



NEERAJ®

FUNDAMENTALS OF FINANCIAL MANAGEMENT

BCOE-143

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Based on

C.B.C.S. (Choice Based Credit System) Syllabus of

I.G.N.O.U.

& Various Central, State & Other Open Universities

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**Sample Preview
of the
Solved
Sample Question
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QUESTION PAPER

June – 2024

(Solved)

FUNDAMENTALS OF FINANCIAL MANAGEMENT

BCOE-143

Time: 3 Hours]

[Maximum Marks: 100

Note: Answer any five questions. All questions carry equal marks.

Q. 1. (a) Explain the concept of Risk and Return.

Ans. Ref.: See Chapter-1, Page No. 5, Q. No. 5.

(b) Explain time value of money with examples.

Ans. Ref.: See Chapter-2, Page No. 11, Q. No. 1 (SAQ).

Q. 2. XY Ltd. is considering investment in Machine Y for replacement of existing Machine X having a remaining life of 5 years, book value of ₹ 5,00,000 at present, salvage value NIL. However, Machine X can be sold presently at ₹ 2,00,000. The Machine Y has useful life of 5 years, Cost ₹ 10,00,000 and has NIL salvage value. The purchase of Machine Y to replace Machine X will generate an annual cost savings of ₹ 5,00,000 per annum over its useful life of 5 years. The company uses SLM of depreciation and is subject to tax rate 30%. Using NPV method, suggest the XY Ltd. as to whether it should replace Machine X by Machine Y, if the discount rate is 12%.

Ans. Step 1: Depreciation Calculation

- Machine X (existing machine):
- Book Value = Rs. 5,00,000
- Salvage Value = Rs. 0
- Life remaining = 5 years
- Depreciation per year

$$= \left(\frac{5,00,000}{5} = \text{Rs. } 1,00,000 \right)$$

- Machine Y (new machine):
- Cost = Rs. 10,00,000
- Salvage Value = Rs. 0
- Life = 5 years
- Depreciation per year

$$= \left(\frac{10,00,000}{5} = \text{Rs. } 2,00,000 \right)$$

Step 2: Tax Savings on Depreciation

The tax savings come from reducing taxable income by the depreciation amount:

- Tax savings on Machine X:
- Tax rate = 30%
- Tax savings = Rs. 1,00,000 × 30% = Rs. 30,000 per year
- Tax savings on Machine Y:
- Tax rate = 30%
- Tax savings = Rs. 2,00,000 × 30% = Rs. 60,000 per year

Step 3: Calculate After-Tax Cost Savings

Machine Y will result in cost savings of Rs. 5,00,000 per year. However, since these savings reduce taxable expenses, we must calculate after-tax savings:

- Annual cost savings before tax = Rs. 5,00,000
- After-tax cost savings = Rs. 5,00,000 × (1 – 30%) = Rs. 3,50,000

Step 4: Initial Investment

To calculate the net initial investment:

- Cost of Machine Y = Rs. 10,00,000
- Sale proceeds of Machine X = Rs. 2,00,000
- Net Initial Investment = Rs. 10,00,000 – Rs. 2,00,000 = Rs. 8,00,000

Step 5: Cash Flows for NPV Calculation

Now, we calculate the cash flows for the NPV calculation, which include:

- After-tax cost savings = Rs. 3,50,000 per year
- Tax savings on depreciation = Rs. 60,000 per year
- Combined annual benefit = Rs. 3,50,000 + Rs. 60,000 = Rs. 4,10,000 per year

For each year from 1 to 5, the cash flow is Rs. 4,10,000. We will discount each year's cash flow by the discount rate of 12% and then sum them.

