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CHAPTER 9

FINANCIAL MANAGEMENT

FINANCIAL MANAGEMENT

MEANING

Financial Management is concerned with optimal procurement as well as the usage of finance.

In the words of J L Massie, ‘Financial Management is the operational activity of a business that are responsible for obtaining and effectively utilizing the fund necessary for efficient operations.

OBJECTIVES

1. Financial Management aim at reducing cost of fund procured, keeping risk under control and achieving effective deployment of such funds

2. It also aim at ensuring availability of enough fund whenever required as well as avoiding idle finance.

ROLE OF FINANCIAL MANAGEMENT

The financial management has the following role to play:

1. Determination of Fixed Assets: - **Fixed assets have an important contribution in the profit of the business concern. Under financial management, the total investment in the fixed assets and every separate fixed asset is determined. This is done through capital budgeting decision.**

2. Determining of Current Assets: - **Current assets are needed in day to day transaction. Under Financial management, the total investment in current assets and every separate asset is determined.**

3. Determination of proportion of Short term and Long term finance: - **All the financial needs of business are fulfilled through long term and short term source. Under financial management, a**

proportion of both the financial source is determined on the basis of liquidity & cost analysis.

4. Determination of proportion of various source of long term finance: - **Long term financial sources include equity share capital, preference share capital, retained earnings, debenture, long term Loans etc. Under financial management, the proportion of various long term sources is determined.**

5. **Determination of various items of profit & loss account get influenced or affected by different financial decision.**

FINANCIAL DECISIONS

Financial management is concerned with the solution of three major issues relating to the financial operations of a firm investment, financing and dividend decision.

1. Investment decision.

It refers to the selection of assets in which funds will be invested by the business. Assets which are obtained business are of two types i.e. long the term assets and Short term assets.

(i) Long term investment Decision- This is referred to as capital budgeting decision. It relates to investment in long term assets.

(ii) Short term investment Decision: - This is referred to as Working Capital Management. It relates to the investment assets such as in short term assets such as cash, stock, debtors etc.

FACTORS AFFECTING LONG TERM INVESTMENT DECISION CAPITAL BUDGETING DECISION

(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.

(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 the risk involved.

(c) The investment criteria involved: - These may be many criteria of the investor while investing in the long term assets. These are funds involved rate of return, Cash flow.

B SHORT TERM INVESTMENT DECISION

This decision is related to the working capital management. Keeping of adequate amount of working capital at all the times in the business is called management of working capital. Thus, the objectives of management of working capital is to determine optimum amount of both the current assets and current liabilities so that profitability of the business remains intact and there is no fall in liquidity.

2. FINANCING DECISION

It refers to the determination as to how the total fund required by the business will be obtained from various long term source. Long term financial sources chiefly includes equity share Capital, Preference share capital, retained earnings, debentures, long term loans etc. An analysis of the cost and benefit of all the sources is made.

FACTORS AFFECTING FINANCING DECISIONS

(1) Cost: - The cost of raising funds through different sources are different. A prudent financial manager would normally opt for a source which is the cheapest.

(2) Risk: - The risk associated with different sources are different. E.g. Debt capital is most risky and from the point of view of risk it should not be used.

(3) Floatation Costs: - Higher the floatation cost, less attractive the source. From the point of floating costs, retained earnings is the most appropriate source.

(4) Cash Flow Position of the Company: - A stronger cash flow position may make debt financing more viable than funding through equity.

3. DIVIDEND DECISION

Dividend is that portion of profit which is distributed to shareholders. The decision involved here is how much of the profit earned by company and is to be distributed to the shareholders and it should be retained in the business for meeting the investment requirement.

FACTOR AFFECTING DIVIDEND DECISION

1. Earning: - Dividend are paid out of current or past earning.

2. Stability of Earning- A Company having stable earning is in position to declare more dividend. A company having unstable earning is likely to pay smaller dividend.

