

## CHAPTER – 9

### FINANCIAL MANAGEMENT

Finance is the life blood and nerve Centre of a business. Business needs money to make money. It is necessary to start, run, expand and modernize any organization. The success of every business depends on how funds are raised in right time, in right quantity, at the least cost and from right sources.

#### **Business Finance**

Money required for carrying out business activities is called business finance. Finance is essential for the commencement, existence and growth of the business. ‘Business Finance’ as an activity or a process which is concerned with acquisition of funds, use of funds and distribution of profits by a business firm. Thus business finance usually deals with financial planning, acquisition of funds, use and allocation of funds and financial controls.

#### **FINANCIAL MANAGEMENT**

Financial management is the management of finance in the organization. It means planning and controlling of financial activities in an organization. It involves all managerial activities concerned with acquisition and utilization of funds. It includes each and every aspect of financial activity in the business.

#### **Definitions**

“ Financial management is the application of the planning and control functions to the finance function”  
- Howard and Upton

“ Financial Management is an area of financial decision making, harmonizing individual motives and enterprise goals”  
-Westing and Brongham

Financial management involves the application of general management principles to financial operations. It deals with planning, organizing, directing and controlling financial activities.

#### **FEATURES OF FINANCIAL MANGEMENT**

- Financial management is concerned with procurement, allocation and utilization of funds in proper manner.
- It aims at maximizing profit and wealth of an organization
- Financial management is considered part of general management. In large organisations, it is function is performed by a special department called finance department. The chief of this department is known as Finance Manager.

## IMPORTANCE /ROLE OF FINANCE MANGEMENT

The importance of Financial Management is increasing day by day in all business enterprises irrespective of their size and nature. The future of a business depends on the quality of its Financial Management.

The financial statements like balance sheet and profit and loss account truly depict a firm's financial position and operations result. All most all items in the financial statements are affected directly or indirectly through financial management decisions. Some of the examples are listed below:

### 1. The size and composition of fixed assets

Excessive investment in fixed assets would result in increase in the size of fixed capital block

### 2. The quantum of current assets as well as its break up into cash, inventories and receivables:

An increase in the investment in fixed assets, the working capital requirement also increases. The quantum of current assets and its compositions are also influenced by the decisions taken by the financial management.

### 3. The proportion between long term and short term funds

Finance management includes the decision about the proportion of long term and short term finance. There is a choice between liquidity and profitability. More profitability leads to less liquidity. Financial managers consider the choice between liquidity and profitability.

### 4. Break up of long term financing into debt, equity etc.

Of the total long term finance, the proportions to be raised by way of debt and/or equity are also a financial management decision. The amount of debt, equity share capital, preference share capital is affected by the financing decision which is a part of financing management.

### 5. All items in profit and loss account : eg; interest, expense, depreciation etc. of the company is using more debt; it has to pay more interest in future. Similarly higher use of equity capital may lead higher payment of dividend.

Thus **financial management is indispensable** due to the following reasons.

1. It helps in acquiring fund and when required at the minimum possible costs.
2. It helps in financial planning
3. It ensures proper use and allocation of funds
4. It enables to improve profitability through financial control
5. It helps to take effective financial decisions

## OBJECTIVES OF FINANCIAL MANAGEMENT

### Profit maximization:

The financial management should ensure maximum return on investment to the shareholders. maximisation of the profit is the objective of every business. The company should earn sufficient profit to meet its expenses and also pay dividend to shareholders. Sufficient profit also required for expansion and modernization of enterprises.

## **Wealth maximization:**

Financial management involves the procurement and use of funds. The overall objectives of financial management are to provide maximum returns to the owners on their investments. This is called maximizing the wealth of owners. Wealth maximization means maximizing the **market value** of equity shares of the company.

