CHAPTER 9

FINANCIAL MANAGEMENT

CONCEPT SUMMARY

Meaning of Business Finance: Money required for carrying out business activities is called business finance.

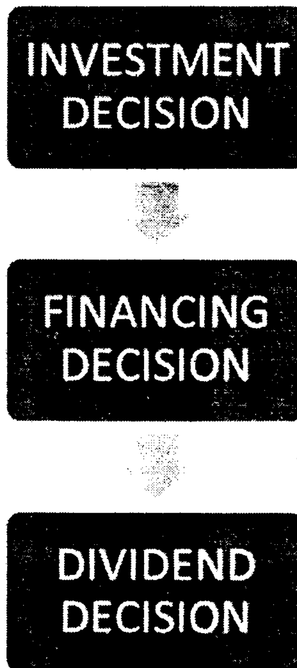
Financial Management: It is concerned with optimal procurement as well as usage of finance.

Role of Financial Management: It cannot be over-emphasized, since it has a direct bearing on the financial health of a business. The financial health of a business. The financial statements such as profit and loss A/C and B/S reflect a firm's financial position and its financial health.

i. The size as well as the composition of fixed assets of the business
ii. The quantum of current assets as well as its break –up into cash, inventories and receivables.
iii. The amount of long-term and short- term financing 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, expenses, depreciation etc.

Objectives of Financial Management: Maximization of owner's wealth is some objective of financial management. It means maximization of the market value of equity shares. Market price of equity share increases if the benefits from a decision exceed the cost involved.

FINANCIAL DECISIONS



Investment Decision: It relates to how the firm's funds are invested in different assets. Investment decision can be long- term or short- term. A long – term investment decision is also called a capital budgeting decision.

Factors affection capital Budgeting Decision/Investment Decision:

1. Cash flows of the project: if anticipated cash flows are more than the cost involved then such projects are considered.

2. The rate of return: The investment proposal which ensures highest rate of return is finally selected.

3. The investment criteria involved: Through capital budgeting techniques, investment proposals are selected.

Financing Decision:-It refers to the quantum of finance to be raised from various sources of long-term of finance. It involves identification of various sources. The main sources of funds for a firm are shareholders' funds and borrowed funds. Shareholders' funds refer to equity capital and retained earnings. Borrowed funds refer to finance raised as debentures or other forms of debt.

Factors Affecting Financing Decision:-

a) **Cost:** The cost of raising funds through different sources is different. A prudent financial manager would normally opt for a source which is the cheapest.

b) **Risk:** The risk associated with different sources is different.

c) **Floatation costs:** Higher the floatation cost, less attractive the source.

d) **cash flow position of the Business:** A stronger cash flow position may make debt financing more viable than funding through equity.

e) **Level of fixed operating costs:** If a business has high level of fixed operating costs (e.g., building rent, Insurance premium, salaries etc.), It must opt for lower fixed financing costs, Hence, lower debt financing is better, Similarly, if fixed operating cost is less, more

g) **State Of Capital Markets:** Health of the capital market may also affect the choice of source of fund. During the period when stock market I rising, more people are ready to invest in equity. However, depressed capital market may make issue of equity shares difficult for any company.

DIVIDEND DECISION:- The decision involved here is how much of the profit earned by company (after paying tax) is to be distributed to the shareholders and how much of it should be retained in the business for meeting the investment requirements.

FACTORS AFFECTING DIVIDEND DECISION:-

a) **Earnings:** Dividends are paid out of current and past earning. Therefore, earnings are a major determinant of the decision about dividend.

b) **Stability of Earnings:** Other things remaining the same, a company having stable earning is in a position to declare higher dividend. As against this, a company having unstable earnings is likely to pay smaller dividend.

c) **Stability of Dividends:** It has been found that the companies generally follow a policy of stabilizing dividend per share.

d) **Growth Opportunities:** Companies having good growth opportunities retain more money out of their earnings so as to finance the required investment.

