

Chapter – IX

Financial Management

Business Finance -meaning

Money required for carrying out business activities is called business finance. Availability of adequate finance is very crucial for the survival and growth of a business.

Financial Management -meaning

Financial Management is concerned with **optimal** procurement as well as usage of finance. It aims at reducing the cost of funds procured, Keeping the risk under control and ensuring effective deployment of funds.

Importance of financial management



1. It helps in obtaining funds at minimum cost.
2. It ensures effective utilization of funds.
3. It helps in generating sufficient profits to finance expansion and modernization.
4. It secures a stable growth to the enterprise.
5. It ensures safety of funds through creation of reserves, re investments of funds etc.

The overall financial health of a business is determined by the quality of its financial management. Almost all items in the financial statements of a business are affected directly or indirectly through some financial management decisions. (B/S –Asset, Liability, Capital structure, P&L A/C, income& expenses). The future of a business depends on the quality of its financial management.

Objectives of financial Management

The primary objectives of financial management are to maximize the shareholders wealth. Shareholders wealth depends upon the market price of a company's equity shares. Market price of equity shares increases when the company's financial decisions add value.

In order to maximize the shareholders wealth, financial management must achieve the following specific objectives.

1. To procure sufficient funds at reasonable cost
2. To ensure effective utilization of funds
3. To ensure safety of funds
4. To plan optimum capital structure

Scope of financial Management

The three board financial decisions on which financial management is based are,

1. Investment decision.
2. Financing decision.
3. Dividend decision.

1. Investment Decision

The investment decision is concerned with how the firm's funds are to be invested in different assets. Investment decision may be long term or short term.

a) Long term investment Decision (Capital Budgeting Decision)

It involves commitment of funds for long period.(investments in fixed assets) E.g.: Acquiring new fixed asset(machinery) Opening a new branch etc.

Capital budgeting decisions are very important because these decisions affect the earning capacity over the long run. Moreover, these decisions cannot be reversed easily and it involve huge amount of investments.



b) Short term investment decision (Working Capital Decision)

These decisions are concerned with investment in current assets. It relate to the levels of cash, inventory and debtors. These will affect day to day working, liquidity and profitability of an enterprise.

2. Financing Decision

This decision is about the quantum of finance to be raised from various long term sources. Two main sources of funds are shareholders funds and borrowed funds. Shareholders' funds refer to equity capital and retained earnings. Borrowed funds refer to debentures, long term loan from banks etc. Thus financing decision is concerned with designing the capital structure. Financing decision determines the overall cost of capital and the financial risk of the enterprise.

3. Dividend Decision

This decision relates to the appropriation of profits earned, ie how much profit is to be distributed as dividend and how much of it is to be retained.

Financial Management					
Investment Decision		Financing Decision		Dividend Decision	
Capital Budgeting	Working Capital Decision	Equity	Debt	Dividend	Retained Earnings

Importance of Capital Budgeting Decision . (Investment Decision)

1. Long term effect on earning and growth
2. Large amount of funds
3. Huge risk
4. Irreversible decisions.

Factors Affecting Capital Budgeting Decision

1. Cash flows of the project

The cash inflows (receipts) and outflows (payments) over the life time of an investment (project) should be analyzed before taking the decision.

2. The rate of return

The expected rate of returns from each project should be considered. Other things being equal, the project that is expected to generate the highest rate of return is the best.

3. Degree of risk

The degree of risk involved in each project should be assessed before making investment.

4. The investment criteria involved

(Various techniques to evaluate investment proposals are applied to each proposal before selecting a particular project. Selection is based on calculations regarding the amount of investment, interest rate, cash flows etc.) By using various capital budgeting techniques (NPV, payback period etc) the financial manager evaluates total amount of investment, interest rate, cash flow etc. of each project.

Factors affecting financing decisions.



1. Cost (Cost of funds/ Cost of capital)

The cost of each type of finance is different. A financial manager would normally opt for a cheaper source of finance. (Debt is considered the cheapest source, because interest on debt is a tax – deductible expense)

2. Risk

The risk associated with each of the source is different. As far as possible the degree of risk should be low. The overall financial risk depends upon the proportion of debt in the total capital. (More debt – high risk)

3. Floatation Costs

It is the cost incurred for floating securities. It is generally less in the case of debt, when compared to equity.

4. Cash flow position of the company

If the cash flow position of a company is strong, it can employ more debt. It can service its debts more effectively.