**Wealth of equity Shareholders = Number of shares held X market price per share**

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

1. To ensure availability of sufficient funds at a reasonable cost ( Liquidity)
2. To ensure effective utilization of funds ( Financial control)
3. To ensure safety of funds by creating reserves, reinvesting profits etc. ( minimization of risk)

## **Financial decisions/Finance Functions**

Financial decision refers to decision concerning financial matters of a business firm. There are many kinds of financial management decision that the firm makes in pursuit of maximizing shareholders' wealth. Viz, kind of assets to be acquired, pattern of capitalization, distribution of firms' income etc. we can classify these decisions into three major group

1. Investment decisions 2. Financing decisions 3. Dividend decisions



1. Investment decisions: Investment decisions are decision related to the selection of assets in which funds will be invested by a firm. The investment decision relates to how the firm's funds are invested in different assets. Investment decision should be taken only after considering volume of requirements. Returns and risks involved with all these. For this purpose Finance manger analyses various alternatives available for investment and evaluate profitability and risks involved with each of it. Thus investment decisions are based on risk –return analyses

Generally two types of investment decisions are to be taken by Finance Manager. They are decision relating to long term investment and short term investment.

- a. **Long Term Investment decisions:** involve decisions to invest money on fixed assets to acquire them. Such decision is known as **management of fixed assets or Capitalexpenditure decision or capital budgeting**.
- b. **Short Term Investment Decisions** involve decision to invest money on current assets. ( cash, inventory, account receivables etc. ) .Such decision is known as **management of current assets or working capital management or liquidity decision**. This decision affect day to day working of business.

## **CAPITAL BUDGETING**

“ Capital budgeting is long term planning for making and financing proposed capital outlays”

-Charles . T. Horngren

The process of making capital budget is known is **capital budgeting**. Capital budget gives an estimate of the amount of capital required for acquiring fixed assets. Capital budget is the statement of expenditure on fixed assets or long term projects and the benefits of which are likely to acquire in future. Capital budgeting decisions are long term investment decisions.

It is highly important in times of

- Replacement of existing assets   \* Purchase of additional assets **Steps in capital budgeting**

1. Develop alternative projects for long term investment
2. Evaluate suitability and profitability of these investment projects
3. Selecting the best project for implementation
4. Allocating funds for such selected projects   (5) .Evaluation of the projects.

## **IMPORTANCE OF CAPITAL BUDGETING DECISIONS**

Capital budgeting decisions are important due to the following reasons

1. Capital budgeting decisions have long term implications for the firm because they affect the future profitability and growth of the firm.
2. Capital investment decision involves a heavy amount of funds. In most cases the decisions are irreversible and amount invested cannot be taken back without causing substantial loss.
3. Capital budgeting decisions are always intended to make future earnings. Such future earnings are the basis of future competitive strength of a firm

## **FACTORS AFFECTING CAPITAL BUDGETING DECISIONS( investment decisions)**

Every decision on capital budgeting has a long term impact on the business. Capital Budgeting involves investment of large amount of money. So capital budgeting requires careful evaluation on the viability of projects. Following factors need to be considered while taking a decision on capital budgeting.

1. **Cash flow of the project:** Investment in long term assets generates cash flows over a period. Cash flows can be cash inflows (receipts) or cash outflows (Cash payments).

These cash flows should be carefully analyzed and evaluated before making a capital budgeting decision.

2. **The rate of return:** Rate of return is the criteria for selecting a project. The company compares the return from different investment proposals. Suppose there are two alternative proposals –one with 10% return and the other with 12% return. Under normal circumstances the higher rate of return should be selected.
3. **The investment Criteria Involved:** A number of calculations are to be made with respect to amount of investment, interest rate, cash flows, rate of return etc. While making investment decision. Again different capital budgeting techniques used to evaluate investment proposals ( eg: NPV, IRR, payback period).

II. **FINANCING DECISIONS:** Financial decision is concerned with the functioning of business activities. There are a number of sources from which funds can be raised. Broadly there are two sources shareholders fund (owned fund) and borrowed funds. Owned funds consist of equity share capital, preference share capital and retained earnings. Borrowed funds include debentures, loans and public deposits.

The cost of each type of finance has to be estimated (Flotation cost). Some sources may be cheaper than others. Eg: Debt is considered to be the cheapest of all other sources. Tax deductibility of interest makes it still cheaper. But the debt has to be repaid after a fixed period of time. Interest on debt has to be paid irrespective of profit or loss. The risk of default of payment (Financial risk) is there. There is no such compulsion to pay any dividend on equity shares.

