FINANCIAL MANAGEMENT

Introduction – Finance refers to money, cash or fund available to carry out business operations. It is the life blood of business. A business enterprise requires funds at different stages - to start a business, to operate and expand it.

Financial Management

"Financial management is considered to be the management of the finance function". It deals with planning, organizing, directing and controlling financial activities like procurement and utilization of funds and distribution of earnings to owners.

"Financial management deals with procurement of funds and their effective utilization in the business" – S.C. Kuchhal.

Role and Importance of Financial Management

All items in the financial statements (Balance Sheet and P/L Account) of a business are directly or indirectly affected by the financial management decisions, some of them are given below:

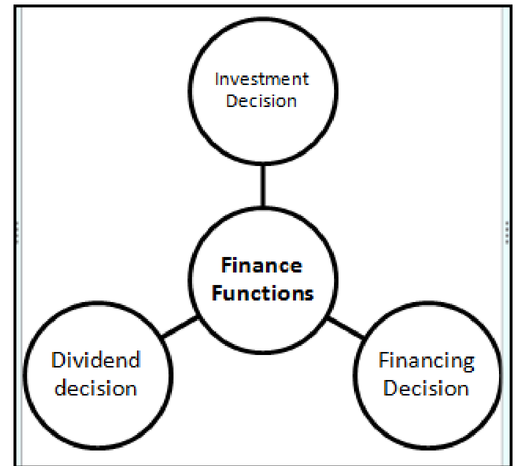
a. **The size and composition of fixed assets** – A decision to invest (capital decision) Rs. 100 crores in fixed assets would result in the increase of fixed capital.
b. **The amount of current assets** – Cash, inventory, accounts receivables etc. are also affected by the financial management decisions.
c. **Amount of long term and short term funds** – Financial management decisions will directly influence the availability of long term as well as short term funds in the business; it will affect the liquidity and profitability of the organizations.
d. **Debt – equity ratio –** Decisions regarding finance will determine the amount of debt, equity capital, preference capital etc.
e. **All items in the Profit and loss account –** Financial management decisions will affect all the items in P/L account also. For instance, if the organization is depending highly on borrowed funds, it may call for higher interest expense, which will result in poor profits.

Objectives of financial management

1. **Profit maximization-** The financial management should ensure maximum return on investment to the shareholders.
2. **Wealth maximization –** The ultimate objective of decision makers must be to increase the wealth of shareholders or investors.
   Wealth of owners = Number of shares held X market price per share

The financial management focuses on three major financial decision areas namely **investment, financing and dividend decisions**. They are collectively known as the finance functions of business.

Finance Functions (Financial Decisions)



1. **Investment Decision –** It is concerned with how firm's valuable funds are to be invested in various assets. It will include the following:
   - **a.** Long term investment decisions (capital budgeting decision) E.g., Purchasing a new machine, opening a new branch etc.
   - **b.** Short term investment decision (working capital decision) – related to the day to day working of a business. E.g., Level of cash in hand, inventory etc.

Factors affecting Capital Budgeting (Investment Decision)

- **a. Cash flow of the project –** The inflow and outflow of cash in the business should be considered before making capital budgeting decisions. Some projects will take a long period of time to start inflow of cash.
- **b. The rate of return –** While selecting a project, the rate of return must be considered. If two projects having 10% return and 15% return with almost equal risk, normally, the 2nd one may be selected.
- **c. Investment criteria involved –** Investment decisions must be based on certain capital budgeting techniques or calculations regarding the amount of investment, rate of return, interest rate, cash flow etc.

2. **Financing Decision –** it is concerned with the quantum of finance to be raised from various long term sources. They are shareholders' fund and borrowed fund such as shares, debentures, loans etc. But a proper mix of the above securities is very much essential for maintaining a good capital structure of the company.