5. Level of fixed operating costs

If a business has high level of fixed operating costs, lower debt financing is better.

6. Control Considerations

Issue of more equity may lead to dilution of management's control over the business. Companies afraid of a takeover bid may consequently prefer debt to equity.

7. State of Capital Market

During depression/recession people do not like to take risk and are not interested in buying equity shares. During boom, investors are ready to take risk and invest in equity shares.

Factors Affecting Dividend Decision

1. Growth opportunities

A company having good growing opportunities is likely to retain more earnings so as to finance the required investment.

2. Earnings



A company having large amount of stable earnings can pay more dividend

3. Stability of Dividend

Most companies generally follow a policy of stabilizing dividend per share. (This policy has a favorable impact on the market value of shares.

4. Cash flow position

Availability of enough cash in the company is necessary for declaration of dividend.

5. Access to Capital Market

If the funds can be raised from the capital market easily then the company can follow a liberal dividend policy.

6. Preference of shareholders

Shareholders preference should be given due consideration.

7. Taxation Policy

If tax on dividend is higher it would be better to pay fewer dividends

8. Stock Market reaction

Stock market prices generally react positively to increase in dividend.

9. Legal Constraints

Provisions of the Companies Act must be adhered to while declaring dividend.

10. Contractual Obligation

Dividends cannot violate the terms and conditions of the loan agreement made with a financial institution.

Financial Planning

Financial Planning means deciding in advance the financial activities to be carried on in order to achieve basic objectives of the firm. Financial Planning mainly concerned with estimating the fund requirement of a business and specifying the source of funds.

Twin Objectives of Financial Planning

1. To ensure availability of funds whenever these are required
2. To see that the firm does not raise resources unnecessarily

Importance of Financial Planning



1. It helps to forecast what may happen in future under different business situations. It makes the firm better prepared to face the future (growth in sales 10%, 20%, 25%, 30%)
2. It helps in coordinating various business functions such as sales and production by providing clear policies and procedures.
3. Detailed plans of action prepared under financial planning reduce waste, duplication of efforts and gaps in planning
4. Financial planning serves as the basis for financial control.
5. It helps in avoiding business shocks and surprises
6. It tries to link the present with future
7. It provides a link between investment and financing decisions.

Capital Structure

Capital structure refers to the mix or composition to long term sources of funds such as debentures long term debt, preference share capital, equity share capital and reserves and surplus. It refers to the mix between owners fund (equity) and borrowed fund (debt)

The financial manager should plan an optimum capital structure for his company. A capital structure is said to be optimum, when the proportion of debt and equity is such that it results in minimizing overall cost of capital and maximizing the value of the equity shares.

The proportion of debt in the overall capital is also called financial leverage. It is computed as debt/equity. As the financial leverage increases, the cost of funds declines because of increased use of cheaper debt, but the financial risk increases.

Trading on Equity [Capital Gearing]

Trading on equity is the use of long term fixed interest bearing debt and preference share capital along with equity share capital in the capital structure to enhance the return of equity shareholders

	I	II	II
Capital Equity	10,00,000	5,00,000	3,00,000
Debt (10%)	-----	500000	7,00,000
ROI	20%	20%	20%
EBIT	2,00,000	2,00,000	200000
Interest	-----	50,000	70000
EBT	2,00,000	150,000	130000
Tax (40%)	80,000	60000	52000
EAT	120,000	90000	78000
No. of shares(Rs.10)	1,00,000	50000	30000
EPS	1.2	1.80	2.6

It is clear from this example that, proposal III gives higher EPS (Earning Per share) due to the debt component in the total capital.

There are two conditions to use trading on equity

- a) The rate of interest should be less than the rate of return on investment [ROI > Rate of interest]
- b) The interest should be deductible from profit before tax.

Factors Affecting Capital Structure



1. Cash Flow Position

The capital mix is decided on the ability of the company to generate sufficient cash flows for

- i) Normal business operations
- ii). Investment in fixed assets
- iii) Service its debts (payment of interest and repayment of principal) if it is ok, then the company can employ more debt in the capital structure.

2. Interest Coverage Ratio (ICR).

It refers to the number of times earning (EBITS) of a company covers the interest obligation.

$$\text{ICR} = \frac{\text{EBIT}}{\text{Interest}}$$

Higher the reaction, lower, the financial risk

3. Debt Service Coverage Ratio (DSCR)

$$\text{DSCR} = \frac{\text{Profit After Tax} + \text{Non cash expenses}}{\text{Preference Dividend} + \text{Interest} + \text{Repayment Obligation}}$$

A higher DSCR indicates better ability to meet cash commitments. So company can employ more debt.

