Chapter- 9

Financial Management

Meaning of Business Finance

Money required for carrying out business activities is called business finance.

→ It is required for buying a variety of assets, which may be Tangible or Intangible

→ Finance is central to running the day-to-day operations of business.

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Financial Management

→ It is concerned with optimal procurement as well as the usage of finance.

→ Financial Management aims at reducing the cost of funds procured, keeping the risk under control and achieving effective deployment of such funds.

Importance :- Almost all items in the financial statements of a business are affected directly or indirectly through some financial management decisions.

Some Prominent Examples of aspects being affected :-

(i) The size and the composition of fixed assets of the business

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

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(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, e.g., Interest, Expense, Depreciation etc.

Objectives

→ The Primary aim of financial management is to maximise shareholder's wealth, which is reffered to as the wealth maximisation concept
→ All financial decision aims at ensuring that each decision is efficient and adds some value
→ Objective of financial management is to maximise the current prices of equity shares of the company or to maximise the ~~health of a company~~ wealth of a ~~comp~~ owners of the company that is, the shareholders.

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Financial Decisions

Financial management is concerned with the solution of three major issues, they are Investment, financing and dividend decisions
→ It means the selection of best financing ~~activities~~ alternative or best investment alternative

Investment Decision

A firm has to choose where to invest the ~~scarce~~ scarce resources, so that they are able to earn the highest possible return for

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their investors.

→ The Investment decision relates to how the firm's funds are invested in different assets

→ A Long Term Investment decision is also called a Capital Budgeting decision. It involves committing the finance on a long term basis.

→ Short term Investment decisions (also called working capital decisions) are concerned with the decisions about the levels of cash, inventory and receivables. These affect the day-to-day working of a business.

Factors affecting Capital Budgeting Decision [RCC]

(i) Cash flow of the project
(ii) The rate of return
(iii) The investment criteria involved

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Financing Decision

→ This decision is about the [quantum] of finance to be raised from various long-term sources. It involves identification of various available sources.

Quantity

* Shareholder's Funds → Equity capital and the retained earnings.

* Borrowed Funds → The finance raised through debentures or other forms of debt.

* Financial Risk → The risk of default on payment.

→ A firm needs to have a judicious mix of both

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debt and equity in making financing decisions.

→ The overall financial risk depends upon the proportion of debt in the total capital.

* Flotation cost - The cost incurred in fund raising exercises.

→ This decision determines the overall cost of capital and the financial risk of the enterprise.

Factors Affecting Financing Decisions

(a) Cost
(b) Risk
(c) Flotation Costs
(d) Cash flow position of the company
(e) Fixed operating costs
(f) Control considerations
(g) State of capital Market.

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Dividend Decision

Dividend - That portion of profit which is distributed to shareholders.

→ The decision involved here is how much of the profit earned by the company (after paying tax) is to be distributed to the shareholders and how much of it should be retained in the business.

* → The dividend constitutes the current income reinvestment.

* → The extent of retained earnings also influences the financing decision of the firm.

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Factors affecting Dividend Decision

(a) Amount of Earnings
(b) Stability Earnings
(c) Stability of Dividends
(d) Growth opportunities
(e) Cash flow position
(f) Shareholder's preference
(g) Taxation Policy
(h) Stock Market reaction
(i) Access to capital market
(j) ~~Law constraints~~ legal constraints
(k) Contractual constraints.

Financial Planning

Process of estimating the fund requirement of a business and specifying the sources of funds is called financial planning.

→ It includes both long term as well as short term planning

→ It is done for three to five years.

* Budget – Plans made for periods of one year or less

→ It usually begins with the preparation of a sales forecast.

Twin objective :-

(a) To ensure availability of funds whenever required
(b) To see that the firm does not raise resources unnecessarily.

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Importance [V.V.V imp]

(i) It helps in forecasting what may happen in future under different business situations
(ii) Helps in avoiding business shocks & Surprises
(iii) Helps the company in preparing for future
(iv) Helps in co-ordinating various business functions.
(v) Detailed plan reduce waste, duplication of efforts and gaps in planning
(vi) Tries to link present with the future
(vii) Provides a link between investment and financing decisions on a continous basis
(viii) It makes the evaluation of actual performance easier.

Capital Structure

Mix between owners and borrowed fund, shall be reffered to as Equity to debt calculated as :-

$$\frac{\text{Debt}}{\text{Equity}} \quad \text{Or} \quad \frac{\text{Debt}}{\text{Debt} + \text{Equity}}$$

Factors affecting the Choice of Capital Structure

1) Cash flow position :- Cash flow must not only cover fixed cash payment obligations but there must be sufficient buffer also.

2) Interest coverage ratio (ICR) :-
It refers to the number of times earning

before interests and taxes of a company covers the interest obligation.

→ $ICR = \frac{\text{Earning before Interest \& Tax}}{\text{Interest}}$

→ The higher the ratio, lower shall be the risk of company failing to meet its interest payment obligations

3) Debt Service Coverage ratio (DSCR):- It takes care of the deficiencies ~~reffered~~ referred to in the Interest Coverage Ratio (ICR)

→ $\frac{\text{Profit after tax + Depreciation + Int. + non cash exp.}}{\text{Pref. Di + Int + Repayment obligation}}$

→ Capital Structure affects both profitability and the financial risk.

* Financial leverage - The proportion of debt in the overall capital

↳ Case I

Q Why the EPS rises with higher debt?

→ Because the cost of debt is lower than ~~that~~ the return that company is earning on funds employed.

* Trading on Equity - The increase in profit earned by the equity shareholders due to the presence of fixed financial charges like debt.

Q Case II

Why EPS is falling with increased use of debt.

→ It is because the company's rate of return on investment (ROI) is less than the cost of debt.

Factors

4) Return on Investment (ROI)
5) Cost of debt
6) Tax rate
7) Cost of Equity
8) Flotation costs
9) Risk Consideration
10) Flexibility
11) Control
12) Regulatory Framework
13) Stock market Conditions
14) Capital Structure of other companies.

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Management of Fixed Capital

→ Must be financed through long-term sources
→ Fixed Assets should never be financed through short-term sources.

Importance :-

(i) long-term growth
(ii) large amount of funds involved
(iii) Risk involved
(iv) Irreversible decision

(3-6m) Factors affecting the requirement of Fixed Capital

1) Nature of Business
2) Scale of operations
3) Choice of Technique
4) Technology Upgradation
5) Growth Prospects

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6) Diversification
7) Financing Alternatives
8) Level of collaboration

Working capital

→ Current assets are usually more liquid but contribute less to the profits than fixed asset
→ These assets provide little or low return.
* Net working capital - The ~~cost~~ excess of current assets over current liabilities.

Factors Affecting the working Capital requirement

1) Nature of Business
2) Scale of operations
3) Business cycle
4) Seasonal factors
5) Production cycle - The time span between the receipt of raw material and their conversion into finished goods.
6) Credit allowed
7) Credit availed
8) Operating Efficiency
9) Availability of raw materials :- lead time - time lag between the placement of order and actual receipt of the materials
10) Growth Prospects
11) Level of Competition
12) Inflation

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