e) **Cash Flow Position:** Dividends involve an outflow of cash. A company may be profitable but short on cash. Availability of enough cash in the company is necessary for declaration of dividend by it.

f) **Shareholder Preference:** while declaring dividends, managements usually keep in mind the preference of the shareholders in this regard.

g) **Taxation Policy:** The choice between payment of dividends and retaining the earnings is, to some extent, affected by difference in the tax treatment of dividends and capital gains.

h) **Stock Market Reaction:** Investors, in general, view an increase in dividend as good news and stock prices react positively to it. Similarly, a decrease in dividend may have a negative impact on the share prices in the stock market.

i) **Access to Capital Market:** Large and reputed companies generally have easy access to the capital market and therefore may depend less on retained earnings to finance their growth. These companies tend to pay higher dividends than the smaller companies which have relatively low access to the market.

j) **Legal Constraints:** Certain provisions of the Company's Act place restrictions on payouts as divided. Such provisions must be adhered to while declaring the dividends.

k) **Contractual Constraints:** While granting loans to a company, sometimes the lender may impose certain restrictions on the payment of dividends in future.

FINANCIAL PLANNING

Financial Planning is essentially preparation of financial blueprint of an organization's future operations. The objective of financial planning is to ensure that enough funds are

OBJECTIVES

(a) To ensure availability of funds whenever these are required: This include a proper estimation of the funds required for different purposes such as for the purchase of long- term assets or to meet day-to-day expenses of business etc.

(b)To see that the firm does not raise resources unnecessarily: Excess funding is almost as bad as inadequate funding.

IMPORTANCE OFFINANCIAL PLANNING

i. It tries to forecast what may happen in future under different business situations. By doing so, it helps the firms to face the eventual situation in a better way. In other words, it makes the firm better prepared to face the future.
ii. It helps in avoiding business shocks and surprises and helps the company in preparing for the future.
iii. If helps in co-ordaining various business functions e.g., sales and production functions, by providing clear policies and procedures.
iv. Detailed plans of action prepared under financial planning reduce waste, duplication of efforts, and gaps in planning.
v. It tries to link the present with the future.
vi. It provides a link between investment and financing decisions on a continuous basis.
vii. By spelling out detailed objectives for various business segments, it makes the evaluation of actual performance easier.

CAPITAL STRUCTURE: Capital structure refers to the mix between owners and borrowed funds.

FACTORS AFFECTING THE CHOICE OF CAPITAL STRUCTURE

1. Cash Flow Position: Size of projected cash flows must be considered before issuing debt.

2. Interest Coverage Ratio (ICR): The interest coverage ratio refers to the number of times earnings before interest and taxes of a company covers the interest obligation.

3. Debt Service Coverage Ratio (DSCR): Debt service coverage Ratio takes care of the deficiencies referred to in the interest coverage Ratio (ICR).

4. Return on Investment (RoI): I the RoI of the company is higher, it can choose to use trading on equity to increase its EPS, i.e., its ability to use debt is greater.

5. Cost of debt: A firm's ability to borrow at a lower rate increases its capacity to employ higher debt. Thus, more debt can be used of debt can be raised at a lower rate.

6. Tax Rate: Since interest is a deductible expense, cost of debt is affected by the tax rate.

7. Cost of Equity: Stock owners expect a rate of return from the equity which is commensurate with the risk they are assuming. When a company increases debt, the financial risk faced by the equity holders, increases.

8. Floatation Costs: Process of raising resources also involves some cost. Public issue of shares and debentures requires considerable expenditure. Getting a loan from a financial institution may not cost so much.

9. Risk Consideration: As discussed earlier, use of debt increases the financial risk of a business.

10. Flexibility: If a firm uses its debt potential to the full, it loses flexibility to issue further debt.

11. Control: Debt normally does not cause a dilution of control.

12. Regulatory Framework: Every company operates within a regulatory framework provided by the law e.g., public issue of shares and debentures has to be made under SEBI guidelines.

