FINANCIAL MANAGEMENT

Contents as per CBSE syllabus

- Financial Management- Meaning, Factors affecting and objectives,
- Financial decisions: investment, financing and dividend- Meaning and factors affecting,
- Financial Planning- Meaning, Objective and importance,
- Capital Structure- Meaning and factors affecting capital structure,
- Fixed and Working Capital- Meaning, Importance and factors affecting their requirements.

MEANING

- Optimal procurement as well as the usage of finance,
- Aims at reducing the cost of funds procured, keeping the risk under control & achieving effective deployment of such funds,
- Ensuring availability of enough funds whenever required as well as avoiding idle finance.

FACTORS AFFECTING FINANCIAL MANAGEMENT

i). The size & the composition of fixed assets of the business.

ii). The quantum of current assets & its break up into cash, inventory & receivables.

iii). The amount of long-term and short-term funds to be used.

iv). Break-up of long term financing into debt-equity etc.

v). All items in the profit and loss account, Eg:- Interest, expense, depreciation, etc.

OBJECTIVES OF FINANCIAL MANAGEMENT

Primary aim is to maximise shareholder's wealth.

Ensure that benefits from the investment exceed the cost so that some value addition take place.

3 TYPES OF FINANCIAL DECISION :

- INVESTMENT DECISIONS
- FINANCING DECISIONS
- DIVIDEND DECISIONS

INVESTMENT DECISIONS :-

- Relates to how the firm's funds are invested in different assets,
- It can be long-term or short-term.

Capital Budgeting decision
(Long-term)

1. These decisions are very crucial as it affects earning capacity in long run,
2. Involves huge amount of investment & are irreversible except at a hige cost,
3. The size of assets, profitability & competitiveness are all affected.

Working-Capital decision
(Short-term)

1. Decision about the levels of cash, inventory & receivables,
2. Affect day-to-day working of business,
3. Affects the liquidity & as well as profitability of a business.

FACTORS AFFECTING CAPITAL BUDGETING DECISION :-

a). Cash flow of the project :-

- Cash flow are in the form of series of cash receipt & payments over the life of an investment,
- Amount of these cashflow should be carefully analysed.

b). The rate of return :-

- These calculations are based on the excepted returns from each proposal & the assessment of the risk involved.

A-10% B-12%

c). The investment criteria involved :-

- Invest in a particular project involves lot of calculations like amount of investment, ROI . interest rate, etc known as capital budgeting technique.

FINANCING DECISIONS :-

- Identification of various available sources,
- Sources are borrowed funds and shareholder's fund,
- The risk of default on payment is known as financial risk,
- The cost of each type of finance has to be estimated,
- The fund raising exercise costs floatation cost,
- Its the decision about how much to be raised from which source,
- This decision determine the overall cost of capital and financial risk of the enterprise.

FACTORS AFFECTING FINANCING DECISION :-

Cost

Prudent manager would opt for a cheapest source. (Debt)

Risk

With each source risk is different, Higher- Debt, Lower- Equity.

Floataion Cost

Higher cost, less attractive the source, Higher in Equity, Lower in Debt.

Cash Flow Position of the company

A stronger cash flow position make debt financing more viable than funding through equity.

State of capital market

When stock market is rising, invest in equity; Depressed capital market, issue of equity difficult.

Control considerations

Companies afraid of a takeover bid would prefer debt to equity, Issue of equity- Control dillution.

Fixed operating Cost

Increase in fixed operating cost, it must be reduced, (Eg:- Rent, premium, etc)
Higher fixed operating- Reduce financing cost,(Equity is better)
Low fixed operating- High debt cost.

DIVIDEND DECISIONS :-

- Dividend is that portion of profit which is distributed to shareholders,
- How much is to be distributed and how much should be retained,
- Dividend constitutes the current income re-investment as retained earning increases the firm's future earning capacity,
- The decision regarding dividend should be taken keeping in view the overall objective of maximising shareholder's wealth.

FACTORS AFFECTING DIVIDEND DECISION :-

Amount of earning

- Paid out of current & past earning.

Growth opportunities

- Companies having good growth opportunities retain more money out of their earnings so as to finance the required investment.

Taxation policy

- Tax on dividend high- Low dividend,
- Tax free income for shareholders & DDT levied on company.

Stability earning

- Stable- Higher dividends,
- Unstable earnings- Smaller dividends.

