# BUSINESS STUDIES

# Financial Management

**Topics Covered**

- Introduction to financial management
- Importance and objectives of financial management
- Types of financial decisions
- Factors affecting financial decisions
- Financial planning and its objectives
- Capital structure
- Fixed and working capital

## Introduction to Financial Management

- Financial management refers to ***efficient acquisition, allocation and usage of funds*** by a company for its smooth working.
- The main objectives of financial management are to ***reduce the expenses involved in procuring funds, to control risk*** and to ***achieve effective deployment of funds***.

**Importance of Financial Management**

- The role of financial management is as such that it has a direct impact on all the financial aspects/activities of a company. Certain aspects affected by financial management decisions are
    1. ***Size and composition of fixed assets:*** The amount of money invested in fixed assets is an outcome of investment decisions. So, if more amount of capital is decided to be invested in fixed assets, then it will increase the value of the total share of fixed assets by the amount invested.
    2. ***Amount and composition of current assets:*** The quantum of current assets and its constituents like cash, bills receivable, inventory etc. is also influenced by management decisions. It is also dependent on the amount invested in fixed assets, decisions about credit and inventory management etc.
    3. ***Amount of long-term and short-term funds to be used:*** Financial management determines the quantum of funds to be raised for the short term and long term. In case a firm requires more liquid assets, then it will prefer to have more long-term finance even when their profits will decrease due to payment of more interest in comparison to short-term debts.
    4. **Proportion of debt and equity in capital:** Financial management also takes decisions regarding the proportion of debt and/or equity.
    5. **All items in profit and loss account:** All items in the profit and loss account are affected by financial management decisions. For example, higher amount of debt will lead to increase in the expense in the form of interest payment in the future.

**Objectives**

1. The basic objective of financial management is to ***maximise the wealth of shareholders***.
2. It aims at taking ***financial decisions*** which prove ***beneficial for shareholders***. Such financial decisions are taken wherein the anticipated benefits exceed the cost incurred. This in turn implies an ***improvement in the market value of shares.***

3. An increase in the market value of shares is gainful for shareholders.
4. It focusses on taking those financial decisions which lead to value addition for the company, so ***the price of the equity share rises.***
5. As this basic objective gets fulfilled, other objectives such as ***optimum utilisation of funds, maintenance of liquidity*** etc. are also fulfilled automatically.
6. It involves ***choosing the best alternative*** which will prove to be beneficial.

## Types of Financial Management

Financial management is mainly concerned with the following decisions:

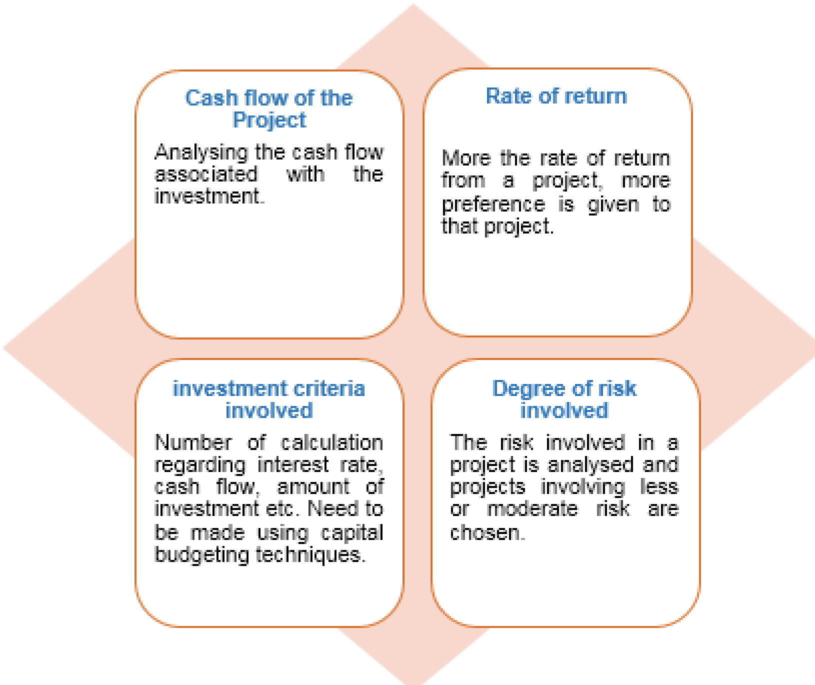

**A. <u>Investment Decisions</u>**

A firm must decide where to invest the funds such that it can earn ***maximum returns***. Such decisions are known as investment decisions and can be classified as long-term and short-term investment decisions.

- **Long-term investment decisions**:
  - It refers to ***long-term investment decisions*** such as investment in a new fixed asset, new machinery or land.
  - They are also known as ***capital budgeting decisions.***
    It affects a firm's long-term earning capacity and profitability and also has long-term implications on the ***business***.
  - Moreover, such investment involves a ***large amount of money***, so it is very difficult to revert such decisions.
  - Example: Decision to purchase a new fixed asset, opening a new branch etc.

- **Short-term investment decisions**
  - These decisions are also known as ***working capital decisions*** and affect day-to-day business operations.
  - It also affects the liquidity and profitability of a business.
  - Example: Decisions related to cash management, inventory management etc.

**Factors Affecting Capital Budgeting Decisions**




**B. <u>Financial Decisions</u>**

- Financing decisions involve decisions with regard to the ***volume of funds*** to be raised from ***various sources.***
- These decisions also include ***identification of sources of finance***.
- There are two main sources of raising funds, namely ***shareholders' funds*** (equity) and ***borrowed funds*** (debt).
- Taking into consideration factors such as ***cost, risk and profitability***, a company must ***decide an optimum combination of debt and equity.***
- For example, while ***debt proves to be cheaper than equity***, it involves greater financial risk.
- Financial decisions must be taken judiciously as they have an ***impact on the overall cost of capital*** of the firm and also involves financial risk.
- Generally, a mixture of both debt and equity funds proves to be beneficial for the company.

| Difference between debt and equity as a source of finance | |
|---|---|
| **Equity** | **Debt** |
| • **Includes equity share capital and retained earnings** | • Includes funds raised through debentures, loans and other forms of debt |
| • **No fixed charges and commitments related to payment of interest and payment of capital** | • Fixed interest and repayment obligations i.e. financial risk is involved |

| Factors affecting the Financial Decision | |
|---|---|
| **Cost** | Cost of raising funds is an important factor taken into consideration while choosing a source of fund. Generally, the source of fund which is the cheapest will be chosen. |
| **Risk** | Risk involved in each source of fund is different. However, funds with moderate or low risk are chosen. |
| **Flotation Cost** | Higher the flotation cost, less attractive is the source of fund. |
| **Cash Flow Position** | Cash flow position of a company also impacts its decision when choosing a source of fund. A company with a strong cash flow position will invest in debt, whereas a company with a weak cash flow position will opt for investment in equity. |
| **Fixed Operating Cost** | Companies having a high fixed operating cost must refrain from investing in debt, whereas companies with less financing cost may opt for investing more in debt. This is because fixed operating costs like a building or rent require a lot of finance. Hence, the company must avoid sources of finance which will add more to their expenses. |
| **Control Considerations** | Companies which do not want to dilute the level of control must invest in debt, as investing in equity will result in dilution of management's control over the business. |
| **State of capital market** | The status of the capital market is also a crucial factor in determining the choice of the source of fund. In case the market is bullish, more people invest in equity, whereas when the market is bearish, it is difficult for companies to issue equity shares. |

