

**EVOLUTION OF FINANCIAL MANAGEMENT:** Financial management emerged as a distinct field of study at the turn of this century. Its evolution may be divided into three broad phases (though the demarcating lines between these phases are somewhat arbitrary): the traditional phase, the transitional phase, and the modern phase

The *traditional phase* lasted for about four decades. The following were its important features:

- The focus of financial management was mainly on certain episodic events like formation, issuance of capital, major expansion, merger, reorganization, and liquidation in the life cycle of the firm.
- The approach was mainly descriptive and institutional. The instruments of financing, the institutions and procedures used in capital markets, and the legal aspects of financial events formed the core of financial management.
- The outsider's point of view was dominant. Financial management was viewed mainly from the point of the investment bankers, lenders, and other outside interests.

A typical work of the traditional phase is *The Financial Policy of Corporations*<sup>1</sup> by Arthur S. Dewing. This book discusses at length the types of securities, procedures used in issuing these securities, bankruptcy, reorganisations, mergers, consolidations, and combinations. The treatment of these topics is essentially descriptive, institutional, and legalistic.

The *transitional phase* being around the early forties and continued through the early fifties. Though the nature of financial management during this phase was similar to that of the traditional phase, greater emphasis was placed on the day-to-day problems faced by finance managers in the areas of funds analysis, planning, and control. These problems, however, were discussed within limited analytical frameworks. A representative work of this phase is *Essays on Business Finance* by Wilford J. Eiteman *et al.*

The *modern phase* began in the mid-fifties and has witnessed an accelerated pace of development with the infusion of ideas from economic theory and application of quantitative methods of analysis. The distinctive features of the modern phase are:

- The scope of financial management has broadened. The central concern of financial management is considered to be a rational matching of funds to their uses in the light of appropriate decision criteria.
- The approach of financial management has become more analytical and quantitative.
- The point of view of the managerial decision maker has become dominant.

Since the being of the modern phase many significant and seminal developments have occurred in the fields of capital budgeting, capital structure theory, efficient market theory, option pricing theory, arbitrage pricing theory, valuation models, dividend policy, working capital management, financial modeling, and behavioural finance. Many more exciting developments are in the offing making finance a fascinating and challenging field.

- Early 1900 : instrument, institution, and procedures of capital market and money market
- Around 1920 : focus on security and banking sector, and investment in common stock
- Around 1930 : focus on liquidity, debt, regulation, bankruptcy, reorganization
- Early 1940 and 1950 : internal analysis, planning and controlling cash flow
- End of 1950 : capital budgeting, valuation, and dividend policy
- Around 1960 : development of portfolio theory
- Around 1970 : CAPM model and APT model that can be used to value the financial assets
- Around 1980 : focus on uncertainty, asymmetric information, financial signaling
- Around 1990 : multinational financial management, behavioral finance, enterprise risk management, good corporate governance

#### Evolution of Finance:

- Financial System and its functions
- Classification of Financial Markets
- Money Market Instruments
- Capital Markets Instruments
- Government Securities Market

#### Financial System and its functions

A financial system is an orderly structure and mechanism that is available in an economy to mobilize the monetary resources/capital from various surplus sectors of the economy and allocate and distribute the same to various needy sectors. It is a composition of various institutions, markets, regulations and laws, transactions, claims and liabilities. It acts as an intermediary and facilitates the flow of funds from areas of surplus to areas of deficit. It performs the following functions:

**Savings function:** Financial system helps in directing the public savings into the hands of producers of goods and services through various money and capital market instruments that would yield income in future.

**Liquidity function:** Financial markets help the investors to liquidate their investments in financial instruments like stocks, bonds etc.

**Payments function:** Financial system helps in making payments for various goods and services through convenient methods like cheque system, credit cards etc.

**Risk function:** The financial system helps in protecting the people against risks associated with life, income and health through various insurance policies.

**Policy function:** As India is a mixed economy, the financial system in the country is governed by certain policies and regulations framed by the government from time to time.

#### Financial Markets and Classification of Financial Markets:

Financial assets represent a claim to the payment of a sum sometime in the future and/or periodic payment in the form of interest or dividend. Financial markets can be defined as the markets where financial assets are either created or transferred.

