FINANCIAL MANAGEMENT

(This is only an outline of the topic. Note disgned in such a way to include maximum value points for examination. Questions from the KSFE examination will be added as second part.)

Finance is considered to be the life blood of any business. It is defined as " the provision of money at the time it is needed. Financial management refers to that part of managerial activity which is concerned with procurement and utilization of funds for business purposes. The notable objectives of financial management are a) Profit maximization b) Wealth maximization. . Profit maximization means the maximizing the rupee income of the business whereas wealth maximization refers to the maximization of market price per share of the company.. Of this, the most significant objective is Wealth maximization.

The financial management decisions can be categorized into a) Financing decisions b) Investment decisions c) Dividend decisions

Financing decisions are concerned with the financing of business activities. Investment decisions are capital budgeting decisions. Dividend decisions are concerned with the disposal of profits.

Financial Engineering is the process of designing , developing and implementing innovative financial instruments and formulating creative solutions to problems in finance.

Financial assets consists of money, debt and stock. Money is issued by the RBI, Ministry of Finance.. while debt is issued by a variety of organizations comprising the government and its agencies, and the stock (equity and preference) is issued by business organizations. From the point of view of the finance managers, the debt and stock are more significant.

Financial markets exists wherever financial transactions take place. A financial transaction is said to occur, when a financial asset is created or transferred. Money market and Capital market are the two classes of financial markets.

Money has a time value on account of the following reasons.

a) An investor can invest a rupee received today for a greater value to be received tomorrow or after a certain period.

b) Generally individuals prefer current consumption

c) The money received today should have greater purchasing power than the same to be received in future during boom or inflation.

d) Financial planning is the process of determining the objectives, policies procedures and programmes to deal with the financial activities of an organization.

Fixed capital is represented by fixed assets like plant and machinery, land and building furniture etc. . Investment in such assets is more or less permanent in nature

Working capital is the amount of capital which is required for the day today working of the business. It refers to that part of capital which is available and used for carrying out routine business operations of financing current assets such as cash, marketable securities, debtors and inventories. It is also known as circulating capital or revolving capital because it keeps on revolving or circulating from cash to current assets and back.

There are two concepts of working capital. A) Gross working capital B) Net working capital. Gross working capital is the funds invested in current assets. . The concept of gross working capital is a going concern concept which is helpful in providing the right amount of working capital at the right time.

Net working capital refers to the difference between current assets and current liabilities. It is a broader and more useful concept. Net working capital may be positive of negative. When current assets exceed the current liabilities, the working capital is positive. On the other hand, when current liabilities are more than the current assets, it is known as negative working capital.

Permanent working capital or Regular working capital is the minimum amount which is required to ensure effective utilization of current assets. The amount of permanent working capital increases with the increase in fixed assets over a long period. The increase in fixed assets leads to increase in turnover which in turn leads to increase in permanent working capital.

Variable or temporary working capital is the amount of working capital which is required to meet the seasonal requirements and some special exigencies.

Financial forecasting means a systematic projection of expected action of finance through financial statements.

Budget is a predetermined detailed plan of action developed and distributed as a guide to current operations and as a partial basis for the subsequent evaluation of performance

Zero Base Budgeting : Peter. A. Phyrr

Programme Budgeting : 2 nd Hoover commission 1961

Performance budgeting : First Hoover commission, 1949

Funds needed for acquiring fixed assets like land and building, plant and machinery etc. are known as long term finance. The long term sources of finance such as shares, debentures and retained earnings are raised mainly for a period not less than 10 years.

Funds required for meeting long term needs of working capital are known as medium term finance. This is generally raised for a period between one year and 10 years.

Funds acquired for meeting the short term needs of the working capital are known as short term finance. This is generally raised for a period of one year and less.

A business can raise funds by raising two types of securities. They are as follows :

1) **Ownership securities 2) Creditor ship securities (Borrowed capital)**

The capital contributed by the owners is known as **owned capital**. It consists of initial capital contribution and the profits reinvested in business. It is a source of permanent capital. Although a part of the owned capital may be used as working capital, it is generally used to acquire fixed assets. It is the risk capital of the business.

Finance raised by way of loans and credit from the public, banks and financial institutions is known as **borrowed capital**. It includes debentures , public deposits, banks loan etc. It is generally safe.