**C. <u>Dividend Decisions</u>**

- Dividend decisions involve decisions regarding how the company would ***distribute*** its profit or surplus.
- Dividend is basically a part of profit which is distributed to shareholders.
- The company decides whether to distribute it to ***equity shareholders in the form of dividends*** or to keep it in the form of ***retained earnings***.
- So, the main decision is regarding how much profit is to be distributed and how much is to be retained in the business.
- This decision is generally taken considering the objective of maximising shareholder's strength and also retaining earnings to increase the future earning capacity of the organisation.

| Factors affecting the Dividend Decision | |
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| **1) Amount of earning** | • A firm decides the ***dividends to be paid*** on the basis of its current and past earnings. |

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| | • If the company has ***higher earnings***, then it would be in a ***better position to pay*** dividends.<br>• As against this, if a company has low earnings, it would be able to pay lower dividends. |
| **2) Stable earnings** | • A company with stable or smooth earnings can ***pay higher dividends*** to shareholders than a company which has unstable and uneven earnings. |
| **3) Stable dividends** | • Generally, companies try to stabilise their dividends such that there is not much fluctuation in the dividends they distribute.<br>• They opt for ***increasing the dividends only when there is a consistent increase in their earnings***. |
| **4) Growth prospects** | • Companies with higher growth prospects prefer to retain a ***greater portion of their earnings for future reinvestment***.<br>• Accordingly, they ***pay lesser dividends.*** |
| **5) Cash flow position** | • Payment of dividends implies a cash outflow from the company. If a company has less cash (low liquidity), then it will pay less in the form of dividends. Similarly, if a company has surplus cash (high liquidity), then it will pay out more dividends. |
| **6) Preference of shareholders** | • The preference of shareholders must also be considered while taking dividend decisions.<br>• For instance, if the ***shareholders prefer*** that a certain minimum amount of dividends be paid, then the company is likely to declare the same. |
| **7) Taxation policy** | • Taxation policy of the government is an important factor in taking the dividend decision.<br>• For instance, if the ***rate of taxation on payment of dividend by companies is high***, then the company ***may distribute less*** by way of dividends. |
| **8) Stock market reactions** | • Dividend decisions taken by a company affect the market price of its stock.<br>• If a company declares ***higher dividends***, then it is seen positively by investors, and its ***stock price increases***.<br>• On the other hand, a fall in the dividends would have an adverse effect on the stock price of a company. |
| **9) Contractual constraints** | • Sometimes, a company may enter a ***contractual agreement with the lenders*** which restrict or shape their dividend decisions.<br>• Such agreements must be kept in mind while taking dividend decisions. |
| **10) Access to capital market** | • Generally, large companies having ***greater access*** to the capital market would not depend on retained earnings to finance their future projects. Hence, they are likely to pay ***higher*** dividends.<br>• On the other hand, small companies with ***less access*** to capital markets are likely to pay ***lower*** dividends. |

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| **11) Legal constraints** | • Companies mandatorily need to adhere to the ***rules and policies of the Companies Act.***<br>• The dividend decisions must be taken in careful consideration of these rules and policies.<br>• Apart from these provisions, if the company enters into a loan agreement wherein the lender lays certain restrictions on the payment of dividend in future, then the company will have to adhere to those restrictions. |

## Financial Planning

Financial planning involves designing the ***blueprint of the overall financial operations*** of a company such that the right amount of funds are available for various operations at the right time.

**Main Objectives of Financial Planning**

1) **Identifying the sources** from where the funds can be raised and ensuring that the required funds are available to the firm as and when needed. For this, under financial planning, an estimation is made regarding the amount of funds which would be required for various business operations. In addition, an estimation is made regarding the time at which the funds would be needed.
2) To ensure that there is ***proper utilisation of funds*** in the sense that there is neither surplus nor inadequate funding by the firm. In other words, it ensures that situations of both ***excess or shortage of funds are avoided***. This is because while inadequate funds obstruct operations of the firm, excess funding leads to wasteful expenditure by the firm. Thus, proper financial planning ensures optimal utilisation of funds by the firm.

