VIDYA BHAWAN BALIKA VIDYA PITH

शक्ति उत्थान आश्रम लखीसराय बिहार

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Teacher name – Ajay Kumar Sharma

BUSINESS FINANCE

OBJECTIVES

Primary aim of financial management is to maximise shareholder's wealth, which is referred to as the wealth maximisation concept. The market price of a company's shares are linked to the three basic financial decisions which you will study a little later. This is because a company funds belong to the shareholders and the manner in which they are invested and the return earned by them determines their market value or price. It means maximisation of the market value of equity shares. Market price of equity share increase if the benefits from a decision exceed the cost involved. Thus, all financial decisions aim at ensuring that each decision is efficient and adds some value. Such value additions tend to increase the market price of shares.

Therefore, when a decision is taken about investment in a new machine, the aim of financial management is to ensure that benefits from the investment exceed the cost so that some value addition takes place. Similarly, when the finance is procured the aim is to reduce the cost so that the value addition is even higher.

In fact, in all financial decisions, major or minor, the ultimate objective that guides the decision-maker is that some value addition should take place so that the market price of equity shares is maximised. It can happen through efficient decision making. Decision-making is efficient if, out of various available alternative the best is selected.

FINANCIAL DECISIONS

In a financial context, it means the selection of best financing alternative or best investment alternative. Financial decision-making is concerned with three broad decisions which are as under:

Investment Decision

A firm's resources are scarce in comparison to the uses to which they can be put. A firm, therefore, has to choose where to invest these resources, so that they are able to earn the highest possible return for their investors. The investment decision, therefore, relates to how the firm's funds are invested in different assets.

Investment decision can be long- term or short-term. A long-term investment decision is also called a Capital Budgeting decision. It involves committing the finance on a long-term basis. For example, making investment in a new machine to replace an existing one or acquiring a new fixed asset or opening a new branch etc. These decisions are very crucial for any business since they affect its earning capacity over the long run. The size of assets, the profitability and competitiveness are all affected by the capital budgeting decisions. Moreover, these decisions normally involve huge amounts of investment and are irreversible except at a huge cost. Therefore, once made, it is often almost impossible for a business to wriggle out of such decisions. Therefore, they need to be taken with utmost care obviously. These decisions must be taken by those who understand them comprehensively. A bad capital budgeting decision normally has the capacity to severely damage the financial fortune of a business. Short term investment decisions (also called working capital decisions) are concerned with the decisions about the levels of cash, inventories and debtors. These decisions affect the day to day working of a business. These affect the liquidity as well as profitability of a business. Efficient cash management, inventory management and receivables management are essential ingredients of sound working capital management.

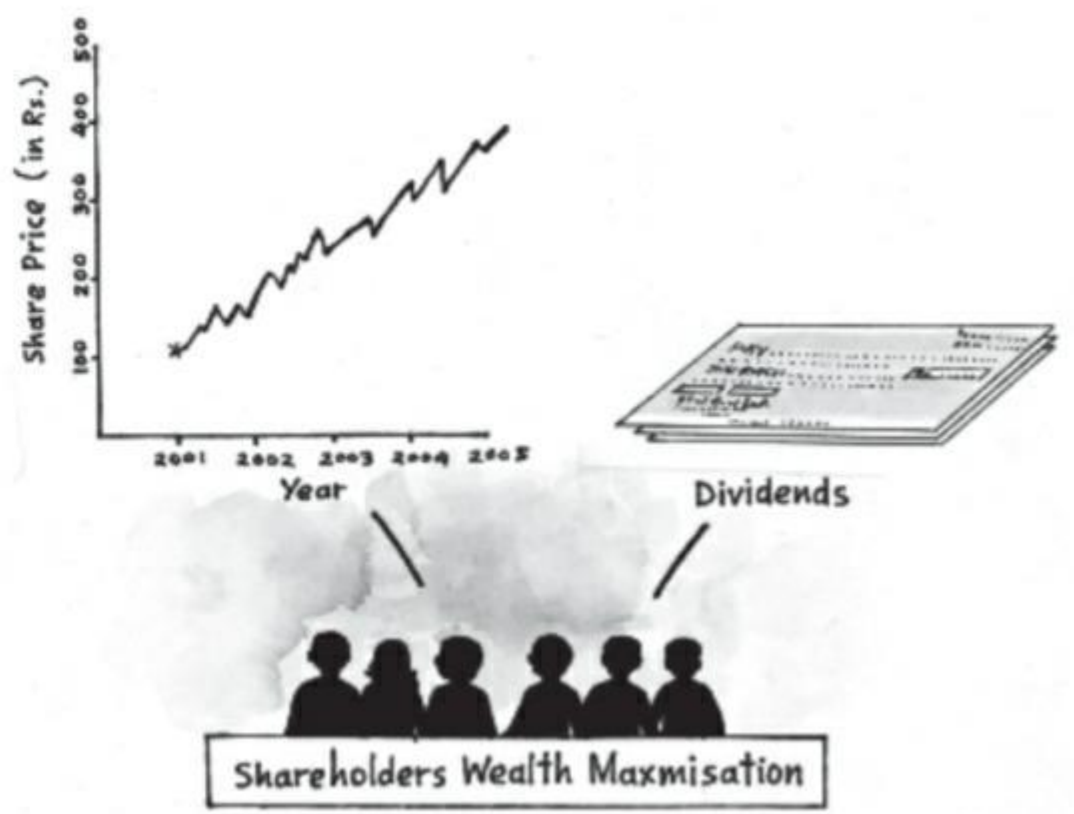
Factors affecting Capital Budgeting Decision

A number of projects are always available to a business to invest in. But each project has to be evaluated carefully and depending upon the returns, a particular project is either selected or rejected. If there is only one project then its viability in terms of the rate of return viz., investment and its comparability with the industry's average is seen. There are certain factors which affect capital budgeting decisions.

(a) Cash flows of the project: When a company takes an investment decision involving huge amount it expects to generate some cash flows over a period. These cash flows are in the form of a series of cash receipts and payments over the life of an investment. The amount of these cash flows should be carefully analysed before considering a capital budgeting decision.

(b) The rate of return: The most important criterion is the rate of return of the project. These calculations are based on the expected returns from each proposal and the assessment of risk involved. Suppose, there are two projects A and B (with the same risk involved) with a rate of return of 10 per cent and 12 per cent, respectively, then under normal circumstance, project B will be selected.

(c) The investment criteria involved: The decision to invest in a particular project involves a number of calculations regarding the amount of investment, interest rate, cash flows and rate of return. There are different techniques to evaluate investment proposals which are known as capital budgeting techniques. These techniques are applied to each proposal before selecting a particular project.



Wealth Maximisation Concept