A Finance Manager has to select such sources of funds which will make optimum capital structure. A debt equity ratio should be fixed in such a way that it helps in maximizing the profitability of the concern. A judicious mix of both owned funds and borrowed funds has to be decided.

Generally there are two kinds of financing decisions

- (a) Total amount of capital to be collected through various sources ( capitalization)
- (b) The proportion of each source in the capitalization ( capital structure)

### **Factors affecting Financing Decisions**

Important factors affecting financing decisions are as follows

1. **Cost:** Obtain the finance from cheaper sources.
2. **Risk:** Risk involved in each source should be evaluated.
3. **Flotation Cost:** Cost of raising finance (Flotation cost) should be lower.
4. **Cash flow position:** A stronger cash flow position normally recommended more of debt financing.
5. **Fixed operating Costs:** If a business has high level of fixed operating cost ( eg: rent, insurance, salary), lower debt financing is better. Similarly if fixed operating cost is less, more of debt financing may be preferred.
6. **Control considerations:** More of owned funds dilute the management control over business . Debt financing has no such danger.

7. **State of Capital market:** Health of capital market may also affect the choice of source of fund. During boom period, more people invest in equity. During depression, people does not like to take risk and are not interested in buying equity shares.

III. **DIVIDEND DECISION:** Dividend is that portion of profit which is distributed to shareholders. Dividend decision relates to the appropriation of earned profits. The two major alternatives are to retain the profits or to distribute them to shareholders. A company has to decide how much profit to distribute as dividend and how much to retain for investment in the business. The dividend policy of the company should be to maximize market value per share. Thus the financial manager should determine the optimum dividend payout ratio.

### FACTORS AFFECTING DIVIDEND DECISION

1. **Amount of earnings:** It is the main determining factor of dividend policy, because dividend can be paid out of current and past earnings.
2. **Stability earnings:-** A company having stable earnings is in a position to declare higher dividend, otherwise strict dividend policy followed.
3. **Stability of dividend:-** Companies generally follow a stable dividend policy. They follow increasing dividend policy when there is confidence that their earning capacity has gone up.
4. **Growth opportunities:-** Companies having good growth opportunities retain more money. Out of their earnings so as to finance the required investment
5. **Cash flow position:** Dividend involves an outflow of cash. A company may be profitable but short in cash. Availability of enough liquid cash in the company is necessary for declaration of dividend.
6. **Shareholder's preference:** Desire of shareholders for dividends depends upon their economic status. Small shareholders and retired people prefer regular income wealthy investors are interested in capital gain
7. **Taxation policy:** The taxation rate affects the net earnings of a company and thereby its dividend policy also. If tax on dividend is higher, it is better to pay less by way of dividends.
8. **Stock market reactions:** An increase in dividend policy has a positive impact on the share price. It is good news for the investors and hence stock price increase .Decrease in dividend has a negative impact on the share price.
9. **Access to capital market:-** large and deputed companies tend to pay higher dividends than the smaller companies which have relatively low access to the market
10. **Legal constraints:-** As per the provisions of companies Act dividend can be paid only out of current or past profit after providing for depreciation. No dividend can be paid out of capital. Such provisions must be adhered to while declaring the dividend.
11. **Contractual constraints:** Sometimes the creditors may impose certain restrictions on the payment of dividends in future. The company doesn't violate the terms of the loan agreement at the time payment of dividend.

### FINANCIAL PLANNING

Financial planning is essentially the preparation of a financial blueprint of firm's future operations. The objectives of financial planning are to ensure that enough funds are available at right time. Financial planning means deciding in advance, the financial activities to carried on to active the

basic objectives of the firm. The basic objective of the firm is to get maximum profit out of minimum efforts or maximization of wealth. It is a process which decides in advance the capital requirements and the capital structure. Financial planning usually begins with the preparation of the sales forecast. Financial planning includes short term planning ( budget) as well as long term planning ( capital expenditure programme).

### **STEPS IN FINANCIAL PLANNING**

1. Determine of long term and short term financial objectives
2. Forecasting the organization's revenues and expenses on long term basis.
3. Formulation of financial policies to quantum of funds, pattern of capitalization, choice of sources etc.
4. Developing financial procedures and programmes
5. Reviewing the financial plan from time to time according to the changed conditions.

