UNIT 9

FINANCIAL MANAGEMENT

Introduction :-

Money required for carrying out business activities is called business finance. Finance is needed to establish a business, to run it, to modernise it, to expand or diversify it.

Finanicial management is the activity concerned with the planning, raising controlling and administering of funds used in the business. It is concerned with optimal procurement as well as usuage of finance. It aims at ensuring availability of enough funds whenever required as well as avoiding idle finance.

The Main Objective of Financial Management is to maximise shareholder s wealth, for which achievement of optimum capital structure and proper utilisation of funds is a must.

Every company is required to take three main **financial decisions** which are as follow:

1. 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 called capital budgeting decisions which involve huge amounts of investments and are irreversible except at a huge cost while short term investment decisions are called working capital decisions, which affect day to day working of a business.

2. Financing Decison :-

It relates to the amount of finance to be raised from various long term sources. The main sources of funds are owner s funds i.e. equity / share holder s funds and the borrowed funds i.e. Debts. Borrowed funds have to be repaid at a fixed time and thus some amount of financial risk (i.e. risk of default on payment) is there in debt financing. Morever interest on

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borrowed funds have to be paid regardless of whether or not a firm has made a profit. On the other hand shareholder funds involve no commitment regarding payment of returns or repayment of capital. A firm mixes both debt and equity in making financing decisions.

3. Dividend Decision :-

Dividend refers to that part of the profit which is distributed to shareholders. A company is required to decide how much of the profit earned by it should be distributed among shareholders and how much should be retained. The decision regarding dividend should be taken keeping in view the overall objective of maximising shareholder s wealth.

Financial Planning :-

The process of estimating the fund requirement of a business and specifying the sources of funds is called financial planning. It ensure that enough funds are available at right time so that a firm could honour its commitments and carry out, its plans.

Importance of Financial Planning

1. To ensure availbility of adequate funds at right time.
2. To see that the firm does not raise funds unnecessarily.

Factors affecting Investment Decisions / Capital Budgeting decisions

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

Factors Affecting Financing Decision

1. **Cost :-** The cost of raising funds from different sources are different. The cheapset source should be selected.
2. **Risk :-** The risk associated with different sources is different, More risk is associated with borrowed funds as compared to owner s fund as

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interest is paid on it and it is rapaid also, after a fixed period of time or on expiry of its tenure.

3. **Flotation Cost :-** The cost involved in issuing securities such as broker s commission, underwriters fees, expenses on prospectus etc is called flotation cost. Higher the flotation cost, less attractive is the source of finance.

4. **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.

5. **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.

6. **State of Capital Markets : -** During boom, finance can easily be raised by issuing shares but during depression period, raising finance by means of debt is easy.

Factors affecting Dividend Decision :

1. **Earnings : -** Company having high and stable earning could declare high rate of dividends as dividends are paid out of current and past earnings.

2. **Stability of Dividends :** Companies generally follow the policy of stable dividend. The dividend per share is not altered/changed in case earning changes by small proportion or increase in earning is temporary in nature.

3. **Growth Prospects :** In case there are growth prospects for the company in the near future them it will retain its earning and thus, no or less dividend will be declared.

4. **Cash Flow Positions :** Dividends involve an outflow of cash and thus, availability of adequate cash is foremost requirement for declaration of dividends.

5. **Preference of Shareholders :** While deciding about dividend the preference of shareholders is also taken into account. In case shareholders desire for dividend then company may go for declaring the same.

6. **Taxation Policy :** A company is required to pay tax on dividend declared by it. If tax on dividend is higher, company will prefer to pay less by way of dividends whereas if tax rates are lower then more dividends can be declared by the company.

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Capital Structure

Capital structure refers to the mix between owner s funds and borrowed funds. It will be said to be optimal when the proportion of debt and equity is such that it results in an increase in the value of the equity share. The proportion of debt in the overall capital of a firm is called **financial Leverage** or **capital gearing**. When the proportion of debt in the total capital is high then the firm will be called **highly levered firm** but when the proportion of debts in the total capital is less then the firm will be called **low levered firm**.

Factors affecting Capital Structure.