Based on the maturity period of the financial assets issued, financial markets are classified into two categories:

**Money Market:** It deals with securities having a short-term maturity period of one year or less than one year. The instruments that come under this category are- treasury bills, bills of exchange, certificate of deposits etc.

**Capital Market:** It deals with securities having a maturity period of more than one year. Instruments that come under this category are debentures, equity and preference stock, etc.

**Government Securities Market**

Government securities market includes all those securities that are issued by the Central government and the state governments and other entities that are wholly owned by the government. They are also referred to as gilt-edged securities as the interest and repayment of principal are completely secured in this case. Depending upon the issuing body, securities can be classified into five categories:

Central government securities

State government securities

Securities guaranteed by the Central Government for All India Financial Institutions like IDBI, IFCI, etc.

Securities guaranteed by state government for state institutions like State Electricity Boards and Housing Boards.

Treasury bills issued by the RBI.

**Stock Certificate:** In case of stock issued by government, a stock certificate is given to the owner, which specifies that he is a registered holder in the book of Public Debt Office (PDO).

It indicates the interest rate, interest due dates and face value of the stock.

It is not transferable by endorsement. Transfer can take place only by means of a transfer deed, by which the transferee's name is substituted in the place of the transferor's name in the books of the PDO.

Interest payment by way of interest warrants and principal repayments are issued by the PDO to the domicile of the holder or to the specified local office of the RBI or any branch of the agent bank conducting government securities business in India.

**Promissory Notes:** They contain promise by the President of India or the Governor of a state for payment of the consideration along with interest, to the holder.

They are negotiable instruments payable to the order of the specified persons and transferable by endorsement.

**Bearer Bonds:** They certify the bearer for entitlement to the specified sum along with interest payable by way of interest warrants.

They are transferable by physical delivery.

**International Equity Instruments:**

**Global Depository Instruments (GDRs):** A depository receipt is a negotiable instrument that represents the beneficial interest in shares issued by a company. A GDR is an instrument in the form of a depository receipt or certificate created by the Overseas Depository Bank outside India and issued to non-resident investors against the issue of ordinary shares or foreign currency convertible bonds of the issuing company. Depository in the case of a GDR is located in a foreign country, whereas the custodian is located in the home country of the issuer.

**American Depository Receipts (ADRs):** It is a dollar denominated negotiable certificate and represents publicly traded equities of non-US companies. Foreign private companies can issue shares of stock on the U.S. equity markets using ADRs. This allows U.S. investors to purchase stock of foreign companies, while allowing foreign companies to benefit from the vast shareholder base and liquidity of U.S. markets.

**Importance of financial management:** In a big organisation, the general manager or the managing director is the overall incharge of the organisation but he gets all the activities done by delegating all or some of his powers to men in the middle or lower management, who are supposed to be specialists in the field so that better results may be obtained.

For example, management and control of production may be delegated to a man who is specialist in the techniques, procedures, and methods of production. We may designate him "Production Manager". So is the case with other branches of management, i.e., personnel, finance, sales etc.

The incharge of the finance department may be called financial manager, finance controller, or director of finance who is responsible for the procurement and proper utilisation of finance in the business and for maintaining co-ordination between all other branches of management.

Importance of finance cannot be over-emphasised. It is, indeed, the key to successful business operations. Without proper administration of finance, no business enterprise can reach its full potentials for growth and success. Money is a universal lubricant which keeps the enterprise dynamic-develops product, keeps men and machines at work, encourages management to make progress and creates values. The importance of financial administration can be discussed under the following heads:-

**(i) success of Promotion Depends on Financial Administration.** One of the most important reasons of failures of business promotions is a defective financial plan. If the plan adopted fails to provide sufficient capital to meet the requirement of fixed and fluctuating capital and particularly, the latter, or it fails to assume the obligations by the corporations without establishing earning power, the business cannot be carried on successfully. Hence sound financial plan is very necessary for the success of business enterprise.