Cash flow position

- Payment of dividend involves outflow of cash,
- Availability of cash - Higher dividend.

Stock market reaction

- Increase in dividend- Positive stock market,
- Decrease in dividend- Negative stock market.

Stability of dividend

- Dividend per share is not altered, Increase in dividend- Confidence regarding earning potential..

Shareholder's preference

- If the shareholders is general desire that at least certain amount is paid as dividend, the companies are likely to declare.

Access to capital market

- Reputed companies easy access to the capital market, may depend less on retained earning to finance their growth.

Legal constraints

- Certain provisions of the companies Act place restriction on payment as dividend.

Contractual constraints

- Lender may impose certain restrictions on the payment of dividend,
- Ensure that dividend does not violate the terms of the loan agreement in this regard.

FINANCIAL PLANNING

- Aims at smooth operations by focusing on fund requirements & their availability in the light of financial decision,
- Preparation of a financial blueprint of an organisation's future operations.

OBJECTIVES

a). To ensure availability of funds whenever required :-

- Proper estimation of the funds required for different purposes & time at which the funds are to be made available,
- Also tries to specify possible sources of these funds.

b). To see that the firm does not raise resources unnecessary :-

- Excess funding will unnecessarily add to cost & may encourage wasteful expenditure,
- Financial planning includes short term & long term planning.

short term ↓ Budget

long term planning ↓ Capital expenditure

IMPORTANCE

i). Helps in forecasting what may happen in future under different situation & prepare for it.

ii). Helps in avoiding business shocks & surprise.

iii). Co- ordinating various business functions by providing clear policies & procedures.

iv). Reduce waste, duplication of efforts & gaps in planning.

v). It tries to link present with the future.

vi). Link between investment & financing decision.

vii). Makes evaluation of actual performance easier.

CAPITAL STRUCTURE

- Refers to the mix between owners & borrowed funds, these shall be referred as equity & debt,
- Debt / Equity ratio of other companies,
- The proportion of debt in the overall capital is called financial leverage computed as : $\frac{D}{E}$ OR $\frac{D}{D+E}$

FACTORS AFFECTING THE CHOICE OF CAPITAL STRUCTURE :-

Cash flow position

- Not only cover fixed payment obligation but also,

A). Normal business operations,
B). Investment in fixed assets,
c). Meeting debt service commitments.

Interest coverage ratio (ICR)

- Refers to number of times earning before interest & tax covers the interest obligation.
- Increase ICR - Lower risk.

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

Debt service coverage ratio

$$\frac{\text{Profit after tax + depreciation + interest + non-cash expenditure}}{\text{Pre dividend + interest + repayment obligation.}}$$

- Increase DSCR= Increase ability cash commitments, Results in Increase debt component.

Return on investment (ROI)

- Higher ROI :- Choose to use trading on equity to increase EPS, its ability to use debt is greater.

Cost of debt

- More debt can be used if debt can be raised at a lower rate.

Tax rate

- Interest is tax deductible expense, Higher tax rate makes debt cheaper & increase its attraction.

Cost of equity

- When a company increases debt, financial risk increase, Owners expect desired rate of return,
- Cost of equity may go up & share price may decrease inspite of increased EPS.

Floatation cost

- Process of raising resources involves some cost,
- Increase in Equity - Decrease in Debt.

Risk consideration

- There are financial risk & operating risk (also known as business risk)
- Use of debt increase financial risk.
- Capacity to use debt higher when business risk is lower.

Flexibility

- Maintain some borrowing power to take care of unforeseen circumstances,
- Flexibility increase- Equity,
- Flexibility decrease- Debt.

Control

- Debt not cause a dilution of control, Issue of Equity reduce the management's holding and make it vulnerable to takeover.

Regulatory framework

- Provided by the law,
- Eg:- Shares & debentures under SEBI guidelines.

Stock market condition

- Bullish- Shares are easily sold at higher price,
- Bearish- Raising of equity more difficult.

Capital structure of other companies

- Management must know which industry norms should be followed or deviated,
- Debt / Equity ratio of other companies.

FIXED CAPITAL

- Refers to investment in long - term assets,
- These decisions are called investment decisions or capital budgeting decision,
- It must be financed through long term source and never through short term sources,
- Involves allocation of capital to different projects or assets with long term implications for the business.

IMPORTANCE

Long term growth

The funds invested in long term assets are likely to yield returns in the future, these will affect future prospectus of the business.