Factors affecting financing decision

- **a. Cost –** Try to obtain the fund from cheaper sources.
- **b. Risk –** Risk factor in each source must be considered.
- **c. Flotation coast –** Cost of raising finance should be less.
- **d. Cash flow position –** A stronger cash flow position recommends more debt financing.
- **e. Fixed cost –** If fixed operating costs like rent, insurance premium, salaries etc. are high, it is better to reduce debt financing having fixed interest burden.
- **f. Control –** More dependence on owners fund will reduce control among the existing shareholders.
- **g. Capital market condition –** During rising trends in capital market, it is easy to accumulate shareholders fund, otherwise better to depend on borrowed fund.

3. **Dividend Decision –** It is concerned with the disposal of profits. Profits are required for different purposes. A portion of the profit is to be retained in the business for growth and expansion. That part of profit is called retained earnings and the rest of the profit is to be distributed to the shareholders in the form of dividends. Here is the role of financial management that, how much is to be retained and what would be distributed.

Factors affecting dividend decision

a. **Amount of earnings –** Dividend decision is always depend on the amount of profit during the current period.
b. **Stability of earnings –** Stable earnings promotes higher dividend.
c. **Stability of dividend –** It will improve the confidence of shareholders and higher reputation for the company.
d. **Growth opportunities –** Fewer dividends may be given to the investors if the company is having growth and expansion projects.
e. **Cash flow position –** Payment of dividend involves outflow of cash, therefore, enough cash must be available for the declaration of dividend.
f. **Shareholders' preference –** Normally, shareholders want to get regular income from their investment, hence at least a minimum dividend may be distributed every year.
g. **Taxation Policy –** If tax on dividend is higher, it is better to pay less by way of dividends. But the dividends are free of tax in the hands of shareholders as a dividend distribution tax is levied on companies. In the present tax policy, shareholders may demand higher dividend.
h. **Stock Market Reaction –** Investors generally evaluate the companies on the basis of their dividend declaration status. Higher the rate of dividend gives a positive impact in the market.
i. **Access to Capital Market –** Reputed companies generally have easy access to the capital market and therefore they may depend less on retained earnings to finance their growth. So that they may declare high rate of dividend than small companies.
j. **Legal Constraints –** While declaring dividends, the companies have to follow the restrictions laid down by Companies Act.
k. **Contractual Constraints –** While granting loans to a company, sometimes the lender may impose certain restrictions on the payment of dividends in future.

Financial Planning – When the process of planning employed in finance, it is called financial planning. It involves the estimation, procurement, utilization and administration of funds. Its objective is to ensure that enough funds are available at right time, but having no surplus funds*. It involves the following aspects*:

a. **Estimation of quantum of finance**
b. **Determining the pattern of financing –** proportion of various securities to be issued.
c. **Proper utilization of finance –** through effective policies and programs.

Types of financial planning

a. **Long term financial planning –** focuses on capital expenditure for long term growth and investment in business – usually 3 to 5 years.
b. **Short term financial planning –** in the form of budget – usually for a period of 1 year or less.

Objectives of Financial Planning

1. To ensure availability of funds whenever required – it includes estimation of funds for long term and short terms needs of the organization.

2. To ensure that the firm does not raise resources unnecessarily – it will help to minimize the loss due to idle fund in the organization.

Importance of financial planning

1. **Forecasting –** It helps the organization to foresee the future financial requirements in advance.
2. **Avoiding uncertainties –** Helps in meeting unexpected situations by arranging necessary funds.
3. **Coordination –** Helps to coordinate the activities of all departments in the organization by allotting them necessary funds in time.
4. **Reduces wastages –** Through proper planning about the financial requirements helps to reduce wastages and duplication of efforts.
5. **Easy evaluation –** It helps to evaluate the actual performance of the organization based on the plans formulated in advance.

Capital Structure

Capital structure refers to the mix or composition of long term sources of funds such as equity share capital, preference share capital, debentures, long term loans and reserves and surplus. In other words, it refers to the proportion of borrowed funds to owner's funds. *(It is a mix between owners' funds and borrowed funds).* Owners' funds are called **equity** and borrowed funds as **debt.**

The capital structure of a company consists any of the following forms:

1. Equity shares only.
2. Equity shares and preference shares.
3. Equity shares and debentures.
4. Equity shares, preference shares and debentures.
5. Equity, Preference, debentures and long term loans.