**(ii) Smooth Running of an Enterprise.** Sound Financial planning is necessary for the smooth running of an enterprise. Money is to an enterprise, what oil is to an engine. As, Finance is required at each stage of an enterprise, i.e., promotion, incorporation, development, expansion and administration of day-to-day working etc., proper administration of finance is very necessary. Proper financial administration means the study, analysis and evaluation of all financial problems to be faced by the management and to take proper decision with reference to the present circumstances in regard to the procurement and utilisation of funds.

**(iii) Financial Administration Co-ordinates Various Functional Activities.** Financial administration provides complete co-ordination between various functional areas such as marketing, production etc. to achieve the organisational goals. If financial management is defective, the efficiency of all other departments can, in no way, be maintained. For example, it is very necessary for the finance-department to provide finance for the purchase of raw materials and meeting the other day-to-day expenses for the smooth running of the production unit. If financial department fails in its obligations, the Production and the sales will suffer and consequently, the income of the concern and the rate of

profit on investment will also suffer. Thus Financial administration occupies a central place in the business organisation which controls and co-ordinates all other activities in the concern.

**(iv) Focal Point of Decision Making.** Almost, every decision in the business is take in the light of its profitability. Financial administration provides scientific analysis of all facts and figures through various financial tools, such as different financial statements, budgets etc., which help in evaluating the profitability of the plan in the given circumstances, so that a proper decision can be taken to minimise the risk involved in the plan.

**(v) Determinant of Business Success.** It has been recognised, even in India that the financial manger splay a very important role in the success of business organisation by advising the top management the solutions of the various financial problems as experts. They present important facts and figures regarding financial position an the performance of various functions of the company in a given period before the top management in such a way so as to make it easier for the top management to evaluate the progress of the company to amend suitably the principles and policies of the company. The financial manges assist the top management in its decision making process by suggesting the best possible alternative out of the various alternatives of the problem available. Hence, financial management helps the management at different level in taking financial decisions.

**(vi) Measure of Performance.** The performance of the firm can be measured by its financial results, i.e, by its size of earnings Riskiness and profitability are two major factors which jointly determine the value of the concern. Financial decisions which increase risks will decrease the value of the firm and on the to the hand, financial decisions which increase the profitability will increase value of the firm. Risk an profitability are two essential ingredients of a business concern.

**The importance of financial management can be summarized as follows:**

1. It brings economic growth and development through investments, financing, dividend and risk management decision which help companies to undertake better projects.
2. When there is good growth and development of the economy it will ultimately improve the standard of living of all people.
3. Improved standard of living will lead to good health and financial stress will reduce considerably.
4. It enables the individual to take better financial decision which will reduce poverty, reduce debts and increase savings and investments.
5. Better financial ability will lead to profitability which will create new jobs and in turn lead to more development, expansion and will promote efficiency.

**Objective of Financial Management:**

Keeping in view the prime objective of maximizing the shareholders' wealth, financial management involves the determination of the optimal combination of three inter-related decisions, In the course of performing these functions finance manager takes the following decisions:-

1. Financing decision
2. Investment Decision

- 3. Dividend decision
- 4. Liquidity decision

**Investment Decisions:** To survive and grow, all organizations must be innovative. Innovation demands managerial proactive actions. Proactive organizations continuously search for innovative ways of performing the activities of the organization. Innovation is wider in nature. It could be expansion through entering into new markets, adding new products to its product mix, performing value added activities to enhance the customer satisfaction, or adopting new technology that would drastically reduce the cost of production or rendering services or mass production at low cost or restructuring the organization to improve productivity. All these will change the profile of an organization. These decisions are strategic because, they are risky but if executed successfully with a clear plan of action, they generate super normal growth to the organization.

If the management errs in any phase of taking these decisions and executing them, the firm may become bankrupt. Therefore, such decisions will have to be taken after taking into account all facts affecting the decisions and their execution.

Two critical issues to be considered in these decisions are:-

1. Evaluation of expected profitability of the new investments.
2. Rate of return required on the project.

The rate of return required by investor is normally known by hurdle rate or cut-off rate or opportunity cost of capital.