### **OBJECTIVES OF FINANCIAL PLANNING**

The objectives of financial planning are

1. To make sure that adequate funds are available at the right time.
2. To ensure that the firm does not raise resources unnecessarily
3. To ensure effective and most profitable use of available fund.
4. To ensure that the cost of funds are minimized through proper mix of different sources of finance.
5. To ensure proper control financial activities through effective policies, programmes and procedures.

### **IMPORTANCE OF FINANCIAL PLANNING**

Financial planning is an important part of overall planning of any business enterprise. A well prepared financial plan is necessary for the success of any business enterprises. The role of financial planning is

1. A sound financial plan helps a business enterprise to avoid the problems of shortage and surplus of funds.
2. It helps in coordinating various business function. All activities of the business ie. Production, sales, distribution etc. depend on the financial plan.
3. It tries to link the present with the future.
4. It provides a link between investment and financing decisions on a continuous basis.
5. It serves as a basis of financial control.
6. It balances the cash flow and out flow of funds thus ensures liquidity of business.
7. It helps to reduce the cost of financing to the minimum.



## **FUNCTIONS OF FINANCIAL MANGER**

- † Estimating Financial requirements
- † Determining sources of finance
- † Raising required funds
- † Utilizing available funds
- † Disposal of surplus
- † Managing cash
- † Controlling funds.

## **CAPITAL STRUCTURE**

Capital structure refers to the mix between owner's funds and borrowed funds. Capital structure refers to the mix or composition of long term sources of funds. Such as equity share, preference shares, debentures etc.

“ **Capital structure or financial structure** of a company refers to the type of securities to be issued and proportionate amount that make up the capitalization” -Gerstenberg

The capital structure of an enterprise may consists of any one of the following

- Equity only
- Equity shares and preference shares
- Equity shares and debentures
- Equity shares, preference shares and debentures
- Equity shares, preference shares, debentures and long term loans

It is the duty of the finance manager to see that there is optimum capital structure. 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 firm.

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

$$\text{Financial leverage} = \text{debt} / \text{equity} \quad \text{or} \quad \text{debt} / (\text{debt} + \text{equity})$$

Owned capital includes equity shares and preference shares and borrowed (Debt ) capital include loans, debentures, bonds etc.

### **Essential Features of Appropriate Capital structure**

An appropriate capital structure should have the following essential features

- . Maximize shareholder's return.
- .Reduce risk to the minimum
- Flexibility in the structure of capital
- .Ensure effective control on the organization



Maintain solvency and efficiency  
Effective utilization of resources  
Proper debt -equity finance

### **Factors affecting the choice of capital structure**

#### **1. Trading on equity or Financial leverage**

Trading on equity refers to the use of the fixed cost sources of funds (debentures, preference shares etc.) in the capital structure of a company, with a view to increase return on equity shares. Hence existing shareholders wisely make use of creditor ship securities to increase their own income. This technique is generally called financial leverage. The EPS (earnings per share) is more when debt is used in capital employed.

**2. Cash Inflow of the business :-** Companies which have regular cash inflow can issue more debt capital as they are in a position to repay the debt regularly.

**3. Interest coverage Ratio ( ICR) :-** The interest coverage ratio refers to the number of times Earnings before interest and taxes(EBIT) of a company covers the interest obligation

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

The higher the ratio, the lower shall be the risk of company.

#### **4. Debt Service Coverage Ratio (DSCR)**

A debt service coverage ratio takes care of the deficiencies referred to in the ICR. It is calculated as follows

$$\frac{\text{Profit after tax} + \text{Depreciation} + \text{Interest} + \text{Non cash. exp.}}{\text{preference dividend} + \text{interest} + \text{Repayment obligation}}$$

A higher DSCR indicates better ability to meet cash commitments and that type of company can include more debt capital in its capital structure.

**5. Return on Investment ( ROI) :-** if the ROI of the company is higher , it can choose to use trading on equity to increase its EPS. ie. Its ability to use debt is greater.