4. Return on Investment (ROI)

If the ROI of the company is higher, it can choose to use trading on equity to increase its EPS, its ability to use debt is greaten.

5. Cost of debt

Cost of debt is the rate of interest on debentures or loans. If it is low the company can employ more debt.

6. Tax Rate

If the tax rate is higher, the debt become more attractive because the interest on debt is a deductible expense.

7. Cost of Equity

Cost of equity means the expected rate of return on equity capital. When a company increases debt, the financial risk faced by the equity holders also increase consequently, their desired rate of return may increase.

8. Floatation Costs



Flotation costs are the costs involved in the issue of shares or debentures.

9. Risk consideration

Use of debt increase the financial risk of a business, Similarly, higher fixed operation costs results in higher business risk (operating risk).if a firms business risk is lower, its capacity to use debt is higher.

10. Flexibility

The capital structure should be in such a way that the company should be able to effect changes as and when required. Redeemable preference shares and debentures may add flexibility to the capital structure.

11. Control [Desire for control of existing share holders]

If the existing shareholders do not want to loose their control over the company affairs, they would prefer to issue preference shares and debentures to raise more funds.

12. Regulatory frame work

Every company should operate within the regulatory frame work provided by the Law [SEBI guide lines, RBI norms etc].

13. Stock Market Conditions

In depressions/recession, investors will prefer fixed interest bearing securities for safety and in booming situation, issue of shares will be more preferable.

14. Capital structure of others companies

Debt equity ratios of other companies in the same industry are a useful guideline for planning the capital structure.

Fixed Capital

Fixed capital refers to investment in long term assets.

Factors affecting the requirement of fixed capital

1. Nature of business

A manufacturing enterprise and a public utility concern require a large amount of fixed capital as compared to a trading concern.

2. Scale of operations (Size of business)



A large organization operation at a large scale requires higher investment in fixed assets.

3. Choice of techniques of production

A capital intensive organization requires higher investment in fixed assets as compared to labour intensive organizations.

4. Technology upgradation

Organization which use assets, which are speedily obsolete require higher fixed capital for their replacement.

5. Growth Prospects

Higher growth of an organization requires higher investment in fixed assets.

6. Diversification [Product diversification]

When a company chooses to diversity its operations, then it requires larger amount of fixed capital [Textile, steel, IT etc]

7. Financing Alternatives

Companies acquiring fixed assets on hire purchase or lease system require lesser amount of fixed capital as against cash purchase.

8. Level of collaboration

An enterprise can reduce the level of investment in fixed assets by sharing other firms facilities.

Eg: A bank using another banks ATM, sharing mobile towers

Working Capital

Working capital means the portion of capital investment in short term assets of a firm. Total amount of current assets is gross working capital. The excess of current assets over current liabilities is known as net working capital.

Factors affecting the working Capital requirement

1. Nature of Business

Business units which do not keep very high stock of goods and which sell goods on cash basis can manage with less working capital. [Trading/service industries require less working capital than manufacturing industries]

2. Scale of operations

Firms which operate on a large scale maintain more inventory and debtors and therefore require more working capital than small scale firms.

3. Business Cycle

During boom, higher amount of working capital is required. Sales and production are likely to be larger in boom.

4. Production cycle



The time interval between the receipt of raw material and their conversion into finished goods is called production cycle. Working capital requirement is higher in firms with longer production cycle.

5. Seasonal Factors

In the peak season, higher amount of working capital is required due to higher level of activity.

6. Credit allowed

A firm which offers liberal credit to its customers needs more working capital. (cash purchase and credit sale)

7. Credit availed

A firm which avails more credit from its suppliers requires less working capital.

8. Operating Efficiency

An enterprise that operates with high efficiency requires less working capital, because it can turnover its inventory and debtors more quickly.

9. Availability of raw materials

IF the raw materials are available freely and without interruption the firm has to invest less in the stock of materials.

10. Growth prospects

A firm with greater growth potential needs more working capital.

11. Level of competition

High level of competition may require higher stock of finished goods to meet urgent orders from customers.

12. Inflation

With rising prices, working capital requirement increases to maintain constant volume of production and sale.