3. Stability of dividends - It has been found that the companies generally follow a policy of stabilising dividend per share. The increase in dividend is generally made when there is confidence that their earning potential has gone up and not just the earning of the current year.

4. Growth opportunities- Companies having good growth opportunities retain more money out of their earning so as to finance the

required investment. The dividend in growth companies is smaller than that non growth companies.

5. Taxation policy: - The dividend decision, to some extent, depends on tax policy. If the tax rate on dividend is higher it would be better to declare less dividend and vice versa.

6. Contractual Constraints: - when a company receives finance in the form of debt. The debt providers can put a ban on the dividend.

OBJECTIVES OF FINANCIAL MANAGEMENT

Wealth Maximisation: - Primary aim of financial management in to maximize shareholder's wealth which is referred to as wealth maximisation concept. Wealth Maximisation means to increase the capital invested in the business by the shareholder.

The market price of a Company's shares are linked with three basic financial decision:

i. Optimum investment decision: - It means that he should take such decision regarding investment as are relatively more profitable.

ii. Optimum financing decision: - It means he should make such a mix of debt capital and share capital that has a minimum Cost of Capital.

iii. Optimum dividend decision: - It means that total profit of the company should be distributed among the shareholders in such a manner that they feel satisfied and at the same time Company also has sufficient reserve to meet its future requirements.

FINANCIAL PLANNING

Financial planning refers to predetermining the financial could be achieved. Financial planning implies forecasting financial needs of the organization and their suitable sources and to ensure their efficient utilisation.

PROCESS OF FINANCIAL PLANNING

Following decisions are included in financial planning process

1. Determination of Financial objectives

In the first stage, of Financial objectives of the organization are determined. Financial objectives are of two kind

a) Short term objectives: - It includes maintenance of adequate liquidity in the organisation.

b) Long term financial objectives: - It includes procurement of adequate finance from different sources so as to increase the efficiency of organization.

2. Determination of financial Policies

In the second stage of financial planning, financial policies are determined so that financial objectives could be achieved.

3. Determination of financial Procedure

In the third Stage of financial planning, financial procedures are determined. Procedures are clearer than policies.

OBJECTIVES OF FINANCIAL PLANNING

1. To Ensured timely availability of finance: - The first objective of financial planning is to make finance available in time. Under it, the Long term and Short term financial needs are anticipated and then the sources of availability of finance located.

2. Ensure balance of finance: It is always ensured that the balance of cash should neither be in excess nor short. The proper balance of cash in both these Situation is harmful.

IMPORTANCE OF FINANCIAL PLANNING

1. It takes to forecast what may happen in future under different business situations.

2. It helps in avoiding business shocks and surprises and helps the Company in preparing for the future.

3. It helps in coordinating various business functions. Such as sales, purchase, production finance etc.

4. It tries to link the present with the future

CAPITAL STRUCTURE

MEANING AND DETERMINANTS

MEANING OF CAPITAL STRUCTURE

Capital structure refers to the mix between owners and borrowed fund. It refers to the relative proportion of different sources of long term finance.

(i) Equity Share Capital

(ii) Borrowed capital

(iii) Preference Share Capital

(iv) Retained Profit &

(v) Current liabilities.

Debt Capital and Equity Share Capital: Cost and Risk

1. The Cost of debt capital is less than the equity Capital.

2. Debt Capital is cheaper but is more risky for a business because, payment of interest and return of principal is obligatory for the business.

DEBT CAPITAL AND PREFERENCE SHARE CAPITAL

Similarities.

1. The Company has to pay a definite rate of interest in the debt capital and a definite dividend in the preference share Capital.

2. Both these sources of Capital are less Costly or cheaper than the equity share Capital.

Dissimilarities

1. A Company has to make payment of interest on debt Capital whether it earns profit or losses. However, the dividend on Preference share Capital is paid only if the Company earns profits.