Equity shares are ordinary shares and such shareholders are the real owners of the company. It is the most important source of finance for fixed capital and they represent the ownership capital of a company. They are known as risk bearers.

Preference shares are those shares which carry preferential rights in respect of dividend and repayment of capital in the event of the winding up of the company. Since preference shareholders have no voting rights, they do not have to take any risk and hence ownership is not affected. By virtue of special privileges enjoyed by preference share holders, they are denied the right to take part in matters which may be discussed in the general body meeting. They cannot also take part in the election of directors. In effect, the management and control of the company vests with the equity shareholders.

In the case of cumulative preference shares, they will get a fixed rate of dividend and in any year, if they are not paid that fixed rate on account of inadequate profits, arrears of dividend will accumulate and will have to be paid out of profits of future years. Non-cumulative preference share holders do not have such rights. In the case of participating preference shares, they are eligible to participate in the surplus profit along with the equity share holders, in addition to the fixed preferential dividend.

When a company retains a part of undistributed profits in the free resources and the same is utilized for further expansion, it is known as **ploughing back of profits** or retained earnings or self financing. It is an internal source of finance and no obligation is created.

Debenture is a major source of borrowed capital. It is a certificate issued by a company under its seal acknowledging a debt due by to its holders. They are the creditors of the company. In the case of Registered debentures, the names of holders of such debentures are found in the register of debenture holders of the company. Bearer debentures are the debentures, which are payable to the bearer. When the debentures are secured by a charge on the assets of the company, they are known as secured or mortgage debentures. When the debentures are issued without any security in respect of interest or repayment of the principal, they are known as unsecured debentures or naked debentures.

The deposits made by the public with the joint stock companies are known as public deposits. Commercial banks play a very significant role in financing the short term requirements of companies.

The Industrial Finance Corporation of India was set up in 1.7.1948. The IDBI set up in July 1964.

The State Financial Corporation Act was passed by the Government of India in 1951 to meet the requirements of small concerns.

A high risk capital : Venture capital.

A temporary loan given to cover the gap between purchase of an asset and the sale of another asset, the proceeds of which are required to finance the purchase : **Bridge Loan**

If the financial needs of a single unit cannot be met by a single bank, two or more banks come together to finance the unit by jointly spreading the risk and sharing the responsibilities of monitoring and finance. **This arrangement is called consortium lending.**

Loan Syndication is also same as consortium lending, which includes two methods a) Direct Lending b) Through participation. Under direct lending, all the lenders sign the loan agreement independently with the borrower and agree to lend up to their respective share. But under participation, the lead bank is the only lending bank as far as the borrower is concerned. Here the lead bank approaches the other lenders without the knowledge of the borrower to participate in the loan.

Cost of capital : The term cost of capital refers to the minimum rate of return which a firm must earn on its investment. In the economic aspect , it is the cost of raising funds required to finance the proposed project. Ie, the borrowing rate of the firm. In other words, it is the rate of return the firm requires from investment in order to increase the value of the firm in the market place. It is haurdle rate. (Business risk relates to capital budgeting decisions and variability in operating profit by virtue of change in sales. Financial risk relates to the pattern of capital structure..)

The explicit cost of capital of any source of finance may be defined as the discount rate that equates the present value of cash inflows with the present value of expected cash out flows.

The implicit cost may be defined as the rate of return associated with the best investment opportunity for the firm and its shareholders that will be foregone if the projects presently under consideration by the firm were accepted.

The cost of each component of capital is called specific cost of capital. The marginal cost of capital is the additional amount of capital which is raised by a firm for current and fixed capital requirements. Under the traditional approach of cost of capital, it relates to the capital structure of a firm. But under Modigliani and Miller approach, total cost of capital and capital structure are independent.

Capitalisation refers to the total amount of securities issued by a company. It is the aggregate of equity shares , preference shares debentures, long term borrowings and free reserves.

According to the cost theory of capitalization, the value of a company is the aggregate of the value of fixed assets, working capital, cost of establishing business and expenses on promotion. But the earnings theory suggests that true value of the company depends on its earning and earning capacity. That means the value of capitalization of a company is equal to the capitalized value of its estimated earnings.