After a firm takes a decision to enter into any business or expand its existing business, plans to invest in buildings, machineries etc. are conceived and executed. The process involved is called Capital Budgeting. Capital Budgeting decisions demand considerable time, attention and energy of the management. They are strategic in nature as the success or failure of an organization is directly attributable to the execution of capital budgeting decisions taken.

Investment decisions are also known as Capital Budgeting Decisions. Capital Budgeting decisions lead to investment in real assets

Dividends are pay-outs to shareholders. Dividends are paid to keep the shareholders happy. Dividend policy formulation requires the decision of the management as to how much of the profits earned will be paid as dividend. A growing firm may retain a large portion of profits as retained earnings to meet its needs of financing capital projects. Here, the finance manager has to strike a balance between the expectation of shareholders on dividend payment and the need to provide for funds out of the profits to meet the organization's growth.

**Financing Decisions:** Financing decisions relate to the acquisition of funds at the least cost. Here cost has two dimensions viz explicit cost and implicit cost.

Explicit cost refers to the cost in the form of coupon rate, cost of floating and issuing the securities etc.

Implicit cost is not a visible cost but it may seriously affect the company's operations especially when it is exposed to business and financial risk. For example, implicit cost is the failure of the organization to pay to its lenders or debenture holders loan installments on due date on account of fluctuations in cash flow attributable to the firm's business risk. In India if the company is unable to pay its debts, creditors of the company may use legal means to sue the company for winding up. This risk is normally known as risk of insolvency. A company which employs debt as a means of financing, normally faces this risk especially when its operations are exposed to high degree of business risk.

In all financing decisions a firm has to determine the proportion of equity and debt. The composition of debt and equity is called the capital structure of the firm.

Debt is cheap because interest payable on loan is allowed as deductions in computing taxable income on which the company is liable to pay income tax to the Government of India. For example, if the interest rate on loan taken is 12 %, tax rate applicable to the company is 50 %, then when the company pays Rs.12 as interest to the lender, taxable income of the company will be reduced by Rs.12.

In other words when actual cost is 12% with the tax rate of 50 % the effective cost becomes 6% therefore, debt is cheap. But, every installment of debt brings along with it corresponding insolvency risk.

Another thing notable in this connection is that the firm cannot avoid its obligation to pay interest and loan installments to its lenders and debentures.

On the other hand, a company does not have any obligation to pay dividend to its shareholders. A company enjoys absolute freedom not to declare dividend even if its profitability and cash positions are comfortable. However, shareholders are one of the stakeholders of the company. They are in reality the owners of the company. Therefore well managed companies cannot ignore the claim of shareholders for dividend. Dividend yield is an important determinant for stock prices. Dividend yield refers to dividend paid with reference to the market price of the shares of the company. An investor in company's shares has two objectives for investing:

1. Income from Capital appreciation (i.e. Capital gains on sale of shares at market price)
2. Income from dividends.

It is the ability of the company to give both these incomes to its shareholders that determines the market price of the company's shares.

The most important goal of financial management is maximisation of net wealth of the shareholders. Therefore, management of every company should strive hard to ensure that its shareholders enjoy both dividend income and capital gains as per the expectation of the market. But, dividend is declared out of the profit earned by the company after paying income tax to the Govt of India.

For example, let us assume the following facts:

Dividend = 12 % on paid up value

Tax rate applicable to the company = 30 %

Dividend tax = 10 %

When a Company pays Rs.12 on paid up Capital of Rs.100 as dividend, the profit that the company must earn before tax is:

Since payment of dividend by an Indian Company attracts dividend tax, the company when it pays Rs.12 to shareholders, must pay to the Govt of India

10 % of Rs.12 = Rs.1.2 as dividend tax. Therefore dividend and dividend tax sum up to  $12 + 1.2 = \text{Rs.}13.2$ .

Since this is paid out of the post tax profit, in this question, the company must earn:

Post-tax dividend paid (1 - Tax rate)	=	Pre-tax profit required to declare and pay the dividend
= $\frac{13.2}{1 - 0.3}$	=	$\frac{13.2}{0.7}$ = Rs. 19 approximate

Therefore, to declare a dividend of 12 % Company has to earn a pre tax profit of 19 %. On the other hand, to pay an interest of 12 % Company has to earn only 8.4 %. This leads to the conclusion that for every Rs.100 procured through debt, it costs 8.4 % where as the same amount procured in the form of equity (share capital) costs 19 %. This confirms the established theory that equity is costly but debt is a cheap but risky source of funds to the corporates.