13. Stock market conditions: If the stock markets are bullish, equity shares are more easily sold even at a higher price. However, during a bearish phase, a company may find rising of equity capital more difficult and it may opt for debt.

14. Capital Structure of other companies: A useful guideline in the capital structure planning is the debt- equity rations of other companies in the same industry. There are usually some industry norms which may help.

MANAGEMENT OF FIXED CAPITAL

Fixed capital refers to investment in long –term assets. Management of fixed capital involves around allocation of firm's capital to different projects or assets with long- term implications for the business. These decisions are called investment decisions or capital budgeting decisions and affect the growth, profitability and risk of the business in the long run. These long- term assets last for more than one year.

IMPORTANCE OF CAPITAL BUDGETING DECISIONS

(i) Long- term growth and effects: These decisions have bearing on the long –term growth. The funds invested in long- term assets are likely to yield returns in the future.

(ii) Large amount of funds involved: These decisions result in a substantial portion of capital funds being blocked in long –term projects

(iii)Choice of Technique: Some organizations are capital intensive where others are labour intensive. A capital – intensive organization requires higher investment in plant and machinery as it relies less on manual labour.

(iv) Technology Up gradation: 'n certain industries, assets become obsolete sooner consequently, their replacements become due faster. Higher investment in fixed assets may, therefore, be required in such cases/

(v) Growth Prospects: Higher growth of an organization generally requires higher investment in fixed assets.

(vi) Diversification: A firm may choose to diversity its operations for various reasons, with diversification, fixed capital requirements increases.

(vii) Financing Alternatives: A developed financial market may provide leasing facilities as an alternative to outright purchase. Availability of leasing facilities, thus, may reduce the funds required to be invested in fixed assets, thereby reducing the fixed capital requirements. Such a strategy is especially suitable in high risk lines of business.

(viii) Level of Collaboration: At times, certain business organizations share each other's facilities. For example, a bank may use another's ATM or some of them may jointly establish a particular facility. Such collaboration reduces the level of investment in fixed assets for each one of the participating organizations.

WORKING CAPITAL REQUIREMENTS

Net working capital may be defined as the excess of current assets over current liabilities.

FACTORS AFFECTING WORKING CAPITAL REQUIREMENTS

1) **Nature of Business:** Trading Organizations- Less working capital Manufacturing organizations – more working capital
2) **Scale of Operations:** Large scale organizations- more working capital small scale organizations –less working capital
3) **Business Cycle:** Boom period – more working capita Depression period –less working capital

4) **Seasonal factors:** Peak season – more working capital lean season – less working capital
5) **Production cycle:** Longer production cycle- more working capital shorter production cycle- less working capital
6) **Credit allowed:** Conservative/strict credit policy-less working capital liberal credit policy- more working capital
7) **Credit availed:** If credit is available easily form suppliers – less working capital

   If credit is not available easily from suppliers- more working capital

8) **Operating efficiency :** If current assets are managed efficiently- less working capital

   If current assets are not managed efficiently – more working capital

9) **Availability of Raw Material:** Easy and timely availability of raw material –less working capital

   Difficulty and lengthy time period are involved in getting raw materials – more working capital

10) **Growth Prospects:**If there is possibility of growth potential- more working capital if there is no possibility of growth potential-more working capital if there is no possibility of growth- less working capital

11) **Level of competition:** If there is stiff and cut- throat competition –more working capital

12) **Inflation:** During inflation – more working capital

During recession – less working capital

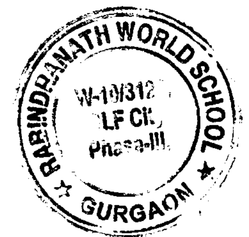
FINANCIAL LEVERAGE/CAPITAL GEARING/TRADING ON EQUITY

It is an assumption that by using fixed charge bearing securities in the capital structure of a company, return to the equity shareholder can be increased. But this is possible only when the rate of return of the company is higher than the rate interest which a company pays on its debt capital.