1. **Cash flow position :** In case a company has strong cash flow position then it may raise finance by issuing debts.
2. **Interest Coverage Ratio :** It refers to the number of times earning before interest and taxes of a company covers the interest obligation. High Interest coverage ratio indicate that company can have more of borrowed funds.
3. **Return on Investment :** If return on investment is higher than the rate of interest on debt then it will be beneficial for a firm to raise finance through borrowed funds.
4. **Flotation Cost :** The cost involved in issuing securities such as brokers commission, under writers fees, cost of prospectus etc is called flotation cost. While selecting the source of finance flotation cost should be taken into account.
5. **Control :** When existing shareholders are ready to dilute their control over the firm then new equity shares can be issued for raising finance but in reverse situation debts should be used.
6. **Tax Rate :** Interest on debt is allowed as a deduction, thus in case of high tax rate debts are prefered over equity but in case of low tax rate more preference is given to Equity.

   In addition, cost of debt, cost of equity, flexibility, risk consideration etc are other factors affecting capital structure.

Fixed Capital and Factors affecting 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. The factors affecting the requirement of fixed capital are as follows.

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1. **Nature of Business :** Manufacturing concern require huge investment in fixed assets & thus huge fixed capital is required for them but trading concern needs less fixed capital as they doesn t require to purchase plant and machinery etc.

2. **Scale of Operations :** An organisation operating on large scale require more fixed capital as compare to an organisation operating on small scale.

3. **Choice of Technique :** An organisation using capital intensive techniques require more investment in plant & machinery as compare to organisation using labour intensive techniques.

4. **Technology upgradation :** Organisations using assets which become obsolete faster require more fixed capital as compare to other organisations.

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

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

Working Capital and Factors affecting working capital

Working Capital refers to the capital required for day to day working of an organisation. Apart from the investment in fixed assets every business organisation needs to invest in current assets, which can be converted into cash or cash equivalents within a period of one year. They provide liquidity to the business. Working capital is of two types : **Gross working capital** and **Net working capital** Investment in all the current assets is called gross working capital whereas the excess of current assets over current liabilities is called net working capital. Following are the factors which affect working capital requirements of an organisation.

1. **Nature of Business :** A trading organisation needs a lower amount of working capital as compared to a manufacturing organisation as trading organisation undertake no processing work.

2. **Scale of operations : -** An organisation operating on large scale will require more inventory and thus, its working requirement will be more as compared to small organisation.

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3. **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.

4. **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.

5. **Credit allowed :** If credit is allowed by a concern to its customers than it will require more working capital but if goods are sold on cash basis than less working capital is required.

6. **Credit availed :** If a firm is able to purchase raw material on credit from its suppliers then less working capital will be required.

   In addition to above growth prospects, operating efficiency, inflation, level of competition etc also affect working capital requirement.

Trading on Equity :

It refers to the increase in profit earned by the equity shareholders due to the presence of fixed financial charges like interest. Trading on equity happen when the rate of earning of an organisation is higher than the cost at which funds have been borrowed and as a result equity shareholders get higher rate of dividend per share.

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One Mark Questions

1. Name the concept which increases the return on equity shares with a change in the capital structure.
2. A company wants to establish a new unit in which a machinery of worth Rs. 10 lakhs is involved. Identify the type of Decision involved in financial management.
3. What is the primary aim of financial management?
4. What is financial risk?
5. Why service-industry require less working capital?

Three / Four Marks Questions

1. What are capital budgeting Decisions? Explain three factors affecting capital budgeting Decisions.
2. What is meant by fiancial planning? Explain its objectives.
3. Explain the meaning and objectives of financial management.

4. Explain financial Leverage and Trading on Equity.
5. Explain the various financial decisions taken by an organisation.

Five / Six Marks Questions

1. Define capital structure. Explain five factors affecting it.
2. Explain six factors affecting fixed capital of a concern.
3. Give the meaning of working capital. Explain any five factors determing working capital requirements.
4. What is meant by Divident Decision? State & Explain five factors affecting the Dividend Decision.
5. Suggest working capital requirement for following manufacturing concern:
   a) Bread
   b) Sugar
   c) Coolers
   d) Motor Car
   e) Locomotive
   f) Furniture on Specific order.

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