| Importance of Financial Planning | |
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| **1) Helps in facing eventual situations** | • Forecasts things that are to happen<br>• Helps a business to prepare itself to face future situations in a better manner<br>• Prepares a blueprint depicting alternative situations and equips management in advance to tackle changed prevailing scenario |
| **2) Improves Coordination** | • ***Helps in coordinating*** various business functions<br>• For example, coordinating the functions of the sales, production and finance departments by providing clear rules, policies and procedures |

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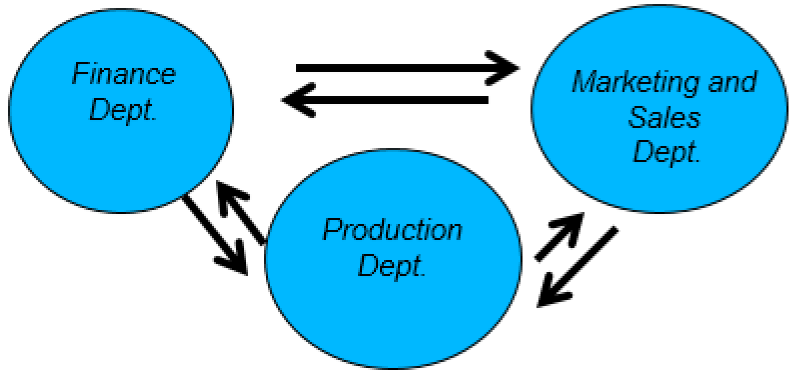
| |  |
| 3) **Helps in optimum utilisation of funds** | • Ensures reduction of wastes, thereby leading to good management of funds |
| 4) **Evaluation of performance** | • By providing detailed business objectives and depicting all the financial plans for varied business segments, it makes it easier to evaluate ***segment-wise business performance*** |
| 5) **Helps in avoiding surprises & shocks** | • Helps a company to prepare itself for ***future shocks*** and ***surprises*** |
| 6) **Reduces wastage & duplicity** | • Detailed plans of action helps in ***reducing wastage and avoids duplication of efforts*** |
| 7) **Acts as a link** | • Tries to link the present with the future<br>• Provides a link between investment and financing decisions |

**Differences between financial planning and financial management**

| Financial Planning | Financial Management |
|---|---|
| • It is the process of estimating the amount of funds which would be required by the business and determining the sources through which these would be obtained. | • It refers to the efficient acquisition, allocation and usage of funds of the company. |
| • Financial planning aims at ensuring smooth operations by considering the requirement of funds against their availability. | • Financial management aims at determining the best investment alternative by considering the relative costs and benefits. |
| • It has a narrow scope and is a part of financial management. | • It has a wider scope. |
| • The objective is to ensure availability of funds as and when required and that unnecessary fund raising is avoided. | • The objective is to manage various activities related to finance. |

## Capital Structure

- Capital structure simply implies a combination of different financial sources which a firm uses to raise funds.
- There are two broad categories of sources of funds, namely ***borrowed funds and owner's funds***. Borrowed funds refer to borrowings in the form of loans, borrowings from banks, public deposits etc. In general, 'borrowed funds' are simply called ***debt.***
- On the other hand, owner's funds can be in the form of reserves, preference share capital, retained earnings etc. In general, owner's funds can be called ***equity.***
- Accordingly, capital structure can be simply stated as the ***combination of debt and equity*** used by a firm.
- The capital structure of a company affects the profitability as well as the financial risk of the company.
- Hence, it needs to be taken after considering various aspects.
- The way capital structure is framed by the company depends on three main factors—***cost, risks and returns.***