The challenge before the finance manager is to arrive at a combination of debt and equity for financing decisions which would attain an optimal structure of capital. An optimal structure is one that arrives at the least cost structure, keeping in mind the financial risk involved and the ability of the company to manage the business risk. Besides, financing decision involves the consideration of managerial control, flexibility and legal aspects. As such it involves quite a lot of regulatory and managerial elements in financing decisions.

**Organization of Finance Function:** Financial decisions are strategic in character and therefore, an efficient organizational structure is required to administer the same. Finance is like blood that flows throughout the organization. In all organizations CFOs play an important role in ensuring proper reporting based on substance to the stake holders of the company. Because of the crucial role these functions play, finance functions are organized directly under the control of Board of Directors. For the survival of the firm, there is a need to ensure both long term and short term financial solvency. Failure to achieve this will have its impact on all other activities of the firm.

Weak functional performance by financial department will weaken production, marketing and HR activities of the company. The result would be the organization becoming anemic. Once anemic, unless crucial and effective remedial measures are taken up, it will pave way for corporate bankruptcy.

CFO reports to the Board of Directors. Under CFO, normally two senior officers manage the treasurer and controller functions.

**A Treasurer performs the following function:**

1. Obtaining finance.
2. Liasoning with term lending and other financial institutions.
3. Managing working capital.
4. Managing investment in real assets.

**A Controller performs:**

1. Accounting and Auditing
2. Management control systems
3. Taxation and insurance
4. Budgeting and performance evaluation
5. Maintaining assets intact to ensure higher productivity of operating capital employed in the organization.

In India CFOs have a legal obligation under various regulatory provisions to certify the correctness of various financial statements and information reported to the stake holders in the annual reports. Listing norms, regulations on corporate governance and other notifications of Govt of India have adequately recognized the role of finance function in the corporate set up in India.

**Scope of Financial Management:** Financial management has a wide scope. According to **Dr. S. C. Saxena**, the scope of financial management includes the following **five 'A's**.

1. **Anticipation** : Financial management estimates the financial needs of the company. That is, it finds out how much finance is required by the company.
2. **Acquisition** : It collects finance for the company from different sources.
3. **Allocation** : It uses this collected finance to purchase fixed and current assets for the company.
4. **Appropriation** : It divides the company's profits among the shareholders, debenture holders, etc. It keeps a part of the profits as reserves.
5. **Assessment** : It also controls all the financial activities of the company. Financial management is the most important functional area of management. All other functional areas such as production management, marketing management, personnel management, etc. depends on Financial management. Efficient financial management is required for survival, growth and success of the company or firm.

**Interface between Finance and Other Business Functions**

**Finance and Accounting:** Looking at the hierarchy of the finance function of an organization, the controller reports to CFO. Accounting is one of the functions that a controller discharges. Accounting and finance are closely related. For computation of Return on Investment, earnings per share and of various ratios for financial analysis the data base will be accounting information. Without a proper

accounting system, an organization cannot administer effectively function of financial management. The purpose of accounting is to report the financial performance of the business for the period under consideration. It is historical in character. But financial management uses the historical accounting information for decision making. All the financial decisions are futuristic based on cash flow analysis. All the financial decisions consider quality of cash flows as an important element of decisions. Since financial decisions are futuristic, it is taken and put into effect under conditions of uncertainty.

Assuming the degree of uncertainty and incorporating their effect on decision making involve use of various statistical models. In the selection of these models, element of subjectivity creeps in.