**6. Cost of debt:-** More debt can be used if debt can be raised at a lower rate.

**7. Tax Rate:-** Cost of debt is affected by the tax rate. A higher tax rate makes debt relatively cheaper and increases its attraction vis – a vis equity.

**8. Cost of capital :-** The capital structure should provide minimum cost of capital. Usually debt is a cheaper sources of finance when compares to shares. An ideal capital structure is that which has least cost.

**9. Control :-** If the existing equity shareholders does not want to lose control over the company affairs, they would prefer to issue preference shares and debentures to raise more funds. If they are not concerned about control they may issue equity shares to raise funds.

- 10. Flotation cost:-** Issue expenses like brokerage, underwriting commission etc. on equity shares are high compared to creditor ship securities. These expenses are called flotation cost. If the company does not want to spend more on floatation, then they issue debenture.
- 11. Stock market conditions:** In the times of depression debentures are consider good while equity shares find a better market during raising prices. (Boom period) .
- 12. Flexibility:** the capital structure should be designed in such a way that the company should be able to effect changes as and when required. Debt capital is highly flexible as it can increase or reduce very easily.
- 13. Risk consideration:** Use of debt increases the financial risk of the business. Financial risk refers to a position when a company unable to meet its fixed financial obligation like payment of interest, dividend on preference shares etc.
- 14. Regulatory frame work:-** The structure of capital of a company is also influenced by the statutory requirement applicable to them.
- 15. Capital structure of other companies:-** A useful guidelines in the capital structure planning is the debt equity ratios of other companies in the same industry.

### **Capitalization and capital structure**

Capital structure should be differentiated from capitalization. Capitalization refers to total long term investment in the company where as capital structure means the composition of such investment. Capitalization represents the quality of funds while capital structure represents the quality of funds.

#### ***Capital Gearing/ Financial leverage/ trading on equity***

Capital gearing determines the proportion of various securities in the capitalization. A company is said to be highly geared, when the proportion of equity capital is very small. Similarly a company is low geared, when the proportion of equity capital is very high. In other words gearing is determined based on creditor ship securities in the capital structure

### **FIXED CAPITAL:**

The amount invested in acquisition and development of fixed assets is known as **fixed capital (Blocked capital)**. The money invested in fixed capital is blocked and not available for day to day dealings. Fixed capital is represented by fixed assets like Plant and machinery, land, buildings etc.

**Fixed assets are of two types** 1. Tangible assets ( Land, Buildings, Plant etc.) and 2. Intangible assets (Goodwill, patents, trade mark etc.)

**Decision concerning fixed capital are important** because

- ✦ These decisions have effects on long term growth of business ✦ Huge amount of funds are involved.
- ✦ Such decisions not reversible without incurring heavy loss.

### **MANAGEMENT OF FIXED CAPITAL**

Fixed asset required for a long term period. Therefore it is raised from long term sources of finance. Shares, debentures, Long term loans, **ploughing back of profit** are the main sources of fixed capital. Fixed capital provides the foundation of business and acts as the cushion to absorb the shocks of business. Management of fixed capital involves allocation of firm's capital to different projects or assets with long term implications of the business. These decisions are called **investment decision or capital budgeting decision or management of fixed capital or capital expenditure decisions**.

Investment in these assets means expenditures in acquisition, expansion, modernization, replacement etc. These decisions include purchase of land, building, adoption of advanced technology, expenditure incurred for merge etc. **capital budgeting decisions are significant** because of the following **reasons**.

1. **Long term growth** : These decisions have long term implications. It affects future profitability and growth of the firm. A wrong decision adversely affects the growth of the business.
2. **Large amount of funds involved:-** It requires huge investment of funds. But the available funds are usually limited. Hence it is important to plan and control capital expenditure.
3. **Risk involved:-** Fixed capital involves investment of huge amounts. It affects the return of the firm as a whole for a long run. So it involve huge risk.
4. **Irreversible decision:-** Once the decision for acquiring permanent assets is taken, it becomes very difficult to reverse that decision. It is possible but with huge losses.

#### **Factors affecting the requirement of fixed capital**

The amount of fixed capital varies from business to business. This is determined by the following factors.