1) ***Cost considerations***
    - Debt is a ***cheaper source*** of finance than equity. The low cost of debt is because the lenders are assured of the return amount, i.e. it involves a low risk. Low risk, in turn, implies a lower rate of return. This implies a ***lower cost to the company***. The interest to be paid on debt is ***tax deductible.***
    - Equities are more ***expensive*** than tax as they involve flotation cost as well. Moreover, dividends paid to shareholders are not tax deductible (i.e. dividends are paid from profits after tax).
2) ***Financial risk***
    - Debt ***involves financial risk*** in the sense that there is compulsion to repay the debt amount in a fixed period of time. Any default in repayment may even lead to ***liquidation of the firm***.
    - In case of equity, there is no such risk as it is not mandatory to pay dividends to shareholders.
3) ***Return***

    Debt offers higher return in the sense that in case of debt, the difference between ***cost and return*** is greater. Accordingly, the earning per share is greater. Thus, we can say that while ***debt is cheaper and offers higher return,*** it also increases the financial risk of the company.

    Hence, the decision regarding the capital structure must be taken after careful consideration of the factors of ***cost, return and risk involved.***

**Factors Affecting Capital Structure**

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| 1) **Cash flow position** | Determining the company's capital structure is also dependent on the company's ability to generate cash flow.<br>*Strong* cash flow position $\Rightarrow$ More *debt*<br>*Weak* cash flow position $\Rightarrow$ More *equity* |
| 2) **Interest coverage ratio** | It refers to the number of times of earnings before interest, and taxes of a company cover the interest obligation.<br>$\text{ICR} = \left.\dfrac{\text{EBIT}}{\text{Interest}}\right\}$ ***High*** ICR $\Rightarrow$ ***Higher*** Proportion of Debt; ***Low*** ICR $\Rightarrow$ ***Lower*** Proportion of Debt |
| 3) **Debt Service Coverage Ratio (DSCR)** | This ratio is one step ahead of the ICR. It takes into consideration the return of interest as well as repayment of principal. |

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| | $\text{DSCR} = \dfrac{\text{Profit after Tax + Depreciation + Interest + Non Cash- Expense}}{\text{Preference Dividend + Interest + Repayment of Obligations}}$<br>***Higher*** DSCR ⇒ ***More*** Debt<br>***Lower*** DSCR ⇒ ***Less*** Debt |
| 4) **Return on investment** | Rate of interest is also a factor which helps in determining the capital structure of a company.<br>***Higher* ROI ⇒ *More debt***<br>***Lower* ROI ⇒ *Lower debt*** |
| 5) **Cost of debt** | ***Low*** Cost of Debt ⇒ ***Higher*** Proportion of Debt in Capital Structure<br>***High*** Cost of Debt ⇒ ***Lower*** Proportion of Debt in Capital Structure |
| 6) **Tax rate** | ***Low*** Tax Rate ⇒ ***Lower*** Proportion of Debt in Capital Structure<br>***High*** Tax Rate ⇒ ***Higher*** Proportion of Debt in Capital Structure |
| 7) **Flotation cost** | Flotation cost refers to the costs involved in the issue of shares and debentures. It includes the costs of advertising, underwriting, statutory fees etc.<br>**Higher flotation cost involved in raising funds from a particular source ⇒ Lower proportion of that source in capital structure** |
| 8) **Risk consideration** | ***Higher*** Financial & Operating Risks ⇒ ***Lower*** Proportion of Debt<br>***Lower*** Financial & Operating Risks Risk ⇒ ***Higher*** Proportion of Debt |
| 9) **Flexibility** | More use of debt at present⇒ Ability to use debt in the future decreases |
| 10) **Control** | If the management wants to keep control in its own hands ⇒ ***More*** debt<br>If the management can share control with others ⇒ ***More*** equity |
| 11) **Regulatory framework** | Regulatory guidelines provided by law specify the procedures which need to be followed while raising funds from different sources.<br>The ease through which these norms, rules and/or regulations can be followed also affect the choice of sources of funds, i.e. capital structure. |
| 12) **Stock market condition** | Boom condition ⇒ ***Easy to opt for equity***<br>Recession condition ⇒ ***Difficult to opt for equity and may opt for debt*** |
| 13) **Cost of equity** | Use of debt increases ⇒ Financial risk increases ⇒ Expectation of rate of return increases<br>⇓<br>Equity cost increases ⇐ Difficult to opt for equity |
| 14) **Capital structure of other companies** | Industry norms and capital structure of other companies can act as guidelines for a company, but a company should not blindly follow them as it may lead to financial risk |

