Business Studies Notes PDF

On

Financial Management

(Class – 12 / Chapter- 9)

MEANING OF BUSINESS FINANCE

The money required to carry out business activities is known as business finance. Finances are needed to operate a business, as well as to carry out day to day activities of the business.

FINANCIAL MANAGEMENT

- Financial Management is concerned with the proper procurement and usage of finance. It includes business activities such as procuring funds, reducing the cost of funds, keeping the risk under control and deployment of such funds.
- Financial management involves two dimensions, that is finance and management. Hence, Financial management can be said as the application of the management functions, particularly planning and controlling functions in the finance function of the business.
- Financial Management is very important as it has a direct emphasis on the financial health of a business. Financial management decisions affect all the items of the financial statement directly or indirectly.

Role of Financial Management:

- **Size and composition of fixed assets:** Over investment in fixed assets may block funds and increase the size of fixed assets which may not be healthy for business whereas, little investment may hamper the growth of business.
- **The quantum of current assets and its break up into cash, inventory and receivables:** The financial decisions about investments in fixed assets, the credit policy, inventory management, etc., influence the amount of working capital required by a business enterprise.
- **The amount of long term and short financing:** Financing decision decides the proportion of funds raised from long term and short term sources.
- **Break-up of long-term financing into debt, equity etc:** It is important for a financial manager to decide the way by which the proportion of debt and/or equity in a business has to be pumped in. The decisions of the finance managers affect debt, equity share capital, preference share capital and are an integral part of financing management.
- **All items in Profit and Loss account:** Financing decisions affect the value of items appearing in the profit and loss account.

Objectives of Financial Management:

- **Profit maximization:** This was the primary objective of firms which are concerned with the increasing earnings per share (EPS) of the company. It is also the traditional objective of the financial management that focuses on the fact that all the financial efforts should be made to increase the overall profit of the company.
- **Wealth Maximization concept:**
    - 'Owners' of a company are the shareholders.
    - The term wealth refers to wealth of owners as reflected by the market price of their shares.
    - The market price of shares is linked to three basic financial decisions:
        - **a.** Investment decision
        - **b.** Financing decision
        - **c.** Dividend decision
    - Market price of a share will increase if benefits from a decision are greater than the cost involved in it.
    - The goal of a firm should be to maximize the wealth of owners in the long run.
    - Increase in the market price of shares is an indicator of the financial health of a firm.

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- **Other objectives:** It helps a firm achieve the primary objective are:
    - Ensure availability of funds at reasonable costs.
    - Ensure effective utilization of funds.
    - Ensure safety of funds through creation of reserves.
    - Maintain liquidity and solvency.

FINANCIAL DECISIONS

The financial functions relate to three major decisions which every finance manager has to take:
(i) Investment decision
(ii) Financing decision
(iii) Dividend decision

I. Investment Decision (Capital Budgeting Decision):

Each and every organization has limited resources in comparison to the uses of the resources. So it is very important for a firm to decide the source in which the funds should be invested in so as to fetch the best returns.

- Investment decisions in an organization are taken in both long term and short term.
- There are two types of decisions:
    - **Long term investment decisions:** These are also called capital budgeting decisions. This also implies that the funds are invested in a resource for a longer period of time. These decisions affect the profitability and size of assets.
    - **Short term investment decision:** These are also known as working capital decisions. This also implies that the funds are invested in a resource for a shorter period of time. These decisions affect the day to day operations and activities of the organization. It also affects the liquidity and profitability of the business.
- The essential contents in a working capital are:
    - Inventory management
    - Receivables management and
    - Efficient cash management.

Factors affecting Investment Decisions/Capital budgeting decisions:

- **Cash flows of the project:** The series of cash receipts and payments over the life of an investment proposal should be considered and analyzed for selecting the best proposal.
- **Rate of Return:** The expected returns from each proposal and risk involved in them should be taken into account to select the best proposal.
- **Investment Criteria Involved:** The various investment proposals are evaluated on the basis of capital budgeting techniques. These involve calculation regarding investment amount, interest rate, cash flows, rate of return etc.

II. Financing Decision:

- Under this the financial managers of the organization decide the sources from which to raise long-term funds. The main source of funding is shareholders' funds and borrowed funds.
    - Shareholders' funds include share capital, reserves and surpluses and retained earnings.
    - Borrowed funds refer to funds raised through issue of debentures and other forms of debt.
- The decision of raising funds from various sources in appropriate proportion lies in the hands of the financial managers.
- Interest on loan has to be paid regardless of the profitability of the project.
- Debt is considered to be the cheapest form of finance.