Step 6: Present Value of Cash Flows

The present value (PV) of a cash flow is calculated as:

$$PV = \frac{\text{Cash Flow}}{(1 + r)^t}$$

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Where:

(*r*) = discount rate = 12% or 0.12

(*t*) = year number (from 1 to 5)

Let's calculate the present value of the cash flows for each year:

$$\text{Year 1: } \left(\frac{4,10,000}{(1 + 0.12)^1} = \frac{4,10,000}{1.12} = 3,66,071 \right)$$

$$\text{Year 2: } \left(\frac{4,10,000}{(1 + 0.12)^2} = \frac{4,10,000}{1.2544} = 3,26,868 \right)$$

$$\text{Year 3: } \left(\frac{4,10,000}{(1 + 0.12)^3} = \frac{4,10,000}{1.404928} = 2,91,849 \right)$$

$$\text{Year 4: } \left(\frac{4,10,000}{(1 + 0.12)^4} = \frac{4,10,000}{1.57351936} = 2,60,580 \right)$$

$$\text{Year 5: } \left(\frac{4,10,000}{(1 + 0.12)^5} = \frac{4,10,000}{1.76234069} = 2,32,661 \right)$$

Step 7: Total Present Value of Cash Inflows

Sum of all discounted cash flows:

$$\text{Total Present Value} = 3,66,071 + 3,26,868 + 2,91,849 + 2,60,580 + 2,32,661 = \text{Rs. } 14,78,029$$

Step 8: Calculate NPV

Finally, calculate NPV by subtracting the initial investment from the total present value of the inflows:

$$\text{NPV} = 14,78,029 - 8,00,000 = \text{Rs. } 6,78,029.$$

Q. 3. Define working capital. Explain the bases on which it can be classified.

Ans. Ref.: See Chapter-17, Page No. 161, Q. No. 1.

Q. 4. Define cost of capital with examples. Explain its relevance in decision making.

Ans. Ref.: See Chapter-9, Page No. 81, Q. No. 1.

Q. 5. Calculate operating leverage, financial leverage and combined leverage with the following information:

Sales	80,000 units
Selling price per unit	₹ 12.50
Variable cost	60%
Fixed costs	₹ 2,40,000
12% Debentures	₹ 5,00,000
Tax Rate	40%

Ans. To calculate the Operating Leverage (OL), Financial Leverage (FL), and Combined Leverage (CL), we need to go through the following steps:

1. Operating Leverage (OL): Operating leverage shows how sensitive the operating profit (EBIT) is to changes in sales. It is calculated as:

$$\text{Operating Leverage (OL)} = \frac{\text{Contribution}}{\text{EBIT}}$$

Where:

• Contribution = Sales – Variable Costs

• EBIT = Contribution – Fixed Costs

First, calculate the contribution:

• Sales per unit = Rs. 12.50

• Sales in units = 80,000 units

• Total Sales = 80,000 × Rs. 12.50 = Rs. 10,00,000

• Variable cost = 60% of sales

• Variable cost = 60% of Rs. 10,00,000 = Rs. 6,00,000

• Contribution = Sales – Variable Costs = Rs. 10,00,000 – Rs. 6,00,000 = Rs. 4,00,000

Now, calculate EBIT:

• Fixed Costs = Rs. 2,40,000

• EBIT = Contribution – Fixed Costs = Rs. 4,00,000 – Rs. 2,40,000 = Rs. 1,60,000

Now, we can calculate Operating Leverage:

$$\text{OL} = \frac{4,00,000}{1,60,000} = 2.5$$

2. Financial Leverage (FL): Financial leverage

shows how sensitive the net income is to changes in EBIT. It is calculated as:

$$\text{Financial Leverage (FL)} = \frac{\text{EBIT}}{\text{EBT}}$$

Where:

• EBT = EBIT - Interest on debt

First, calculate the interest on debentures:

• Debentures = Rs. 5,00,000

• Interest rate on debentures = 12%

• Interest on debentures = Rs. 5,00,000 × 12% = Rs. 60,000

Now, calculate EBT:

• EBT = EBIT – Interest = Rs. 1,60,000 – Rs. 60,000 = Rs. 1,00,000.