Financial Leverage – The proportion of debt in the capital structure is called financial leverage or capital gearing or trading on equity. When the proportion of owners' funds in capital structure is very small, it is said to be high geared, whereas if borrowed fund is less than equities, it is called a low geared company.

As the financial leverage increases (highly geared) the cost of funds declined and therefore more earnings per share, but the financial risks increases.

The impact of financial leverage on profitability:

Descriptions	Company A	Company B	Company C
No. Equity shares @ Rs.10	30,000	20,000	10,000
Equity Capital	3,00,000	2,00,000	1,00,000
10% Debentures (borrowed fund)	NIL	1,00,000	2,00,000
Total Capital	3,00,000	3,00,000	3,00,000
Profit @ 20% on investment	60,000	60,000	60,000
Interest on debentures	NIL	10,000	20,000
Net Profit	**60,000**	**50,000**	**40,000**
Earnings per share	2.00	2.50	4.00
Leverage	**Unlevered**	**Low**	**High**

Note: Income tax on profit is ignored.

Trading on equity – *It refers to the use of fixed income securities such as debentures and preference capital in the capital structure so as to increase the return on equity capital.* In other words, equity share holders get additional profits with the help of employing others fund. It is also known as **financial leverage or capital gearing.**

For example, A company raises Rs.50,000 through equity shares and earns a profit of Rs.5000. Here the rate of return is 10%. On the other hand, if the company raises Rs.40000 by way of 6% debentures and Rs.10000 through equity shares, the rate of return to equity shareholders is increased to 26% as follows:

Total Investment 40000 +10000	= 50,000
Total Profit	= 5,000
Interest on debentures 40000 * 6%	= 2,400
Balance of Profit to equity shareholders (5000-2400)	= 2,600
Rate of return on equity share capital (2600/10000*100)	= 26%

Factors Affecting the Choice of Capital Structure

1. **Cash flow ability for servicing the debt –** Servicing debts means paying interest and principal amount of loans as and when it is due for payment. If a debt is to be included in the capital structure, the company should estimate the future cash flow to ensure the coverage.
2. **Interest coverage ratio –** ICR refers to the number of times, earnings before interest and taxes (EBIT) covers the interest obligation. Higher the ratio means lower the risk for the company to pay off interest in time.

   $$\text{ICR} = \frac{\text{EBIT}}{\text{Interest}}$$
3. **Debt Service Coverage Ratio (DSCR) –** The cash profits generated from the operations must be enough to service the debts and preference share capital.
4. **Return on Investment (ROI) –** If ROI is higher than rate of interest for debt, borrowed fund can be increased in capital structure, otherwise, increase in equity portion is good.
5. **Cost of debt –** If the firm is able to borrow at a lower rate, it may prefer more debt than equity in capital structure.
6. **Tax rate –** Income tax liability can be reduced by employing borrowed funds in capital structure, as the interest on debt is a deductible expense.
7. **Cost of Equity –** When a company increases debt in their capital structure, the financial risk faced by the equity shareholders may increase, so that the company cannot use debt beyond a point.
8. **Floatation cost –** It is the cost incurred for floating (issue) securities such as brokerage, underwriting commission etc. It is generally less in case of debts.
9. **Risk Consideration –** A business has two types of risks; they are financial risk (to pay interest, preference dividend, repayment of debt etc.) and business risk (operating risk). It must be considered while choosing a suitable capital structure.
10. **Flexibility –** The capital structure should be capable of being adjusted according to the needs of changing conditions. To maintain flexibility, the company should maintain some borrowing power to take care of unforeseen circumstances.
11. **Control –** If the control of the management is to be retained, debt financing is recommended for raising additional fund.