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Factors Affecting Financing Decision:

- **Cost:** The cost of raising funds from different sources is different. The cheapest source should be selected.
- **Risk:** The risk associated with different sources is different. More risk is associated with borrowed funds as compared to the owner's fund as interest is paid on it and it is repaid also, after a fixed period of time or on expiry of its; tenure.
- **Flotation Cost:** The costs involved in issuing securities such as brokers commission, underwriters' fees, expenses on prospectus etc. are called flotation costs. Higher the flotation cost, less attractive is the source of finance.
- **Cash flow position of the business:** In case the cash flow position of a company is good enough then it can easily use borrowed funds and pay interest on time.
- **Control Considerations:** In case the existing shareholders want to retain the complete control of business then finance can be raised through borrowed funds but when they are ready for dilution of control over business, equity can be used for raising finance.
- **State of Capital Markets:** During boom, finance can easily be raised by issuing shares but during the depression period, raising finance by means of debt is easy.
- **Period of Finance:** For permanent capital requirement, Equity shares must be issued as they are not to be paid back and for long and medium term requirement, preference shares or debentures can be issued.

III. Dividend Decision:

- Dividend is that part of profit which has to be distributed among the shareholders of a company. This decision relates to the distribution of dividends among various groups. In this decision, it must be decided that
    - If all profits are to be dispersed,
    - Whether all earnings will be retained in the business, or
    - Whether a portion of profits will be retained in the business and the remainder distributed among shareholders.

Factors affecting Dividend Decision:

- **Earnings:** Companies having high and stable earnings could declare a high rate of dividends as dividends are paid out of current and paste earnings.
- **Stability of Dividends:** Companies generally follow the policy of stable dividend. The dividend per share is not altered and changed in case earnings change by small proportion or increase in earnings is temporary in nature.
- **Growth Prospects:** In case there are growth prospects for the company in the near future then it will retain its earnings and thus, no or less dividend will be declared.
- **Cash Flow Positions:** Dividends involve an outflow of cash and thus, availability of adequate cash is for most requirements for declaration of dividends.
- **Preference of Shareholders:** While deciding about dividend the preference of shareholders is also taken into account. In case shareholders desire a dividend then the company may go for declaring the same.
- **Taxation Policy:** A company is required to pay tax on the dividend declared by it. If tax on dividends is higher, companies will prefer to pay less by way of dividends whereas if tax rates are lower, more dividends can be declared by the company.
- **Issue of bonus shares:** Companies with large reserves may also distribute bonus shares to increase their capital base as it signifies growth of the company and enhances its reputation also.
- **Legal constraints:** Under provisions of Companies Act, all earnings can't be distributed and the company has to provide for various reserves. This limits the capacity of the company to declare a dividend.

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FINANCIAL PLANNING

It means deciding in advance how much to spend, on what to spend according to the funds at your disposal.

Objectives of Financial Planning:

- To ensure availability of funds whenever these are required.
- To see that the firm does not raise resources unnecessarily.

Importance of Financial Planning:

- **Forecasting:** It helps in forecasting the future under different circumstances. This helps the firms and organizations in dealing with contingencies.
- **Prepares for uncertainties:** It helps in preparing firms for various future ventures by avoiding business shocks and surprises.
- **Coordination:** It helps in better coordination of various business functions like production, sales, etc.
- **Building links:** It builds a link between the present of the organization with its future. It also provides a link between the financing and investment decisions on a regular basis.
- **Easy Performance Evaluation:** It makes the evaluation of the performance easier and in a detailed way.

CAPITAL STRUCTURE

- On the basis of ownership, funds => owners funds + borrowed funds.
- Owners funds = equity share capital + preference share capital + reserves and surpluses + retained earnings = EQUITY
- Borrowed funds = loans + debentures + public deposits = DEBT
- Capital Structure = The mix of long-term sources of funds
- Refers to the proportion of debt and equity used for financing the operations of a business.
- Cost and risk- Debt vs Equity
- Cost of Debt is lower than the cost of equity but Debt is more risky than equity.
- Cost of debt < cost of equity as lenders risk < owners risk.
- Lender earns an assured interest and repayment of capital.
- Interest on debt is a tax deductible expense so brings down the tax liability for a business whereas dividends are paid out of profit after tax.
- Debt is more risky for the business as it adds to the financial risk faced by a business.
- Any default w.r.t payment of interest or repayment of principal amt may lead to liquidation.
- Capital structure affects both the profitability and the financial risk faced by a business.
- Optimal Capital Structure is that combination of debt and equity that maximizes the market value of shares of that company

Factors affecting the Choice of Capital Structure:

- **Cash Flow Position:** Before raising finance business must consider the projected flow to ensure that it has sufficient cash to pay fixed cash obligations. A company with high liquidity and a good cash flow position can issue debt capital, as the company will have less chances of facing financial risk than the company with a low cash position.
- **Interest Coverage Ratio:** It refers to the number of times a company can cover its interest obligations from the profits and higher ICR reduces the risk of failing to meet interest obligations.
- **Debt Service Coverage Ratio:** It indicates the company's ability to meet cash commitments for interest and principal amount of debt.
- **Return on Investment:** If a company earns hai returns it has the capacity to opt for death as a source of finance.