Now, calculate Financial Leverage:

$$\text{FL} = \frac{1,60,000}{1,00,000} = 1.6$$

3. Combined Leverage (CL): Combined leverage shows how sensitive net income is to changes in sales. It is the product of Operating Leverage and Financial Leverage:

Combined Leverage (CL) = OL × FL

$$\text{CL} = 2.5 \times 1.6 = 4.0$$

Q. 6. Explain with examples the Net Income and Net Operating Income Approach to Capital Structure.

Ans. Ref.: See Chapter-11, Page No. 100, 'Net Income Approach and Net Operating Income Approach'

Sample Preview of The Chapter

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FUNDAMENTALS OF FINANCIAL MANAGEMENT

Financial Management: An Overview

1

INTRODUCTION

The primary goal of every business entity, whether it operates in manufacturing or the service sector, is profit generation. Regardless of the type of business or activity, financial resources are consistently required. Effectively planning, directing, monitoring, organising, and controlling these financial resources is essential for their optimal utilisation. This is where the significance of a finance manager becomes evident. When financial resources are integrated with management functions, it gives rise to the field of financial management. In this chapter, we will explore the evolution of financial management, its characteristics, scope, objectives, the balance between risk and return, and the pivotal role played by a finance manager.

CHAPTER AT A GLANCE

EVOLUTION OF FINANCIAL MANAGEMENT

Money serves as a medium of exchange for various items, from assets and groceries to clothing. In contrast, finance refers to the strategic deployment of funds for investment, expecting returns. Financial management involves decision-making to manage money effectively. The evolution of financial management can be divided into three phases:

Traditional Phase (1900-1940): Primarily focused on procuring funds for an organisation, emphasising long-term sources and accounting aspects.

Transitional Phase (1940-1950): Shifted towards addressing day-to-day issues, planning, analysis, and control, with a growing emphasis on decision-making.

Modern Phase (1960 to present): Prioritises optimal utilisation of funds to maximise shareholders' wealth, involving rational decision-making by financial managers.

These phases have given rise to two approaches:

Traditional Approach: Concentrates on fund procurement.

Modern Approach: Incorporates fund procurement and its efficient utilisation.

NATURE OF FINANCIAL MANAGEMENT

Finance serves as the lifeblood of any business organisation, emphasising the critical need to efficiently

procure and employ funds. The financial functions revolve around addressing the fundamental questions of why, what, where, how, and when with regards to finances. Key components of financial management encompass planning, resource allocation, resource management, and control.

Ezra Solomon defines it as the efficient utilisation of capital funds, focused on issues surrounding fund utilisation and acquisition.

Weston and Brigham describe it as an area of financial decision-making, harmonising individual motives with enterprise objectives.

Phillipatun offers a broader perspective, relating it to managerial decisions regarding credit acquisition and financing for organisations.

Financial management entails making decisions that result in fund procurement and their optimal use, consisting of investment, financing, and dividend decisions.

Investment decisions: Investment decisions involve selecting assets for long-term or short-term use, known as capital budgeting and working capital management, respectively.

Financing decisions: Financing decisions determine the financing mix or capital structure, considering the balance between internal and external, long-term and short-term funds.

Dividend decisions: Dividend decisions involve evaluating whether to retain or distribute profits to shareholders, guided by various factors.

FINANCE AND OTHER RELATED DISCIPLINES

Finance broadly divides into two categories: Public Finance and Private Finance.

Public Finance: Public Finance pertains to government entities, whether at the central, state, or institutional levels, focusing on funds raised through taxes. Its primary goal is to address social and economic objectives rather than profit generation.

Private Finance: Private Finance encompasses personal, business, and non-governmental institution finances.

Financial Management and Economics: Macroeconomics encompasses the broader national or global environment affecting industries, including factors like

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government policies and economic conditions. This relates to financial management through banking systems, capital markets, monetary and fiscal policies, and economic factors.

Microeconomics, on the other hand, delves into the controllable internal aspects of organisations, such as size, ownership, and liquidity. The connection between financial management and economics becomes evident when analysing these aspects.