Large amount of funds involved

Substantial portion of capital funds being blocked. Thus, planned after a detailed analysis.

Risk Involved

It affects the returns of the firm as a whole in the long term, Involves overall business risk complexion of the firm.

Irreversible Decisions

Not reversible without incurring heavy losses. Decision should be taken after carefully evaluating each detail or else adverse financial consequences may be very heavy.

Factors affecting the requirements of fixed capital

1). Nature of business

Trading-Lower investment, Manufacturing-Higher investment.

2). Scale of operations

Large organisation operating at a higher scale needs higher investment.

3). Choice of techniques

Capital intensive or labour intensive.

↓ Higher investment

↓ Less investment

4). Technology upgradation

Organisation which uses assets that are prone to obsolescence requires higher fixed capital to purchase such assets.

5). Growth prospects

Firm choose to create higher capacity in order to meet the anticipated higher demand quickly entails large investment.

6). Diversification

Diversifying its operations, increase capital requirements.

7). Financing alternatives

Low fixed capital as an alternative to out right purchase, such strategy is specially suitable in high risk lines of business.

8). Levels of collaboration

Sharing each other facilities, This is feasible if the scale of operations of each one of them is not sufficient to make full use of facility, Increase fixed capital requirement.

WORKING CAPITAL

- Invest in current assets,
- Facilitates smooth day to day operationjs of the business,
- Provides liquidity,
- Provides little or low return,
- Financial through short term sources, i.e., Current liabilities.

NWC= CA - CL

FACTORS AFFECTING THE WORKING CAPITAL REQUIREMENTS

1 Nature of business

- Trading organisation - Smaller amount,
- Manufacturing - Large amount, (involves processing)
- Service industry - Less working capital. (do not maintain inventory)

2 Scale of operations

- Higher scale - higher amount,
- Operate at low scale - Lower amount.

3 Business cycle

- Boom - Large amount,
- Depression - Lower.

4 Seasonal factors

- Peak season - Higher level activity, Larger amount,
- Lean season - Low level of activity..

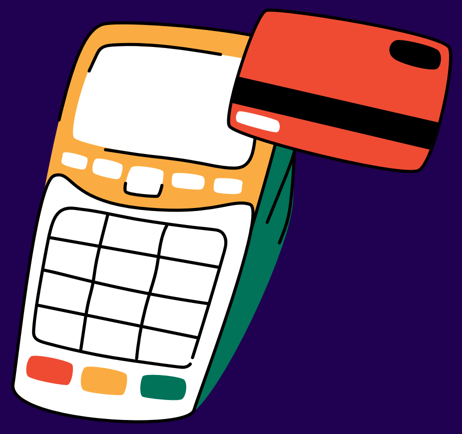
5 Production cycle

- Time span between the receipt of raw material & the conversion into finished goods.
- Longer production cycle - Larger amount,
- Shorter production cycle - Lower requirement.

6 Credit allowed

- Liberal credit policy - Higher requirement of working capital.

7 Credit availed

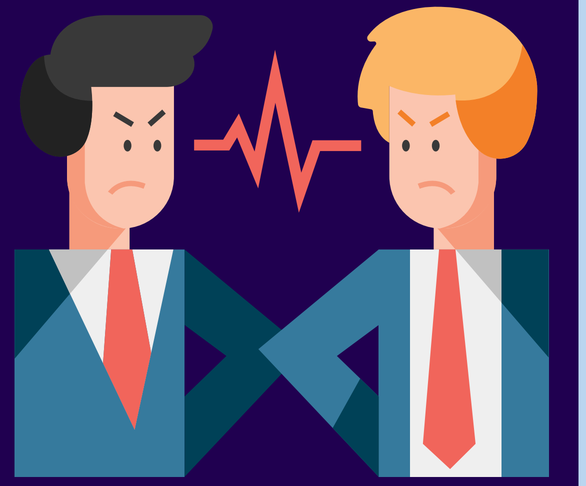


- The extent it avails - Requirement is required,
- Increase in credit availed- Low working capital.

9 Availability of raw material

- The time lag between the placement of order & the actual receipts of the material, (lead time)
- Larger the lead time - Larger working capital required.

11 Level of competition



- Higher level - Higher requirements.

8 Operating efficiency

- Higher inventory turnover ratio, Debtors turnover ratio resulting in lower requirement.

10 Growth prospects

- Growth potential is higher requires large amount.

12 Inflation

- Requires larger amount with rising prices.