The situation of **over capitalization** arises when a company raises more capital than is justified by its earnings. A company is said to be over capitalized " when its profits are not large enough to yield a fair return on the amount of shares and debentures that have been issued

Watered capital : Water is said to be present in the capital when a part of capital of a company is not represented by assets. In other words, the capital of the company is said to have been watered whenever its stock is issued to persons in excess of the benefits received from them. This generally occurs, when assets are acquired by a company at high price.

Under capitalization is the just reverse of over capitalization. It is a state of affair when the capital of the company is less in proportion to its total requirements. It is a situation of efficient use of capital.

Capital structure or Financial structure is the type of securities to be issued and proportionate amounts that make up the capitalization. It is the proportion of different kinds of securities raised by a company as long term finance.

Capital gearing is the relationship between the ownership capital and creditor ship capital. In other words, it stands for the ratio between the various kinds of securities to the total capitalization. A company is said to be highly geared, when the ownership capital is less than the debt capital. On the other hand, low gearing means, ownership capital is more than the creditor ship capital.

EBIT EPS analysis .. An efficient tool to manage the company's capital structure management.

A company is said to be in **optimum capital structure,** when the market value per equity share is the maximum. That means that relationship of debt and equity which maximizes the value of a firm's share in the stock exchange.

According to Net Income approach by David Durand,, the total value of the firm may be enhanced by lowering the cost of capital. The value of the firm depends on its capital structure decisions.. IN the Net Operating Income approach, by David Durand, the value of the firm depends on its Net operating income and business risk.

Leverage is an increased means for attaining an object.. It is the employment of an asset or funds for which the firm pays a fixed cost or fixed return. These fixed cost or returns may be the fulcrum of a lever. In case a firm is not required to pay fixed cost or return, there will be no leverage. The quantum of fixed cost or returns has considerable impact over the amount of profits available for the shareholders as these are required to be paid or incurred irrespective of the volume of sales or output.. So there is a relative change in profits on account of change in sales. A high degree of leverage indicates that there will be a large change in profits on account of a relatively small change in sales and vice versa.

There are three types of leverages. They are Operating leverage, Financial leverage and Composite leverage. **Operating leverage** means use of fixed cost in the operation of a firm. If a firm's ratio of fixed cost to total cost is nil, it should not have operating leverage.. It may be defined as the tendency of the operating profit to vary disproportionately with sales. In other words, it is the firm's ability to use fixed operating costs to magnify the effect of change in sales on its EBIT. **OL = Contribution/EBIT.**

Financial leverage is the use of fixed financing cost by the firm. The British expression financial leverage is capital gearing. Thus the use of fixed interest/dividend bearing securities such as debt and preference capital along with the owners equity in the total capital structure of a company is described as financial leverage.. The leverage is said to be high, when the debt capital is more than equity capital in the capital structure. Sometimes it is also described as Trading on equity. But the term is used only when the financial leverage is favourable. The leverage is said to be favourable, so long as the company earns more on assets purchased with the funds than the fixed cost of their use. **FL= EBIT/ Profit before tax but after interest.**

When both operating and financial leverages are applied, a composite leverage should be obtained.. Composite Leverage = Contribution/ Profit before tax but after interest.

The approaches of financing working capital policy consists of three points. They are :

Hedging or Matching approach : It is the process of matching maturities of debt with maturities of financial needs. Here the effort is to match the life of assets with the term of sources of funds.

The conservative approach : Here, as far as possible, investments in current assets should be financed by funds from long term sources and short term sources should be used only for emergency requirements.

The Aggressive approach : Here a major part of total current assets requirements should be financed from short term sources and even a part of fixed requirements be financed from short term sources.

Inventories are resources of any kind having economic value. It consist of raw materials, work-in progress, finished goods, consumables and stores. It accounts more than 50% of the working capital requirements of the firm. Ordering cost, carrying cost, under stocking cost, over stocking cost etc. are the major costs associated with inventory.

Under stocking cost is the penalty incurred to the concern on account of the inability to meet the demand in time. The quantum of penalty depends on the nature of the demand.

Overstocking cost arises on account of the opportunity lost, when investment in inventories postponed for a longer period, than necessary. To the

Selective Inventory control includes ABC analysis (Basis: Value) HML (Basis: Unit price of the material) XYZ (Basis: Value of items in storage) , VED (Basis: Criticality of the component) FSN (Basis: consumption pattern of the component) SDE (Basis: Problems faced in procurement) GOLF (Basis: Source of material) SOS (Basis: Nature of supplies)

EOQ: Economic Order Quantity

JIT: Just In Time Inventory : Purpose is to eliminate waste.