**Finance and Marketing:** Many marketing decisions have financial implications. Selections of channels of distribution, deciding on advertisement policy, remunerating the salesmen etc have financial implications. In fact, the recent behaviour of rupee against US \$ (appreciation of rupee against US dollar), affected the cash flow positions of export oriented textile units and BPO's and other software companies. It is generally believed that the currency in which marketing manager invoices the exports decides the cash flow consequences of the organization if the company is mainly dependent on exports. Marketing cost analysis, a function of finance managers, is the best example of application of principles of finance on the performance of marketing functions by a business unit. Formulation of policy on credit management cannot be done unless the integration of marketing with finance is achieved. Deciding on credit terms to achieve a particular level of sales has financial implication because sanctioning liberal credit may result in huge bad debt, on the other hand a conservative credit terms may depress the sales. Credit terms also affect the investment in receivable, an area of working capital management. There is a close relation between inventory and sales. Co ordination of stores administration with that of marketing management is required to ensure customer satisfaction and good will. But investment in inventory requires the financial clearance because funds are locked in and the funds so blocked have opportunity cost of capital.

**Finance and Production (Operations):** Finance and operations management are closely related. Decisions on plant layout, technology selection, productions / operations, process plant size, removing imbalance in the flow of input material in the production / operation process and batch size are all operations management decisions but their formulation and execution cannot be done unless evaluated from the financial angle. The capital budgeting decisions are closely related to production and operations management. These decisions make or mar a business unit. We have examples to substantiate this. Failure to understand the implications of the latest technological trend on capacity expansions has cost even blue chip companies. Many textile units in India became sick because they did not provide sufficient finance for modernization of plant and machinery. Inventory management is crucial to successful operation management. But management of inventory involves quite a lot of financial variables.

**Finance and HR:** Attracting and retaining the best man power in the industry cannot be done unless they are paid salary at competitive rates. If an organization formulates & implements a policy for attracting the competent man power it has to pay the most competitive salary packages to them. But it improves organizational capital and productivity. Infosys does not have physical assets similar to that of Indian Railways. But if both were to come to capital market with a public issue of equity, Infosys would command better investor's acceptance than the Indian Railways. This is because the value of human resources plays an important role in valuing a firm. The better the quality of man power in an

organization, the higher the value of the human capital and consequently the higher the productivity of the organization.

Indian Software and IT enabled services have been globally acclaimed only because of the man power they possess. But it has a cost factor i.e. the best remuneration to the staff.

**Conflicts in Principles of Profit vs Value Maximisation:** Goals mean financial objective of a firm. Experts in financial management have endorsed the view that the goal of Financial Management of a firm is maximization of economic welfare of its shareholders. Maximization of economic welfare means maximization of wealth of its shareholders. Shareholders' wealth maximization is reflected in the market value of the firms' shares. A firm's contribution to the society is maximized when it maximizes its value. There are two versions of the goals of financial management of the firm:

**Profit Maximization:** In a competitive economy, profit maximization has been considered as the legitimate objective of a firm because profit maximization is based on the cardinal rule of efficiency. Under perfect competition allocation of resources shall be based on the goal of profit maximization. A firm's performance is evaluated in terms of profitability. Investor's perception of company's performance can be traced to the goal of profit maximization. But, the goal of profit maximization has been criticized on many accounts:

1. The concept of profit lacks clarity. What does the profit mean?

a) Is it profit after tax or before tax?

b) Is it operating profit or net profit available to share holders?

Differences in interpretation on the concept of profit expose the weakness of the goal of profit maximization

2. Profit maximization ignores time value of money because it does not differentiate between profits of current year with the profit to be earned in later years.

3. The concept of profit maximization fails to consider the fluctuation in the profits earned from year to year. Fluctuations may be attributable to the business risk of the firm but the concept fails to throw light on this aspect.

4. Profit maximization does not make clear the concept of profit as to whether it is accounting profit or economic normal profit or economic supernormal profits.

5. Because of these deficiencies, profit maximization fails to meet the standards stipulated in an operationally feasible criterion for maximizing shareholders wealth.

**Value or Wealth Maximization:** Wealth Maximization has, been accepted by the finance managers, because it overcomes the limitations of profit maximisation. Wealth maximisation means maximizing the net wealth of the Company's share holders. Wealth maximisation is possible only when the company pursues policies that would increase the market value of shares of the company.