## Fixed and Working Capital

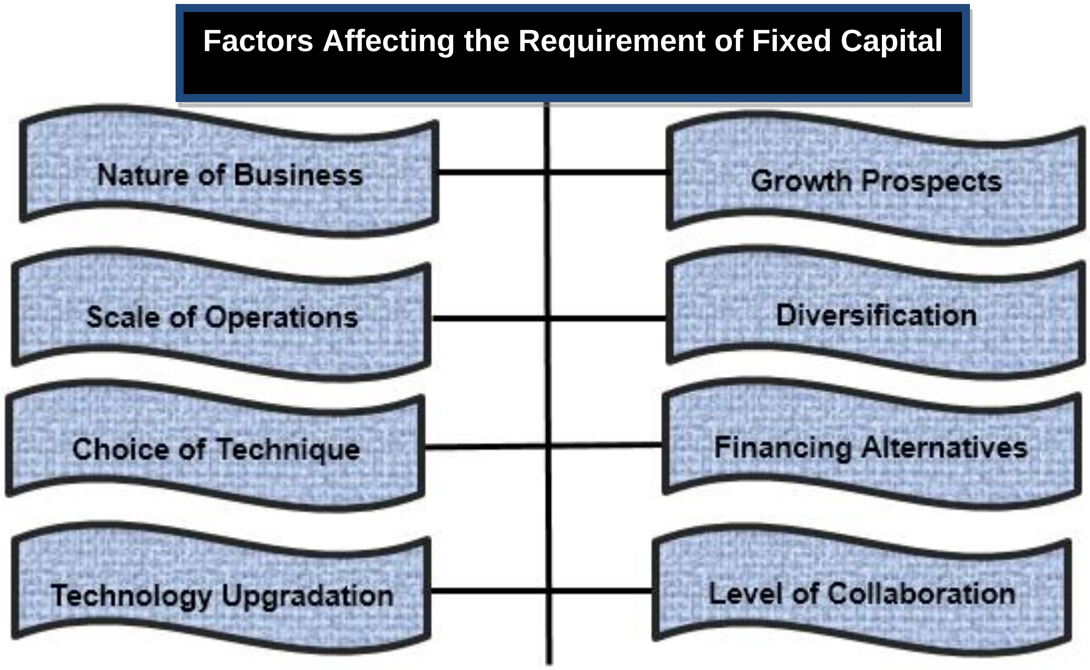
### Fixed Capital

- Fixed capital refers to ***investment in long-term assets***.

- Management of fixed capital includes ***allocating a firm's capital to different projects/assets.***
- Such decisions are known as ***investment decisions or capital budgeting decisions.***
- These decisions affect the ***growth, profitability and risk*** of the business in the ***long run.***
- Fixed assets should be financed through long-term sources of capital:
  - Equity or preference shares
  - Debentures
  - Long-term loans
  - Retained earnings
- Examples:
  - Purchase of land, building, plant and machinery
  - Launching of a new product line
  - Investment in advance techniques of production
  - Expenditure on advertising campaigns and research and development which have long-term implications for the organisation