Receivables are the result of extension of credit facility to the consumers. They are the asset accounts representing amount owed to the firm as a result of goods or services in the ordinary course of the business. Cost of capital, cost of administration, cost of collection, defaulting cost etc. are the various costs associated with receivables.

In case a firms' credit terms are **" net 10"** it means that customers are expected to pay within 10 days from the date of credit sales.

"2/10 net 20" implies that credit period is 20 days, but if a customer pays within 10 days, he would get 2% discount on the amount due from him.

Aging schedule of receivables shows the break down receivables in accordance with the length of time for which they have been outstanding

Five C's include Credit-capital, Capacity, Character, Collateral, and Condition.

The various motives of holding cash are : Transaction Motive, Precautionary Motive, Speculative Motive, Compensation Motive(Free services to customers- but maintain a min. balance- this helps to earn interest to compensate them for the services provided)

Concentration Banking (opens collection centres and opens bank account in local banks of different areas) Lock Box system (Like a post office box maintains by firm's bank used as a receiving point) RTGS

(Real Time Gross Settlement) NEFT (National Electronic Fund Transfer) are the methods employed to speed up the collection of cash.

Playing float: Float refers to amount tied up in cheques that have been drawn but have not been presented for payment.

Capital budgeting is the planning of capital expenditure which provide yields over a number of years. It is the firm's decision to invest in the long term activities against an anticipated flow of future benefits. It is a long term planning for making and financing proposed capital out lays. Project generation, Project evaluation, Project selection, Project execution and Follow up are the various steps included in the capital budgeting process.

Pay Back method : It is also called pay out method. It is the period which is required to get back the original cost of investments by annual savings. PBP = Net investment/Operating savings.

Operating savings or cash inflow here means inflow before depreciation but after tax. The project which is having shortest pay back period will be selected. If the cash flow or operating savings is uneven throughout the life of the asset, cumulative total of cash flows are calculated and exact pay back period is calculated by applying the formula E + B/C

Average Rate of Return : Also known as Accounting Rate of Return . It is used to measure the rate of return on investment of a project. Project which is having the highest ARR will be selected. ARR = Average Annual Profit / Average investment X 100

Average investment = Cost-Scrap/2 +Working capital+Scrap

In order to overcome the limitations of pay back period and ARR, discounted cash flow methods are recognized. These methods consider the time value of money and provide a more objective basis.

In present value method, to determine the discounting rate, a cut off rate which is generally taken to be equal to the cost of capital. The present value of cash inflows should be compared with the present value of cash out flows. In case, the present value of cash flows are greater than or equal to the present value of cash out flows, the project would be accepted. In Net present value method, the project will be accepted, if the NPV is positive and reject if it is negative.

Internal Rate of Return was first introduced by Joel Dean. It is also known as yield on investment method or time adjusted rate or return method etc. It is actually the rate of return which is earned by a project, that is the rate at which the NPV of investment is zero. A project will be accepted when IRR is greater or equal to the cut off rate (generally cost of capital). In the opposite case a project is rejected.

Profitability Index method is also known as benefit cost ratio method. Pi = Pv of cash inflows/Pv of cash out flows

Terminal value method of investment appraisal technique is based on the assumption that the cash flow of each year is reinvested in another asset at a certain rate of return from the moment of its receipt till the end of the economic life of the asset/project.

Capital rationing is a situation where a company has more investment proposals that it can finance. It refers to a situation where a company cannot undertake all profitable projects as it has identified the shortage of capital..

Dividend is a distribution to shareholder out of profits or reserves available for this purpose. When dividend paid in the form of cash, it is known as **cash dividend.** When a company issues its own shares to the existing shareholders in lieu of or in addition to cash dividend, it is called **stock dividend** or scrip dividend in USA and in India, it is known as issue of bonus shares.

I**f a firm issue bonds for the amounts due to shareholders by way of dividends, it is called bond dividend. When a firm pays dividend in the form of assets other than cash, it is called property dividend.**

A dividend which is declared before the declaration of final dividend is called interim dividend. It is declared in between two annual general meetings.

Myron Gordon, James Walter and John Linter are associated with the relevance concept of dividend. Franco Modigliani and Morton. H. Miller and E. Solomon associated with the irrelevance concept of dividend.