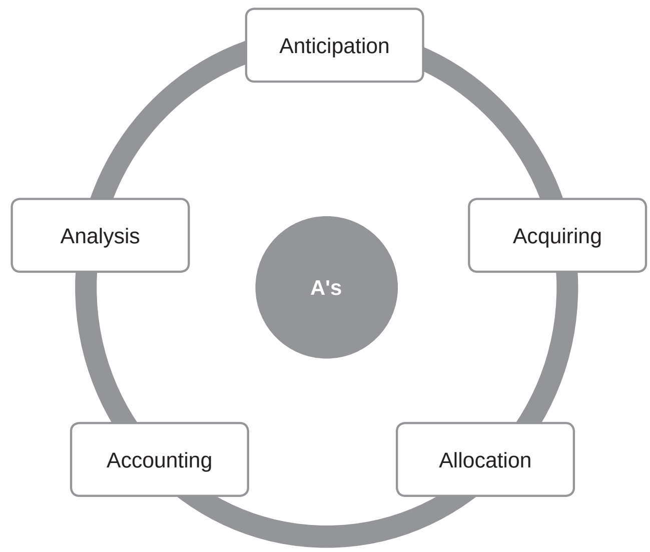
1.4.2 A's of Financial Management

The A's of financial management are depicted as follows:

Figure 4: A's of Financial Management

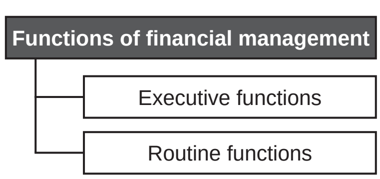


- **Anticipation:** The demands of the fund should be anticipated in the market.
- **Acquiring:** The funds should be acquired at lower interest rate so that profits are maximised.
- **Allocation:** Capital allocation is necessary and should be used in an optimised manner to boost profit.
- **Accounting:** Financial statements, namely balance sheet and profit and loss account are the two most important components of financial management.
- **Analysis:** Financial analysis would go a long way in helping the managers to take important business decisions.

1.4.3 Functions of Financial Management

Functions of financial management are broadly divided into two..

Figure 5: Functions of financial management



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The executive functions of financial management are:

- Estimating capital requirements.
- Determining capital structure.
- Estimating cash flow.
- Investment decisions.
- Allocation of surplus.
- Deciding additional {finance}.
- Negotiating for additional finance.
- Checking the financial performance.

Routine functions of financial management are:-

- Protecting cash balances, securities, and other important papers.
- Taking proper care of mechanical details of financing.

Maintaining records and managing credit. Functions of financial management can be further classified as follows:

1) **Investment decision:** These decisions are taken by the enterprises to determine the viability of a project. The profitability from new investment is compared with the expected returns to influence the managerial decisions.
2) **Financing decision:** These decisions are taken to identify the financial sources for long-term and short-term projects. These decisions emphasise on a judicious mix of equity and debt so that the company has to pay minimum interest to the creditors.
3) **Dividend decision:** The enterprise has to make decision on whether to pay dividend arising out of the profits or to keep the whole profit for its future expansion. Dividend payout ratio is paid in cash or in the form of bonus shares to the stakeholders.
4) **Liquidity decision:** Decisions on whether to sell off the current and fixed assets to maintain liquidity in financing business operations are liquidity decisions.

1.4.4 Scope of Financial Management

Finance is required by an organisation in the following areas:

1) **Production:** To convert the raw material into finished goods, transportation, banking, purchase of material, acquisition of plant & machinery and related technology, expenses are incurred. Therefore, funding is necessary to accomplish the task.

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2) **Marketing:** Sales, along with advertising and distribution, requires financial expenditure as promotion in the electronic media and appointing dealers for shipping the products are all capital-intensive activities. Transportation and rent of retail supply centres are important components of marketing.
3) **Human Resource:** Hiring, selecting, and paying salary to the employees require money.
4) **Research and Development:** If new products are to be created, capital infusion is required.

Section Questions

Q5. Which of the following is related to wealth that an organisation needs to acquire for generating profits?

A. Corporate finance

B. Business finance

Q6. Which of the following is not an 'A' of financial management?

A. Anticipation

B. Accounting

C. Allocation

D. Appropriation

E. Analysis

Q7. Credit management is an executive function of financial management. (True/False)

Q8. Allocation of surplus is an executive function of financial management. (True/False)

1.5 Objectives of Financial Management

A financial manager is concerned with the effective procurement and efficient use of finance for proper utilisation of the finance by the business enterprise. One of the most important responsibilities of the financial manager is to determine the basic objectives of the financial management. Objectives of financial management are two-fold:

- Profit maximisation
- Wealth maximisation

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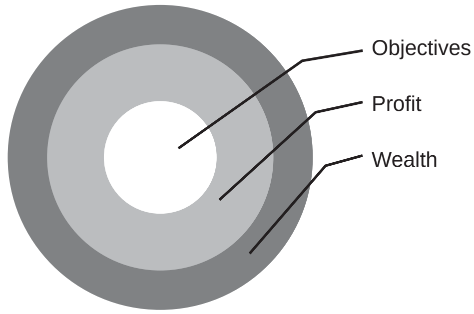
Figure 6: Objectives of financial management