Financial Management and Accounting: Traditional financial management heavily focused on accounting, evolving to encompass decision-making. Financial management picks up where accounting leaves off, as it involves interpreting and using accounting data for informed decisions. For example, a firm's sales and cost data can be analysed from both an accounting perspective (Profit & Loss Account) and a financial perspective (Cash Flow Statement), demonstrating their interdependence.

OBJECTIVES OF FINANCIAL MANAGEMENT

The objectives of financial management serve as a guiding framework for optimal decision-making. There are two primary objectives:

Profit Maximization: Initially a primary goal, profit maximization aimed to maximise a firm's income. It doesn't define profits, earnings per share, ROI, or tax considerations. It raises concerns about financial health and social responsibility.

Pros: Efficient resource use, performance measure, societal interest, economic efficiency.

Cons: Vague, neglects profit timing, risks, time value, quality, and social responsibility.

Wealth Maximisation: This approach, now universally accepted, overcomes profit maximisation's limitations. It aims to maximise shareholders' wealth through profit maximisation, return on capital employed, earnings per share growth, market value of shares, optimal leverage, and minimising the cost of capital. Wealth maximisation considers risk, appropriateness, and the time value of money. It focuses on the market price of shares and calculates the net present worth of the firm.

Wealth maximisation guides the three key functions of financial management: investment, financing, and dividend decisions. However, in cases of short time frames and negligible risk, profit maximisation and wealth maximisation align closely. Nonetheless, wealth maximisation is the ultimate objective in modern financial management, encompassing a comprehensive view of financial decision-making.

RISK AND RETURN TRADE-OFF

Two primary factors dictate the pricing of a security, namely:

- (a) Risk
- (b) Return

It is commonly asserted that the greater the risk, the higher the potential return, emphasising the close relationship between risk and return. In financial management, a profound understanding of this concept is of paramount importance, as it serves as a

guiding principle for decision-making. Risk represents the degree of uncertainty and can be defined as the expected returns from an investment.

The rate of return from operations is typically determined by profit margins and turnover. Profit margins can be increased by (a) raising sales, which should surpass operating expenses, or (b) reducing operating expenses relative to sales. Turnover can be boosted by increasing sales more than operating assets or by reducing operating assets more than sales. Thus, a delicate balance must be maintained to maximise the owner's profit while considering the variability of returns.

ROLE OF FINANCE MANAGER

A finance manager's role involves two key areas: Major functions (capital estimation, fund procurement, allocation, asset management, financial control) and other functions (inventory management, investment evaluation, financial negotiations, share price monitoring). They oversee financial decisions, budgets, liquidity, and risk assessment, aiming to meet funding needs. Challenges include adding shareholder value, understanding investor psychology, market risk management, and demonstrating interpersonal skills. These challenges intensify the demanding and multifaceted nature of the role.

CHECK YOUR PROGRESS

Q. 1. List the phases in evolution of financial management.

Ans. The phases in evolution of financial management are:

(a) The Traditional Phase (1900-1940): During this era, finance primarily revolved around securing funds using various methods such as loans, shares, and debentures. The primary concern was meeting the organisation's financial needs. Emphasis rested on long-term financing sources and accounting practices. This phase persisted for approximately four decades but gradually lost relevance as it lacked decision-making elements, paving the way for the evolution of financial management.

(b) The Transitional Phase (1940-1950): Similar to the traditional phase, this period still dealt with day-to-day financial issues but placed a greater emphasis on planning, analysis, and control. Slowly, decision-making processes started gaining importance during this phase, setting the stage for the modern phase.

(c) The Modern Phase (1960 to the present): Extending the foundation laid by the traditional phase, this period centres on optimising the utilisation of acquired funds. It places a strong focus on maximising shareholders' wealth, introducing a logical and rational approach driven by financial managers' decision-making capabilities. This phase represents a significant shift towards a more strategic and comprehensive understanding of financial management.