For example a company has Rs. 10.crotes capital. Option 1 the company uses only equity capital option 2 the company uses 50% equity and 50% debt capital in its capital structure. Rate of interest on debt is 15%. Rate of

company uses 50% debt capital in its capital structure. Rate of interest on debt is 15%. Rate of Income – tax is 30%.profit before interest and tax is Rs.2 crores.

Particulars	Option1	Option 2
Profit before interest and taxes (PBIT)	2,00,00,000	2,00,00,000
Less: Interest on debt	----------------------------	15,00,000
Profit after tax	2,00,00,000	1,85,00,000
Less: Income – tax @30%	60,00,000	55,50,000
Profit after tax and interest	1,40,00,000	1,29,50,000
No. of equity shares (FV Rs.10 each)	20,00,000	10,00,000
Return to shareholders(EPS)	Rs.7	Rs.12.95



VERY SHORT QUESTION /ANSWERS

Q1 Give the second name for fixed asset management?

Ans. Capital budgeting.

Q2 Delta Cables Ltd. Earned a net profit of Rs50 crores. Atul, the finance manager of Delta Cable Ltd., want to decide how to appropriate these profits. Which financial decision will help him in deciding it?

Ans. Dividend decision

Q3Name the type of investment decision which relates to short-term and affects day to day operation of a company.

Ans. Working capital decisions or short term investment decisions .

Q4 A Company wants to establish a new unit in which a machinery of worth Rs10 lakhs is involved. Identify the type of decision involved in financial management.

Ans. Investment decision/capital budgeting decision.

Q5 What do you call the techniques of evaluating proposals?

Ans. Capital budgeting techniques.

Short question/answers

Q1. Define financial management. Explain in brief any four objectives of financial management.

Ans. financial management may be defined as management of flow of funds.it includes any decision made by business enterprise that affects its finance. it is related to optimum acquisition and allocation of funds for achieving organizational objective.

Objectives of financial management are as follows:-

(1) Wealth maximization: financial management aims at procuring funds at reasonable cost and maximization **wealth of the owners** of the company i.e. of the shareholders.

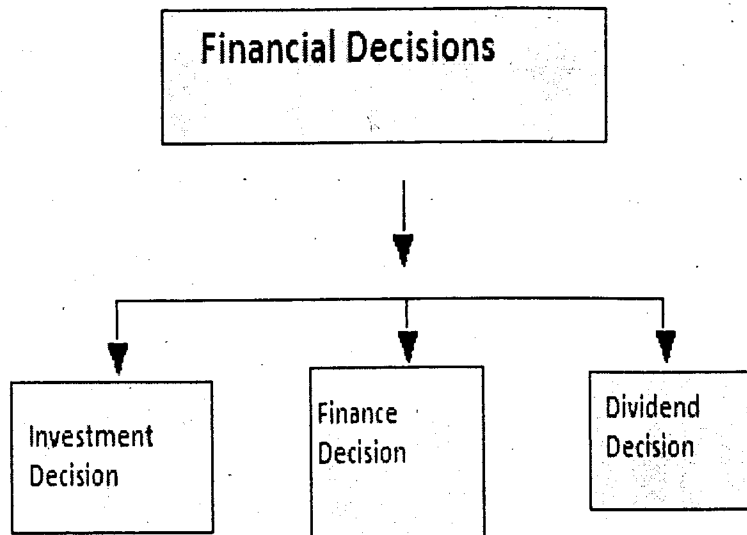
(2) Profit maximization: financial management aims at maximization of profits through **optimum utilization** of finance.

(3) Efficient Utilization of resources: financial management aims at reducing the cost and maximizing benefits by using resources efficiently.

(4) Meeting financial commitments: the aim of financial management is to meet financial commitments like payment of regular interest on long term borrowing and repayment of loans etc.

Q2. Explain briefly the important decision taken in financial management.

Ans. There are three important decisions taken in financial management:



(i) Investment decision

It involves allocation of resources or capital to various investment proposals.

