Financial Management

What is Business Finance…?

Business Finance means the funds and credit employed in the business. Finance is the foundation of a business. Finance requirements are to purchase assets, goods, raw materials and for the other flow of economic activities.

What is Financial Management…?

- Concerns with the *acquisition*, *financing*, and *management of assets* with an overall goal in mind.
- Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise.

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Definition

- "Financial management is to review and control decisions to commit or recommit funds to new or ongoing uses."

  -Solomon Ezra

- "Financial Management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operation."

  -J.L. Massie

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Objectives of Financial Management

1. **Maximize shareholder's Wealth:-** The financial management helps in maximizing the wealth of the shareholders. Wealth maximization means to increase the capital invested in the business by the shareholders. If the market price of the shares increase, means capital invested by the shareholders also increased or wealth of shareholder is increased. If market price decreased of the shares means wealth of shareholder is decreased. Wealth of the shareholder can be calculated by using following formula:- **Shareholder's current wealth in the company =Number of Shares × Market Price per share**
2. **Creating Value:-** The ultimate objective of financial management is value creation. A business proposal creates value only if its net present value is positive. The fundamental finance principle can be applied to major corporate decisions. Profit is essential for a firm to sustain long-term growth.

Role of Financial Management

- **Determination of Fixed Assets:- The total investment in fixed assets and every separate fixed asset is determined.**
- **Determination of Current Assets:- The total investment in current assets and every separate current asset is determined.**
- **Determination of Proportion of Long-term and Short-term Finance:- A proportion of both long term and short financial sources is determined.**
- **Determination of Proportion of Various Sources of Long-term Finance:- The proportion of equity share capital, preference share capital, debentures, retained earning, long term debt etc. is determined.**
- **Determination of Various Items of Profit and Loss Account:- Determination of those items which are included in profit and loss get affected by different financial decisions.**

Types of Financial Decisions

Financial Decision means, the selection of best financial alternate or best investment alternate. Financial decision making is concerned with three broad decisions.

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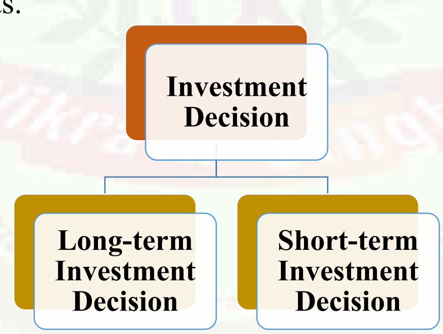
Investment Decisions

Investment decision refers to deciding, how the funds are invested in different assets so that the highest possible return for the investors can be earn. The investment decisions, therefore, relates to how the firm's funds are invested in different assets.



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- **Long Term Investment Decision:-** It is also called a Capital Budgeting Decision. It relates to the investment in long term assets. For example, buying a new machine, buying of furniture etc. These decisions are very important as they affect the earning of the business over the long run.
- **Short-term Investment Decision:-** It is also called Working Capital Decision. These decisions are concerned with the decisions about the levels of cash, inventories, debtors, B/R etc. These decisions affect the day to day working of business and also affect the liquidity position of the business.

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Factors affecting Investment Decisions

Long-term Investment Decision

- 1. Cash Flow of the Project
- 2. The Rate of Return
- Investment Criteria Involved

Short-term Investment Decision

- 1. More Working Capital than Required
- 2. Less Working Capital than Required

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Financing Decisions

Financing Decision relate to when, where and how to acquire funds to meet the firm's investment needs. The central issue is to determine the proportion of equity and debt. The mix of debt and equity is known as the firm's capital structure. After making an analysis of various factors, the proportion of long term sources of capital is determined.

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Factors affecting Financing Decisions

- Cost
- Risk
- Floatation Cost
- Cash Flow Position of the Business
- Level of Fixed Operating Cost
- Control Consideration
- State of Capital Market

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Dividend Decisions

- It refers to the determination of how much part of the earning should be distributed among shareholders by the way of dividend and how much should be retained for meeting future needs as retained earning.
- It determines how much percentage of profit is to be given as dividend to shareholders and how much percentage is to be retained in business for future needs.

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Factors affecting Dividend Decisions

- Amount of Earning
- Stability of Earnings
- Stability of Dividends
- Growth Opportunities
- Cash Flow Position
- Shareholder's Preference
- Taxation Policy
- Stock Market Reactions
- Access to Capital Market
- Legal Constraints
- Contractual Constraints

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Financial Planning

- Financial Planning is the process of estimating the capital requirement and determining its competition. It is about framing financial polices in relation to procurement of funds, investment and administration of funds of an enterprise. In other words, financial planning is preparation of a financial blueprint of an organization's future operations.
- **It has twin objectives :**

A)Timely Availability of Funds

B)No Under/Over Utilization of Funds

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Process of Financial Planning

Determination of Financial Objectives:- Short term and Long term financial objectives are determined.

Determination of Financial Policies:- In this different policies like, dividend policy, working capital policy, capital structure policy etc. are determined.

Determination of Financial Procedure:- In what order a job will be performed.

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Importance of Financial Planning

1. **Forecasting:-** It helps the firm to face the eventual situation in a better way by forecasting various business situations.
2. **Avoiding Business Shocks and Surprises:-** It helps in avoiding business shocks and surprises and help the business in preparing for the future.
3. **Helps in Co-ordination:-** By providing clear policies and procedures, it helps in coordinating various business functions.
4. **Helps in reducing waste activities:-** Detailed action plan reduces the waste, duplication of activities and gaps in planning.
5. **Helps to link the present with future:-** It helps to link the present with future by minimizing the risk of future.
6. **Helps to link the Investment with Financing Decision:-** It helps in deciding that where to invest and from where the required funds will be made available.
7. **Control on Financial Performance:-** By setting detailed objective for various business segments, it makes evaluation of actual performance easily.