1.5.1 Profit Maximisation

Any business concern undertakes an economic activity to earn profit. Profit is the determining method to know the business efficiency of the enterprise. It has both, traditional and narrow viewpoints, with maximisation of the profit of that enterprise, as their goals. The need for profit maximisation is felt the purposes of:

- Organisation's survival: Organisation will only survive if it can make profit on a long- term basis.
- Meeting the other organizational objectives: Profit is necessary to obtain finance for the business operations.
- Measuring growth: Growth and efficiency is measured by the amount of profit generated by an organisation.

1.5.2 Wealth Maximisation

Wealth maximisation has a modern outlook. The concept stems out from latest innovations and improvements in the field of business concerns. The term 'wealth' implies shareholder's wealth or the wealth of persons who are involved in the business concern.

Wealth maximisation is also known as value maximisation or net present worth maximisation. Most of the business concerns follow an objective of wealth maximisation while running their businesses.

Benefits of this approach are:

- Superior to profit maximisation: Wealth maximisation is a long-term approach directed towards the growth of the organisation.
- Fulfilling the goals of different departments: This objective helps in attaining the goals of departments, including production, sales, and distribution.

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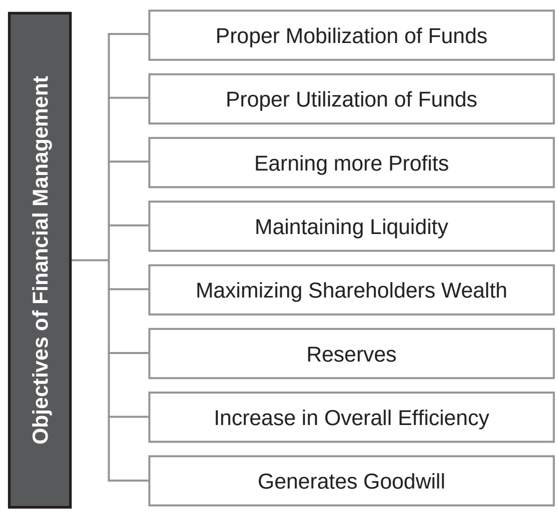
- Increase in earnings per share (EPS): Wealth maximisation assists in the appreciation of EPS and enhances the productivity of organiation.
- Efficient allocation of resources: Wealth is maximised by using resources in an effective way to accomplish the objectives.
- Ensuring social interest: Eco-friendly techniques are deployed to increase the wealth maximisation.

Limitations of the above approach are as follows:

- The concept is limited only to big organisations.
- The approach is not very popular among shareholders as dividends are not distributed on a regular basis on account of reinvestment ofthe profit for enhancing the wealth.

Some of the other objectives of financial management are as follows:

Figure 7: Objectives of Financial Management



Section Questions

Q9. Wealth maximisation is limited only to big organisations. (True/False)

Application Based Questions

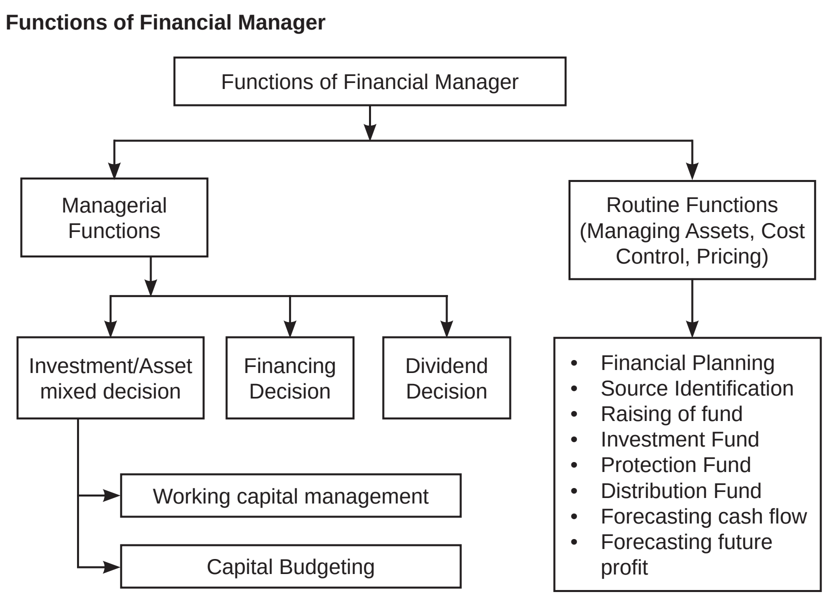
Find out the difference between profit maximisation and wealth maximisation.