- These investment proposal can be short-term or long term.
- Investment decision related to short -term is known as working capital decision.
- long-term decision are referred to as capital budgeting

Investment proposal are **evaluated** on the **basis of their expected returns and risks** involved therein.

(ii) Finance decision

- This decision is related to how much of fund to be raised and from which source etc.
- The pros and cons of different sources are ascertained and best combination of various source viz. shares, loans, debentures etc.is determined.

(iii) Dividend decision

This decision is related to the appropriation of earned profit.

- It involves how much to retain in the business and how much to distribute among shareholders as dividends.

- The part of profits retained in the business, known as retained earnings, is recycled for reinvestment and expansion and diversification of business activities.
- The rest of profits are distributed among shareholders in the form of dividends. The dividend decision greatly influences the finance decisions as the enterprise. Does not require external funds to the extent of retained earnings.

• LONG QUESTION/ANSWERS

1 Explain the factors affecting financing decisions.

Ans. Financing decision is the decision about the quantum of finance to be raised from various long term sources and how much is to be raised from each source.

The following are the main factors affecting decision:

i. **Cost:** the cost of obtaining funds through debt or equity is different and the least expensive source is opted for.

ii. Risk: like cost, the risk associated with different sources for obtaining finance is different.

iii. Flotation Cost: higher floatation cost makes the source for raising funds less attractive.

iv. Cash flow position of the business: If a business enterprise is having a strong cash flow position, it would be beneficial for it to opt for debt financing instead of equity.

v. **Control Consideration:** fear of reduction in management's control over business enterprise results in giving more preference to debt financing rather than equity.

vi. **State of capital markets:** health of capital market greatly affects the choice for a source of fund. people are willing to invest in the market when it is rising. However, it may be very difficult for a company to issue equity shares in depressed capital market.

Q2. Explain the role of financial planning in management.

Financial planning is the preparation of a financial blueprint of an organization's future operations.

- Financial planning means estimating the amount of capital required by enterprise and determining its composition. It is the process of establishing the objective, policies, procedures, programmers and budgets etc. to deal with the financial activities of the organization.
- Sound financial planning is essential for the success of any enterprise because of the following reasons.

i. Forecasts what may happen in the future.

ii. Avoids business shocks and surprises.

iii. Co-ordinates various business functions.

iv. Reduces waste and duplication of efforts.

v. Links present with the future.

vi. Links investment and financing decision.

vii. Makes evaluation easier.

Q3. What do you mean by capital structure? Explain the features of an appropriate Capital structure?

Ans. it refers to the proportion of owners' fund and borrowed funds used for financing the operation of the business. it can be calculated by either of the following two ways:

1. As a debt equity ratio i.e.
2. As a proportion of debt out of total capital i.e.

An appropriate capital structure should have the following features:

1. Return
2. Risk
3. Liquidity

4. Flexibility
5. Economy

Q4. What is meant by 'Fixed capital'? Describe any four factors which affect the requirement of fixed capital requirement of a company.

Ans. Fixed capital: investment made in fixed assets is known as fixed captial.it is usually financed through long term source of finance .

Factors affecting fixed capitals needs are:

1. nature of business
2. scale of operation
3. Growth Prospects
4. Diversification

Q5 What is meant by working capital? Explain any 4 factors affecting working capital needs.

Ans. It refers to the investment in current assets such as cash, bill receivable, prepaid expenses, inventories etc.

Factors affecting working capital needs:-

1. Nature of business
2. Production cycles
3. Seasonal factor
4. Availability of raw materials.
5. Credit allowed and credit availed .etc

Q6 .Explain in brief any five factors that should be taken into consideration while determining the dividend policy.

OR

What is meant by dividend decision? State any four factors affecting the dividend decision.