1. **Nature of business:-** The nature and character of business determine how much fixed capital is required. Eg: A trading concern needs lower investments in fixed assets compared with a manufacturing organization.
2. **Scale of operations/ size of business:-** A large sized business will generally require huge investment in fixed assets as compared to a small sized business.
3. **Choice of techniques:-** Some industries are capital intensive while others are labour intensive. The requirement of fixed capital would be higher in capital intensive industries.
4. **Technology up gradation:-** In certain industries assets become obsolete sooner. Consequently their replacement becomes due faster. Higher investments in fixed assets may therefore require for such business.
5. **Growth prospects:-** Higher growth of an organization generally requires higher investments in fixed assets.

6. **Diversification:** When a firm diversifies its activities, requirements for fixed capital will increase.
7. **Financing alternatives:-** when an assets is taken as lease , the firm pays lease rentals and uses it.By doing so it avoids huge sum required to purchase it and there by reducing investment in fixed assets.
8. **Level of collaboration:** At times certain business organization share each other's facilities. Eg: ATM facility. Such collaboration reduces the investment in fixed assets for each one of the participants.

## **WORKING CAPITAL**

Working capital is the amount of capital which is required for day to day working of a business. Working capital refers to that part of capital which is available and used for carrying out routine business operations or financing current assets such as cash , marketable securities, debtors and inventories. It is also known as **circulating capital or revolving capital**. There are two concepts of defining working capital

(a) **Gross workingcapital** and (b ) **Net working capital**

- (a) **Gross working Capital** : Gross working capital is the capital invested in total current assets. It is the total investment in all the current assets like cash, inventories, prepaid expenses etc.
- (b) **Net working capital**: Net working capital means current assets minus current liabilities. In other words net working capital is the excess of current assets over current liabilities.

**Working capital** = Current assets- current liabilities (current liabilities are those which are to be paid off within a short period of time ie. One year. )

In net working capital concept, working capital may be positive or negative. When the current assets exceed current liabilities, the working capital is positive, otherwise working capital will be negative.

### **Factors affecting working capital requirements**

1. **Nature of business :-** The amount of working capital depends upon the type or nature of business. A trading organization usually needs a smaller amount of working capital compared to manufacturing organization. This is because in trading concern sales can be effected immediately upon the receipts of goods.
2. **Scale of operation:-** high scale of organization demands high amount of inventory and debtors. Such organization therefore, requires large amount of working capital.
3. **Business Cycle:-** In boom period, when the business is prospering , large amount of working capital is required due to raise in prices, increase in sales etc.. In times of depression the sales decline and large amount of working capital may lie idle.
4. **Seasonal operations:** Industries that produce and sell seasonal goods require large amount of working capital during the peak season.

5. **Production cycle:-** Production cycle is the time span between the receipt of raw material and their conversion into finished goods. Larger the process period of manufacture, larger is the amount of working capital required.
6. **Credit Policy:-** A concern buying raw materials on credit and selling product on cash requires less amount of working capital and vice versa. A liberal credit policy required large amount of working capital.
7. **Operating efficiency:-** If cash, debtors and inventories are efficiently managed, working capital requirement can be reduced.
8. **Availability of raw materials:-** If the raw materials are available freely and continuously, lower stock of materials is required. In addition the time lag between the placement of order and the actual receipt of the material (lead time) is important. Larger the lead time, larger the quantity of material to be stored.
9. **Growth prospects:-** The working capital need of a concern depends on the expansion and growth of its business activities.
10. **Level of competition:-** In case market is highly competitive, liberal credit terms may have to be granted to customers. This leads to higher investment in debtors. ie. Require more working capital.
11. **Price level changes:-** During inflation, price level increases and large amounts of working capital is necessary to maintain same quantity of current assets.
12. **Dividend Policy:-** A firm that gives a steady high rate of cash dividend needs more working capital.

#### Difference between Fixed capital and working capital

Fixed Capital	Working Capital
1. Fixed Capital required for longer period.	1. Working Capital required for short period.
2. It is blocked capital, not available for routine business activities	2. It is working, available for routine for business activities.
3. It is required for acquiring fixed assets	3. It is required for buying current assets.
4. It raised through shares, debentures and loans	4. It raised through cash sales, collection from debtors, overdraft etc.