12. **Regulatory Framework –** Rules and regulations framed by SEBI etc. must be considered while choosing a capital structure.
13. **Stock Market Conditions –** During depression in capital market, investors will prefer fixed interest bearing securities for safety and hence it is not advisable to issue shares that time. In a booming situation, issue of share will be more preferable.
14. **Capital Structure of other Companies –** Capital structure followed by other companies in the same industry may be adopted by considering whether they are in conformity with the industry norms or not.

Fixed Capital and Working Capital

Fixed Capital

Fixed capital represents a long term investment which needed to acquire fixed assets like land and building, plant and machinery, vehicles etc., benefits of which are expected to be received over a number of years in future.

Management of fixed capital – It refers to the allocation of firm's capital to different projects or assets which will have a long term implications in the business.

Importance of management of fixed capital

1. **Long term growth –** This capital is invested in fixed assets and long term projects, therefore, it will affect the future prospects of business.
2. **Large amount of funds involved –** A major portion of capital may be blocked in this areas, hence careful planning and detailed analysis is very essential in this segment.
3. **High risk –** Investment decisions involving huge capital outlay influence the overall performance of the business.
4. **Irreversible decision –** Once the decision to acquire a permanent asset is taken, it becomes very difficult to reverse that decision. It is possible but with huge losses.

Factors affecting the requirement of fixed capital

1. **Nature of Business –** The nature and character of business determine how much fixed capital is required. In a manufacturing concern fixed assets require huge investments.
2. **Scale of Operations –** Large scale business generally require huge investments in fixed capital than a small scale business organization.
3. **Choice of technique –** Highly mechanized and automated industries require large amount of fixed capital.
4. **Technology up gradation –** Assets in certain industries become obsolete sooner, this requires replacement faster which will demand more fixed capital, e.g., computers, mobile phone manufacturing equipments etc.
5. **Growth prospects –** Higher investment in fixed capital is necessary, if the organization is in the way of growth and expansion.
6. **Diversification –** When a firm diverts its operations to new segments, higher fixed capital requirement arises, e.g., ITC Company diverted its business to note books manufacturing along with their traditional item of cigarettes.
7. **Method of acquiring fixed assets (financing alternatives) –** If it is on hire purchase or lease system, less amount of investment is required for cash purchase.

8. **Collaboration –** By collaborating with other firms, the requirement of fixed capital can be reduced, e.g., establishment of ATM counters by cooperative banks by collaborating with certain scheduled banks.

Working Capital

Working capital is that part of capital required for investing in short term or current assets like inventory (raw materials, work in progress and finished goods), bills receivables, sundry debtors, cash required for day to day affairs like salaries, wages, rent, etc. There are two concepts of defining working capital as follows:-

i. Gross working capital = Total investment in current assets

ii. Net working capital = Current assets – Current Liabilities

Factors affecting Working Capital Requirements

A business concern must neither have excessive nor inadequate working capital. Both the situations are dangerous. Following are the factors influencing working capital requirements:

1. **Nature of business –** Concerns which do not keep very high stock of finished goods and sells on cash basis can manage with less working capital.
2. **Scale of Operations –** Generally big enterprises have to keep higher working capital.
3. **Business Cycle –** In boom period, the production and sales will be larger and hence huge amount of working capital is required. But in case of depression, it will be less.
4. **Seasonal Factors –** Industries that produce and sell seasonal goods require large amount of working capital.
5. **Production cycle –** Longer the period of manufacture, larger is the amount of working capital required.
6. **Credit allowed –** A liberal credit policy results in higher amount of debtors and thereby more working capital requirement.
7. **Credit availed –** If a business gets credit facility from its suppliers for goods, lesser would be the working capital requirement.
8. **Operating efficiency –** If cash, debtors and inventories are efficiently managed, working capital requirement can be reduced.
9. **Availability of raw materials –** If raw materials are available regularly without any shortage, less working capital is needed.
10. **Growth prospects –** If a firm is growing fast, it will require large amount of working capital to meet higher production and sales.
11. **Level of competition –** In case the competition is high, more shall be the stock of finished goods, this increases working capital requirement.
12. **Inflation –** Huge amount of working capital is needed at the time of inflation (price rises) to maintain a constant volume of production and sales.

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