Answer – dividend decision is the decision about **how much of the profit** earned by the company is to be distributed to the shareholders and how much of it is to be retained in business. Factors affecting dividend policy are as follows:

i. **Earning:** it is the most important factor influencing the decision about dividend because later is declared out of current as well as past earnings.

ii. **Stability of earnings:** generally, a company with stable earnings pays higher dividend as compared to a company with unstable earnings.

iii. **Stability of Dividend:** usually the companies have policy of stabilizing dividend per share. A company should carefully assess its earning potential while stabilizing dividend per share. A company should carefully assess its earning potential while stabilizing the dividend per share because even in a year of small earnings, usually dividend per share is not altered.

iv. **Growth Opportunities:** if growth opportunities are available to the company, the company retains a large share of their profits for financing the required investment. Result, less amount is available for distribution as dividends.

v. **Cash flow position:** strong cash flow position is also an essential element for declaring dividends because sufficiency of profit may not necessarily mean sufficiency of cash too.

7. How does trading on equity increase return on equity shares? Explain with an example.

OR

Are the shareholders of a company likely to gain with a debt component in the capital employed? Explain with the help of an example.

ANS. Trading on equity is a practice followed by a company under which **earning per share is increased by employing cheaper debt.** The sole objective enterprises are always interested in employing debts whose interest is less than the average rate of return on capital employed.

The position will be reversed if interest on debt is much more than the average rate of return on capital employed. Now with the help of an example, we shall move to discuss the position in detail.

Example: x Ltd, Y Ltd, and z Ltd are three companies having the same capital employed viz Rs.50, 00,000 each. Capital employed of X Ltd. Has only one component viz. Equity share Capital of Rs.50, 00,000. However, capital employed of y Ltd. comprises of equity share capital of Rs.40, 00,000 and 10% Debentures of 10, 00,000and capital employed of Z Ltd. Comprises of equity share capital of Rs.40, 00,000 and 25% Debentures of Rs.10,00,000. Earnings before interest and tax in all the companies is Rs.10, 00,000 i.e., 20% on the total capital employed and tax rate is 50%. Now with the help of EBIT-EPS analysis, we small examine which company is trading on equity.

COMPARATIVE STEMENT SHOWING EBIT-EPS ANALYSIS

	X Ltd.	**Y Ltd.**	**Z Ltd.**
Share capital (Equity share of Rs.10 each)	Rs.50, 00,000	Rs.40, 00,000	Rs.40, 00,000
Debentures	-	10% Debentures of Rs.10, 00,000	25%Debenture Rs.10, 00,000
EBIT	Rs.10, 00,000	Rs.10, 00,000	Rs.10, 00,000
Interest	-	Rs.1, 00,000	Rs.2, 50,000
EBT	Rs.10, 00,000	Rs.9, 00,000	Rs.7, 50,000
Tax	Rs.5, 00,000	Rs.4, 50,000	Rs.3, 75,000
EAT	Rs.5,00,000	Rs.4, 50,000	Rs.3, 75,000

Return on equity $= \frac{5,00,000}{50,00,000} \times 100$ $= \frac{4,50,000}{40,00,000} \times 100$

$= \frac{3,75,000}{40,00,000} \times 100$

=10% =11.25%

=9.37%

EPS Rs.10 Rs.11.25

Rs.9.37

From the above it can be observed that EPS is the highest in Y Ltd. Which is using debt at 10%? The EPS is the lowest in Z Ltd. (Rs.9.37) which is using debt at 25%. This is so because debt carries a fixed charge and the amount of interest paid is deductible from earnings before tax payment. The benefit to shareholders will be realized only if the average rate of return on total capital invested is more than the rate of interest payable on debt. It only

means that Y Ltd. Is trading on equity as it is earning @11.25% whereas it is paying interest on debt @10%.

From the above it above it can be concluded that with a debt component in the total capital (i.e. capital employed), shareholders are likely to have the benefit of a higher rate of return on share capital provided debt is employed at cheaper rates. In other words, by employing debts at cheaper rates, the shareholders can increase their earnings.

Value based question

Q1What is the aim of financial management? State the value that should be kept in mind while setting the objectives of financial management.
(1)Ans:
Honesty
Social Responsibility
Commitment