Q. 2. What are the different kinds of finance functions?

Ans. Finance functions in an organisation encompass various activities that are crucial for

FINANCIAL MANAGEMENT: AN OVERVIEW / 3

managing its financial resources effectively. The different kinds of finance functions typically include:

Financial Planning: This involves setting financial objectives, estimating future financial needs, and creating a plan to meet those needs. It includes budgeting, forecasting, and developing financial strategies.

Cash Management: This function ensures that the organisation maintains adequate liquidity to meet its short-term financial obligations while optimising the use of cash resources to generate returns.

Working Capital Management: Working capital management involves managing the day-to-day operating liquidity, which includes managing inventory, accounts receivable, and accounts payable to ensure smooth operations.

Financial Reporting: Preparing accurate and timely financial reports for internal and external stakeholders is essential. It includes creating financial statements like the balance sheet, income statement, and cash flow statement.

Tax Planning and Management: Finance functions also encompass planning and managing taxes effectively to minimise tax liabilities while ensuring compliance with tax laws and regulations.

Cost Management: Managing costs efficiently is essential for profitability. Finance functions involve analysing and controlling costs across various aspects of the organisation's operations.

Financial Control: This involves establishing internal controls, policies, and procedures to safeguard assets, prevent fraud, and ensure compliance with financial regulations.

Dividend Policy: Deciding on the distribution of profits to shareholders in the form of dividends versus retaining earnings for reinvestment is an important finance function.

Corporate Finance: Corporate finance deals with the financing decisions of the organisation, including raising capital through debt or equity, managing capital structure, and making investment decisions.

Financial Strategy: Developing and implementing a financial strategy that aligns with the organisation's overall strategic goals and objectives.

Q. 3. How is Financial Management related to:
(i) Economics

(ii) Accounting

Ans. Financial Management is closely related to both Economics and Accounting, as these disciplines provide the foundation and framework for effective financial decision-making within an organisation.

(i) **Relationship with Economics:** Financial Management and Economics share a deep connection, as they both address the allocation of scarce resources. Macroeconomics, which examines the broader economic environment at the national or global level, plays a crucial role in financial management. Factors like government policies, interest rates, inflation rates, and overall economic conditions directly impact financial decisions. Financial managers must consider these external economic factors when making investment, financing, and dividend decisions.

Microeconomics deals with the internal environment of an organisation. It focuses on factors within a company's control, such as production costs, pricing strategies, and market competition. Financial managers apply microeconomic principles when analysing investment opportunities, setting pricing strategies, and managing costs to maximise profitability.

(ii) **Relationship with Accounting:** Accounting is the language of business, and financial management heavily relies on accounting information for decision-making. Accounting provides essential financial data, including income statements, balance sheets, and cash flow statements. Financial managers use this data to assess the financial health of the organisation. Financial managers analyse accounting information to evaluate performance, assess liquidity, profitability, and solvency, and make informed decisions based on these analyses. Financial management often begins with budgeting and forecasting, which involves using historical accounting data to predict future financial needs and plan accordingly. Accounting data helps financial managers make decisions regarding capital budgeting, financing, and dividend policies. It provides the basis for evaluating the financial implications of various choices.

Q. 4. Mention the functions of a finance manager.

Ans. The functions of a finance manager can be categorised into two main areas:

- (a) Major Functions
- (b) Other Functions

Major Functions include	Other Functions encompass
<ul style="list-style-type: none"> • Estimation of capital requirements • Procurement of the necessary funds • Allocation of funds • Management of current assets • Financial control 	<ul style="list-style-type: none"> • Maintaining an optimum level of Inventory and receivables • Evaluation of investments • Financial negotiations • Monitoring share prices

Q. 5. What is wealth maximisation?

Ans. Wealth maximisation surpasses the limitations of profit maximisation by aiming to enhance shareholders' wealth. It achieves this through various

means, including maximising profits, optimising return on capital employed, fostering growth in earnings per share, increasing the market value of shares, optimising leverage, and minimising the cost

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of capital. Wealth maximisation takes into account factors such as risk, appropriateness, and the time value of money. It places a strong emphasis on the market price of shares and calculates the net present value of the firm. Wealth maximisation serves as a guiding principle for the three fundamental functions of financial management: investment decisions, financing decisions, and dividend decisions. While in situations involving short timeframes and minimal risk, profit maximisation and wealth maximisation may align closely, wealth maximisation remains the ultimate goal in contemporary financial management. It embodies a holistic approach to financial decision-making.