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Capital Structure, Working Capital and Fixed Capital

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Capital Structure

- Capital structure refers to the mix between owners and borrowed funds.
- Capital Structure is the relative proportion of different sources of long term funds.

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A company requires finance in order to run its business properly and the business can obtain these funds from the following sources:

- Equity Share Capital
- Preference Share Capital
- Borrowed Funds
- Retained Earnings
- Current Liabilities

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This can be understood with the following table:-

Sources of Capital	Amount	%age of Total Capital	%age of Long Term Capital
Equity Share Capital	9,00,000	45.00	50.00
Preference Share Capital	4,50,000	22.50	25.00
Borrowed Funds	2,25,000	11.25	12.50
Retained Earnings	2,25,000	11.25	12.50
Current Liabilities	2,00,000	10.00	------
	20,00,000	100	100

1. Financial Structure:- It is the aggregate of liability side of Balance Sheet and %age of different financial sources.
2. Capitalisation:- It is the Total Liabilities less Current Liabilities.
3. Capital Structure:- It is the %age of different sources of capitalization.

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Debt and Equity Share Capital: Cost and Risk

For Investors		
	Returns	**Risk Associated**
Debt Capital	Low	Low
Equity Capital	High	High
For Company		
	Cost of Capital	**Risk Associated**
Debt Capital	Low	High
Equity Capital	High	Low

Financial Leverage and Financial Risk

- **Financial Leverage:-** Use of fixed cost capital **(debt capital and preference share capital)** along with equity share capital in the capital structure is called financial leverage. With the increase of financial leverage the total capital cost decreases.
- **Financial Risk:-** The burden of the payment of fixed financial costs increases due to use of fixed cost capital. In case of inability to pay the fixed financial costs creates a financial risk.

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Trading on Equity

Trading on Equity means to raise fixed cost capital (Debt capital and preference share capital) on the basis of equity share capital so that the income of equity shareholders can be increased. It is possible only when the rate of return is more than the rate of interest on borrowed capital or the rate of dividend on preference shares.

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EBIT-EPS Analysis
Case 1

Particulars	Situation I	Situation II
Equity Share Capital (Rs.10 each)	20,00,000	8,00,000
10% Debentures	--------	12,00,000
EBIT	3,00,000	3,00,000
Tax Rate	30%	30%

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EBIT-EPS Analysis

Particulars	Situation I	Situation II
EBIT	3,00,000	3,00,000
Less: Interest	-----------	1,20,000
Earning before Tax	3,00,000	1,80,000
Less: Tax @ 30%	90,000	54,000
Earning after Tax	2,10,000	1,26,000
No. of Equity Shares	3,00,000	80,000
Earning per share (EPS)	0.70	1.58

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Case 2

Particulars	Situation I	Situation II
Equity Share Capital (Rs.10 each)	20,00,000	8,00,000
10% Debentures	--------	12,00,000
EBIT	1,50,000	1,50,000
Tax Rate	30%	30%

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EBIT-EPS Analysis

Particulars	Situation I	Situation II
EBIT	1,50,000	1,50,000
Less: Interest	-----------	1,20,000
Earning before Tax	1,50,000	30,000
Less: Tax @ 30%	45,000	9,000
Earning after Tax	1,05,000	21,000
No. of Equity Shares	3,00,000	80,000
Earning per share (EPS)	0.35	0.26

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Case 1:-

$$\text{ROI} = \frac{EBIT}{Total\ Investment} \times 100 = \frac{3{,}00{,}000}{20{,}00{,}000} \times 100 = \mathbf{15\%}$$

In this case ROI is more than the rate of interest on debt i.e., 10%. So, use of debt capital with equity capital is increasing the earning per share.

Case 2:-

$$\text{ROI} = \frac{EBIT}{Total\ Investment} \times 100 = \frac{1{,}50{,}000}{20{,}00{,}000} \times 100 = \mathbf{7.5\%}$$

In this case ROI is less than the rate of interest on debt i.e., 10%. So, use of debt capital with equity capital is decreasing the earning per share.

In conclusion, Trading on Equity is profitable only when the rate of return on investment is more than the interest rate.

Factors affecting the Choice of Capital Structure

1. Cash Flow Position	2. Interest Coverage Ratio	3. Debt Service Coverage Ratio	4. Return on Investment
5. Cost of Debt	6. Tax Rate	7. Floatation Cost	8. Flexibility
9. Cost of Equity Capital	10. Control	11. Stock Market Conditions	12. Regulatory Framework
	13. Capital Structure of Other Companies		

Fixed Capital

Fixed Capital means the capital invested in Long-term assets.

Fixed Capital is that capital which is used to purchased the fixed assets, such as machinery, furniture, building etc.

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Factors affecting the Requirement of Fixed Capital

1. Nature of Business
2. Scale of Operation
3. Choice of Technique
4. Technology Upgradation
5. Growth Prospects
6. Diversification
7. Financial Alternatives
8. Level of Collaboration

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Working Capital

Working Capital means the capital invested in Short-term assets of the business.

It is the difference between current assets and current liabilities.

Aggregate of current asset is **Gross Working Capital** and difference between current assets and current liabilities is **Net Working Capital**.

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Factors affecting the Requirement of Working Capital

1. Nature of Business	2. Scale of Operation	3. Business Cycle
4. Seasonal Factors	5. Production Cycle	6. Credit Availed
7. Credit Allowed	8. Operating Efficiency	9. Growth Prospect
10. Level of Competition	11. Inflation	12. Availability of Raw Material

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