2. The company gets tax benefit in payment of interest on debt Capital. In the Contrary, the tax is calculated before the payment of dividend on the preference share capital is made. Hence, no tax benefit becomes available in this case.

FINANCIAL LEVERAGE AND FINANCIAL RISK

Financial leverage

The proportion of debt in the overall capital is called financial leverage.

Financial Risk

By using the fixed cost capital the burden of payment of fixed financial costs increases. In case of the adverse conditions the inability to pay the fixed financial cost, creates a risk which is called financial risk.

TRADING ON EQUITY

Trading in equity refers to the increase in profit earned by the equity shareholder due to the presence of fixed financial charges like interest.

SIGNIFICANCE OF TRADING ON EQUITY

Significance of trading on equity lies in the fact that if the earning more profit then it can increase the earning of the equity shareholders by making use of the fixed Cost Capital (i.e. debt capital and preference share Capital)

LIMITATIONS OF TRADING ON EQUITY

1 when the Company has regular earning.

2. When the earning of the company are higher than the rate of interest in debt or dividend on preference shares.

3. When the Company has sufficient fixed asset to offer as the security to the lender.

FACTOR AFFECTING THE CHOICE OF CAPITAL STRUCTURE

1. Cash Flow Position- while making a choice of the capital structure the future cash flow position should be kept in mind.

2. Interest Coverage ratio: The interest Coverage refers to the number of times earnings before interest and taxes of a company covers the interest Obligation. This may be calculated

ICR = EBIT / Interest

The higher the ratio, lower is the risk of Company failing to meet its interest payment obligations.

3. Debt service Coverage Ratio (DSCR):- Debt & service coverage Ratio take Care of the deficiencies referred to in the interest coverage ratio: A higher DSCR Indicates better ability to cash commitment and consequently, the Company's potential to Increase debt component in its Capital structure.

4. Return on investment (ROI): - The greater the return on investment of, a Company increases its Capacity to utilise more debt Capital.

5. Cost of debt: - A firm's ability to borrow at a lower rate increases its capacity, to employ higher debt. In case the rate of interest on the debt is less, more debt Capital Can be utilised and vice- versa.

6. Floatation Cost: - Process of raising also involves some cost. These Consideration may also affect the Choice between debt and equity and hence the Capital structure.

7. Risk Consideration: - Use of debt increases the financial risk of a business. Financial risk refers to a position when a Company unable to

meet its fixed financial charges i.e. interest payment, Preference dividend and repayment obligation.

SOME IMPORTANT DEFINITION

1. EARNINGS BEFORE INTEREST AND TAXES (EBIT)

EBIT is that profit of the business from which the payment of interest and tax remains to be deducted. It is also known as operating profit of business.

2. EARNINGS PER SHARE EPS

After the deduction of the interest and tax respectively out of EBIT, the balance left is known as EAIT. It is also known as EAT

EAT = Earnings available for equity shareholder / No. of Equity shares

FIXED AND WORKING CAPITAL

MEANING AND DETERMINANTS

Capital need of a business enterprise is divided mainly into two parts: (i) working Capital requirements and (ii) Fixed Capital requirement.

Working capital is required to purchase current assets and to make payment fox day-to- day expenses which are necessary to run the business: On the Other hand fixed capital is required to purchase fixed assets.

MEANING OF FIXED CAPITAL

Fixed Capital refers to that Capital which is used for the purchase of fixed assets, Such as land, building, machinery furniture etc. To earn income for a long time is the motive behind purchase of these assets and not to sell them off immediately.

FACTOR AFFECTING THE REQUIREMENT OF FIXED CAPITAL

1. Nature of business - Need of fixed Capital depends upon the nature of business. Usually nature of business is of two kinds: Manufacturing business and trading business. In case of manufacturing business, large investment is made in land, building, machinery etc. Thus, there is a need for large amount of fixed Capital. On the Contrary, in case of trading business in which finished goods are bought and sold less amount of fixed Capital is needed.