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- **Cost of debt:** A company may raise funds from debts if it has the capacity to borrow funds at a lower interest rate.
- **Tax Rate:** Higher the tax rate, more preference for debt capital in the capital structure, as interest on debt capital being a tax deductible expense makes the debt cheaper.
- **Cost of equity:** If a company has high risk, its shareholder may expect a high rate of return resulting in increased cost of capital.
- **Floatation cost:** Choosing a source of fund depends on the flotation cost to be incurred to raise such funds, flotation cost makes this show less attractive.
- **Risk Consideration:** A company chooses debts as a source of finance depending on its operating risk and overall business risk.
- **Flexibility:** The choice of debts depends on the company's potential to borrow and the level of flexibility it wants to retain for choosing a source of funds in future.
- **Control:** Debt normally does not cause dilution of control whereas a public issue makes the firm vulnerable to takeovers. To retain control, firms should issue debt.

FIXED CAPITAL

Fixed capital refers to investment in long-term assets. Investment in fixed assets is for longer duration and they must be financed through long-term sources of capital. Decisions relating to fixed capital involve huge capital funds and are not reversible without incurring heavy losses.

Factors Affecting Requirement of Fixed Capital:

1. Nature of Business: Manufacturing concerns require huge investment in fixed assets & thus huge fixed capital is required for them but trading concerns need less fixed capital as they are not required to purchase plant and machinery etc.

2. Scale of Operations: An organization operating on a large scale requires more fixed capital as compared to an organization operating on a small scale.

For Example – A large scale steel enterprise like TISCO requires large investment as compared to a mini steel plant.

3. Choice of Technique: An organization using capital intensive techniques requires more investment in plant & machinery as compared to an organization using labour intensive techniques.

4. Technology upgradation: Organizations using assets which become obsolete faster require more fixed capital as compared to other organizations.

5. Growth Prospects: Companies having more growth plans require more fixed capital. In order to expand production capacity more plant & machinery are required.

6. Diversification: In case a company goes for diversification then it will require more fixed capital to invest in fixed assets like plant and machinery.

7. Distribution Channels: The firm which sells its product through wholesalers and retailers requires less fixed capital.

8. Collaboration: If companies are under collaboration, Joint venture, then they need less fixed capital as they share plant & machinery with their collaborators.

WORKING CAPITAL

- Working capital is that amount of capital which is used in the day-to-day operations of the business this may be in cash or cash equivalents. The working capital is utilised by the business within one year. For example: stocks and inventories, debtors, bills receivables, etc.
- Various type of Current assets that contribute to the working capital are:
  - Cash in hand/cash at Bank

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  - Marketable securities
  - Bills receivable
  - Debtors
  - Finished goods
  - Inventory
  - Work-in-progress
  - Raw material
  - Prepaid expenses
- Various sources of Current liabilities that contribute to the working capital are:
  - Bills payable
  - Creditors
- Outstanding expenses and advances received from customers.

Factors affecting the Working Capital requirements advance from customers:

- **Nature of Business:** A trading organization needs a lower amount of working capital as compared to a manufacturing organization, as trading organizations undertake no processing work.
- **Scale of Operations:** An organization operating on a large scale will require more inventories and thus, its working capital requirement will be more as compared to a small organization.
- **Business Cycle:** In the time of boom more production will be undertaken and so more working capital will be required during that time as compared to depression.
- **Seasonal Factors:** During peak season demand of a product will be high and thus high working capital will be required as compared to lean season.
- **Credit Allowed:** If credit is allowed by a concern to its customers then it will require more working capital but if goods are sold on a cash basis then less working capital is required.
- **Credit Availed:** If a firm is able to purchase raw materials on credit from its suppliers then less working capital will be required.
- **Inflation:** Working capital requirement is also determined by price level changes. For example, during inflation prices of raw material, wages also rise resulting in increase in working capital requirements.
- **Operating Cycle/Turnover of Working Capital:** Turnover means speed with which the working capital is converted into cash by sale of goods. If it is speedier, the amount of working capital required will be less.

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