SELF-ASSESSMENT QUESTIONS

Q. 1. Distinguish between 'Money' and 'Finance'.

Ans. 'Money' and 'Finance' are two related but distinct concepts in the field of economics and finance. Money refers to the physical or digital medium of exchange that is widely accepted in transactions for goods and services. Money includes currency notes, coins, and digital representations of currency like bank deposits. Finance encompasses a broader concept that deals with the management of money, assets, liabilities, and investments. Finance involves the allocation, acquisition, and utilisation of funds to achieve financial goals and optimise resources. Money primarily serves as a medium of exchange, a unit of account, a store of value, and a standard of deferred payment. It facilitates transactions and serves as a common measure of value. Finance involves the strategic planning and management of funds. Finance includes activities such as budgeting, investing, borrowing, lending, and financial analysis to achieve various financial objectives.

Scope: Money is a subset of finance and is primarily concerned with the actual currency and liquid assets used in daily transactions. Finance encompasses a wider spectrum, including money but also covering capital markets, financial institutions, investment decisions, and risk management. Money is used for day-to-day transactions, payment of bills, and satisfying immediate financial needs. Finance is concerned with both short-term and long-term financial planning and decision-making, which can include investments, savings, and wealth management.

Examples of money include cash in hand. Examples of finance-related activities include investing in stocks, bonds, managing a company's budget, or securing a loan for a home purchase.

Q. 2. What is Financial Management?

Ans. Financial management is a vital aspect of business and personal financial planning that involves the strategic planning, control, and optimization of financial resources to achieve specific financial goals and objectives. It encompasses a wide range

of activities and decisions related to the acquisition, allocation, and utilisation of funds and resources.

Key components of financial management include:

Financial Planning: This involves setting financial goals, developing a financial plan, and establishing a roadmap for achieving those goals. It includes forecasting financial needs and evaluating various options for meeting those needs.

Budgeting: Creating a budget is a fundamental aspect of financial management. It involves estimating income and expenses over a specified period, which helps in controlling spending, allocating resources efficiently, and ensuring financial stability.

Investment Management: Decisions related to investments in assets such as stocks, bonds, real estate, and other financial instruments are critical in financial management. This includes assessing risk tolerance and determining the best investment strategies to achieve financial objectives.

Risk Management: Identifying and managing financial risks is crucial. This may involve purchasing insurance, diversifying investments, or implementing strategies to mitigate risks associated with economic, market, or business factors.

Capital Structure Management: For businesses, determining the optimal mix of debt and equity to finance operations and growth is a key consideration in financial management. This decision affects the cost of capital and overall financial stability.

Cash Flow Management: Ensuring a healthy cash flow is essential for both individuals and businesses. Proper management of cash flow involves monitoring inflows and outflows of funds to ensure there is enough liquidity to cover expenses and meet financial obligations.

Financial Analysis and Reporting: Regularly assessing financial performance through financial statements and reports is a critical part of financial management. It helps in evaluating the success of financial strategies and making informed decisions.

Dividend Policy: For businesses, determining the distribution of profits to shareholders is an important financial decision. This involves deciding how much of the earnings will be retained for reinvestment and how much will be paid out as dividends.

Tax Planning: Efficient tax planning is essential to minimise tax liabilities while remaining compliant with tax laws. This includes taking advantage of available deductions and tax credits.

Financial Control: Establishing financial controls and internal procedures is crucial to prevent fraud, mismanagement, and financial irregularities. This