2. Scale of operations: - A larger creation operating at a higher scale needs bigger plant, more space etc. and therefore, requires higher investment in fixed assets when compared with the small organisation.

3. Choice of technique: - Some Organisations are capital intensive whereas other are labor intensive. A Capital Intensive organisation requires higher Investment in plant and machinery as it relies less on manual labour. The requirement of fixed Capital for such organisations would be higher labour intensive Organisations on the other hand require less investment in fixed assets. Hence there fixed Capital requirement is lower.

4. Technology upgradation: - In certain industries, assets become obsolete sooner. Consequently, their replacement became due faster. Higher investment in fixed asset, may, therefore, be required in such cases.

CAPITAL BUDGETING

MEANING OF CAPITAL BUDGETING.

Capital budgeting means the decision regarding investment in fixed assets that income yield for a long period. Such a decision are capital budgeting decision. This decision affect growth, profitability and risk of the business in the long run.

IMPORTANCE OF CAPITAL BUDGETING

The management of fixed Capital or investment or Capital budgeting decision are important for the following reasons.

1. Long-term growth and effect: - These decision have bearing on the long term growth. The funds Invested in long term assets are likely to yield return in the future.

2. Large amount of funds involved: - These decision results in a substantial portion of Capital funds being blocked in long-term projects. If these decision turn out wrong these occurs heavy loss of Capital which is a scarce resources.

3. Risk involved: - Capital budgeting decision are full of risk. First, these decision to a long period and as such expected profit for several years are to be anticipated. These estimates may turn out to be wrong. Second, because of heavy investment involved it is very difficult to change the decision once taken.

4. Irreversible decision: - These decision once taken, are not reversible without incurring heavy loses. Abandoning a project after heavy investment is made is quite Costly in terms of waste of funds.

WORKING CAPITAL

MEANING OF WORKING CAPITAL

Difference between current assets and current liabilities is called working capital.

It refers to the portion of capital invested in short term assets of a business. Current assets mainly includes

1. **Cash in hand/ Cash at bank**

2. **Stock (finished goods)**

3. **Bills receivable**

4. **Marketable securities**

5. **Raw material**

6. **Work in progress**

7. **Prepaid expenses**

8. **Debtors**

Current assets are expected to get converted into cash and cash equivalents within a period of one year. These provide liquidity to the business.

Current liabilities are those payment obligation which when they arise, are due for payment within one year; such as bills payable, creditors, outstanding expenses etc.

Net working Capital = Current Asset - Current liabilities.

Gross working Capital is aggregate of current assets.

FACTOR AFFECTING WORKING CAPITAL REQUIREMENT

1. Nature of business: - The basic nature of a business influences the amount of working Capital required. A trading organisation usually needs a lower amount of working Capital compared to a manufacturing Organisation.

2. Scale of operation: - For organisation which operates on a higher scale of operation, the quantum of inventory, debtor required is generally high. Such organisations, therefore, require large amount of working capital as compared to the organisation operates on a lower scale.

3. Business Cycle: - Different phases of business cycles affect the requirement of working Capital by a firm. In case of a boom, the sales as well as production are likely to be higher and therefore, higher amount of working capital is required. As against this, the requirement of working capital will be lower during period of depression as the sales as well as production will be low.

4. Seasonal factor: - Most business have some seasonality in their operations. In peak season, because of higher level of capacity activity, higher amount of working capital is required. As against this, the level of activity as well as the requirement for working Capital will be lower during the lean season.

5. Production cycle: - Production cycle means the time involved in converting raw material into finished product. The longer period, the more will be the time for which the capital remain blocked in the raw material and semi - finished products.

6. Cash Credit Allowed: - Those enterprises which sell goods on cash payment basis needs little working Capital. On the Contrary, those who provide Credit facilities to the customer’s needs more working Capital.

7. Availability of raw material: - Availability of raw material also influences the amount of working capital. If the enterprise makes use of such raw material which are available easily throughout the year, then less working capital will be required.