Notes

1.6 Functions of Finance Managers

The finance manager is a key player in the field of finance function. He/she is an epitome of knowledge in the areas of accounting, finance, economics, and management. He/she is responsible for critically analysing the problems related to finance and provide solutions thereto. Such a person who deals with finance and related activities is called a finance manager. Finance manager performs the following major functions:

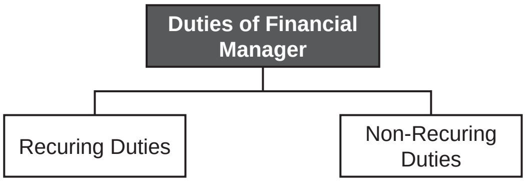
Figure 8: Functions of Finance Manager



Source: http://bdjournal.com/?tag=finance

Further, the functions of a finance manager can be described in terms of his/her duties. Duties of a finance manager could be divided into two parts:

Figure 9: Duties of financial manager



Recurring Duties

These functions are performed regularly to conduct business operations. These duties are:

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- **Estimating the financial needs:** Finance manager evaluates the fund requirement for advertisements, working capital, and purchase of assets.
- **Raising the funds required:** Finance manger must identify the sources of funding, such as equity shares along with long-term and short-term loans.
- **Allocation of funds:** Funds should be allocated to different departments in a judicious manner.
- **Control of funds:** Planning and the actual usage of the cash flow funds should be in synchronisation to deliver the best results.
- **Evaluation of performance:** Finance manager needs to evaluate the performance of the organisation and must also maintain the account books.
- **Corporate taxation:** Finance manager is responsible for handling the tax issues pertaining to income, wealth, and sales along with the management of tax saving plans.
- **Other duties:** The management must carry out internal tax audit, creation, and presentation of financial reports combined with the insurance of the assets of organisation.

Non–recurring Duties

Non-routine functions, such as expansion of company are carried out by financial manager for developing an efficient financial plan to accomplish the task. Joint venture issues are also handled by the finance manager who is responsible for formulating the contract.

Section Questions

Q10. Managing assets is a managerial function of a finance manager. (True/ False)

1.7 Importance of Financial Management

Every business enterprise should maintain sufficient amount of funds for its smooth functioning. , Every concern should also manage its activities to achieve its objectives and reach its goals. Business' can only reach their goal through effective finance management. Some importance of financial management is as follows:

1) **Economic growth and development:** Capital budgeting aspect of financial management, falls into 3 categories: investing, financing, and dividend decisions, along with risk management decisions help companies undertake better and more economically viable projects. These result in economic growth and development of the economy.

Notes

2) **Improved standard of living:** Financial management facilitates growth and development in the economy. , This ultimately leads to improved standard of living for all.
3) **Promotes efficiency:** Good financial management eliminates wastes and inefficiencies that might arise due to poor decision making.
4) **Effective utilization of funds:** Effective utilisation of funds enhances operational efficiency of the business enterprise.
5) **Improve profitability:** Financial management provides various strong financial regulation tools, such as budgetary control, ratio analysis, and cost volume profit which aid in enhancing profitability status of the enterprise.
6) **Increase the value of the firm:** Financial management helps to increase wealth of the investors and thus of the business concern.

Section Questions

Q11. Good financial management eliminates wastes and inefficiencies that in decision-making. (True/False)

1.8 Recall

- The financial system is complex in structure and is created to facilitate the flow of funds from savers to borrowers.
- Financial management is a crucial component of management. It is directly concerned with various functional departments, such as personnel, marketing and production.
- Financial management is necessary for business as it would go a long way in enhancing the productivity of an organisation.
- Financial management is important because it helps in identifying the business decisions that need to be taken to improve the health and fortunes of the company.

1.9 Important Terms

- **Bonds**: A debt investment in which an investor loans money to an entity (corporate or governmental) that borrows the funds for a defined period of time at a fixed interest rate.
- **Dividend payout ratio**: The fraction of net income a company pays to its stockholders in dividends
- **Debentures**: A debenture is a medium- to long-term debt instrument used by large companies to borrow money at a fixed rate of interest.

Notes

- **Earnings per share**: The part of a company's profit allocated to each outstanding share of common stock.
- **Equity shares**: also known as ordinary share, equity shares are held by the shareholders in certain fraction. Equity shareholders undertake the maximum entrepreneurial risk associated with a business venture.

1.10 Recall Test

1. Explain the structure of financial system.
2. Differentiate between the two approaches of financial management.
3. What do you understand by the term financial management?
4. Describe the A's of financial management.
5. What are the functions of financial management?
6. Define the scope of financial management.
7. What are the objectives of financial management?
8. Explain the functions of finance managers.
9. Why financial management is important?

1.11 Answers

Section Questions

1. A
2. C
3. A
4. False
5. A
6. D
7. False
8. True
9. True
10. False
11. True

Recall Test

1. Refer section 1.2.
2. Refer section 1.3.

3. Refer section 1.4.1.
4. Refer section 1.4.2.
5. Refer section 1.4.3.
6. Refer section 1.4.4.
7. Refer section 1.5.
8. Refer section 1.6.
9. Refer section 1.7.

Notes

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