**Factors affecting the requirement of fixed capital**

1) **Nature of business:** Nature of business is a very essential factor which helps in determining the capital requirements of a company. For example, fixed capital requirement is more in a manufacturing company than in a trading company.
2) **Scale of operation:** Companies functioning on a large scale require more fixed capital than small-scale companies because large-scale companies purchase more machinery and plants for their operations and require more space.
3) **Technique of production**: When a company adopts capital intensive technology, it relies less on manual work and the requirement of fixed capital is more. On the other hand, a company based on labour-intensive technology will require less fixed capital as it makes less investments in fixed assets.
4) **Technology upgradation:** When industrial upgradation takes place in the fast phase, the company requires more fixed capital for replacing old machinery with new machinery to upgrade technology. While upgradation is slow, the fixed capital requirement will be less.
5) **Growth prospects:** Companies expanding their activities to attain higher growth will require more fixed capital than companies having no such activities.
6) **Diversification:** Companies diversifying their range of production activities will require more fixed capital to produce goods.
7) **Availability of finance and leasing facility:** When companies are provided leasing facilities, they can avoid purchase of fixed assets. This leads to reduction in fixed capital requirements.
8) **Level of collaboration:** Companies which prefer collaborations will require less fixed capital as they can share available machinery with their collaborators.




## Working Capital

Working capital refers to the capital of business used in day-to-day activities.

**Two main concepts of working capital:**

- ***Gross working capital:*** It simply implies investment in current assets.
- ***Net working capital:*** It implies the excess of current assets (cash in hand/at bank, bills receivable, debtors etc.) over current liabilities (obligatory payments which are due; for example, bills payable, outstanding expenses etc.).
  Algebraically, **Net Working Capital = Current Assets − Current Liabilities**

**Factors affecting the requirement of working capital**

1) **Type of business:** The nature of business is one of the important determinants of working capital requirement.
   a. For instance, trading organisations have shorter operating cycles, i.e. no processing is done in such organisations. Accordingly, they require low working capital.
   b. As against this, an organisation dealing in manufacturing would require large working capital. This is because it involves a large operating cycle, i.e. the raw materials first need to be transformed to finished goods before they are offered for sale.
2) **Scale of operations:** Firms which operate on a larger scale require greater working capital than those which operate on a lower scale. This is because firms with greater scale of operations are required to maintain high stock of inventory and debtors. As against this, a business with smaller scale of operation requires less working capital.
3) **Fluctuations in business cycle:** In various phases of the business cycle, the requirement of working capital is different. For instance, in the phase of boom, both production and sales are higher. Accordingly, the requirement of working capital is also high. As against this, in the phase of depression, the demand is low, and so production and sale are low. Accordingly, there is less requirement of working capital.
4) **Production cycle:** Production cycle refers to the time gap between receiving goods and their processing into final goods. Longer the production cycle for a firm, larger are the requirements of

working capital and *vice versa*. This is because a longer production cycle would imply greater inventories and other related expenses, so greater requirement of working capital.

5) **Growth prospects:** Higher growth prospects imply higher production, sales and inputs. Accordingly, higher growth prospects for a company imply greater requirement of working capital.
6) **Seasonal factors:** Companies require huge amount of working capital because of the high level of activity in the peak season, whereas during the lean season they require less as the activities reduce.
7) **Credit allowed:** Credit policy refers to the average period for collection of sale proceeds. This depends on credit worthiness of clients. So, a company which allows liberal credit policy will require more working capital.
8) **Credit availed:** A company/firm may get credit from its suppliers depending on their credit worthiness. The more they get such credit, the more the requirement of working capital reduces.
9) **Operating efficiency:** Companies with a high degree of operating efficiency will require less working capital, *whereas companies having a low level of efficiency will require more working capital because* efficiency may help the company/firm in reducing the level of raw materials required, average time for which finished goods inventory is held etc.
10) **Availability of raw materials:** If raw materials are easily and continuously available, then lower levels of stocks would suffice. This will help the firm/company to avoid storing a large amount of raw materials, thereby reducing the need of working capital. However, if the lead time between placing the order and supply of goods increases, then the company will require to store a large amount of stock of raw materials which will lead to more requirement of working capital.
11) **Level of competition:** If the market is more competitive, the company will require larger stocks of finished goods in order to supply goods on time. So, they maintain higher inventories which require a large amount of capital.