Following arguments are in support of the superiority of wealth maximisation over profit maximisation:

1. Wealth maximisation is based on the concept of cash flows. Cash flows are a reality and not based on any subjective interpretation. On the other hand there are many subjective elements in the concept of profit maximisation.
2. It considers time value of money. Time value of money translates cash flows occurring at different periods into a comparable value at zero period. In this process, the quality of cash flows is considered critically in all decisions as it incorporates the risk associated with the cash flow stream. It finally crystallizes into the rate of return that will motivate investors to part with their hard earned savings. It is called required rate of return or hurdle rate which is employed in evaluating all capital projects undertaken by the firm. Maximizing the wealth of shareholders means positive net present value of the decisions implemented. Positive net present value can be defined as the excess of present value of cash inflows of any decision implemented over the present value of cash out flows associated with the process of implementation of the decisions taken. To compute net present value we employ time value factor. Time value factor is known as time preference rate i.e. the sum of risk free rate and risk premium. Risk free rate is the rate that an investor can earn on any government security for the duration under consideration. Risk premium is the consideration for the risk perceived by the investor in investing in that asset or security.

X Ltd is a listed company engaged in the business of FMCG (Fast Moving Consumer goods). Listed means the company's shares are allowed to be traded officially on the portals of the stock exchange. The Board of Directors of X Ltd took a decision in one of its Board meeting, to enter into the business of power generation. When the company informs the stock exchange at the conclusion of the meeting of the decision taken, the stock market reacts unfavourably with the result that the next days' closing of quotation was 30 % less than that of the previous day.

The question now is, why the market reacted in this manner. Investors in this FMCG Company might have thought that the risk profile of the new business (power) that the company wants to take up is higher compared to the risk profile of the existing FMCG business of X Ltd. When they want a higher return, market value of company's share declines. Therefore the risk profile of the company gets translated into a time value factor. The time value factor so translated becomes the required rate of return. Required rate of return is the return that the investors want for making investment in that sector.

Any project which generates positive net present value, creates wealth to the company. When a company creates wealth from a course of action it has initiated the share holders benefit because such a course of action will increase the market value of the company's shares.

#### **Superiority of Wealth Maximisation over Profit Maximisation**

1. It is based on cash flow, not based on accounting profit.
2. Through the process of discounting it takes care of the quality of cash flows. Distant cash flows are uncertain. Converting distant uncertain cash flows into comparable values at base period facilitates better comparison of projects. There are various ways of dealing with risk associated with cash flows.

These risks are adequately considered when present values of cash flows are taken to arrive at the net present value of any project.

3. In today's competitive business scenario corporates play a key role. In company form of organization, shareholders own the company but the management of the company rests with the board of directors. Directors are elected by shareholders and hence agents of the shareholders. Company management procures funds for expansion and diversification from Capital Markets. In the liberalized set up, the society expects corporates to tap the capital markets effectively for their capital requirements. Therefore to keep the investors happy through the performance of value of shares in the market, management of the company must meet the wealth maximisation criterion.

4. When a firm follows wealth maximisation goal, it achieves maximization of market value of share. When a firm practices wealth maximisation goal, it is possible only when it produces quality goods at low cost. On this account society gains because of the societal welfare.

5. Maximization of wealth demands on the part of corporates to develop new products or render new services in the most effective and efficient manner. This helps the consumers as it will bring to the market the products and services that consumers need.

6. Another notable features of the firms committed to the maximisation of wealth is that to achieve this goal they are forced to render efficient service to their customers with courtesy. This enhances consumer welfare and hence the benefit to the society.

7. From the point of evaluation of performance of listed firms, the most remarkable measure is that of performance of the company in the share market. Every corporate action finds its reflection on the market value of shares of the company. Therefore, shareholders wealth maximization could be considered a superior goal compared to profit maximisation.

8. Since listing ensures liquidity to the shares held by the investors, shareholders can reap the benefits arising from the performance of company only when they sell their shares. Therefore, it is clear that maximization of market value of shares will lead to maximisation of the net wealth of shareholders.

Therefore, we can conclude that maximization of wealth is the appropriate of goal of financial management in today's context.