FINANCIAL MANAGEMENT

Concept: Financial Management: It is concerned with decisions related to procurement and utilisation of fund.

Objectives of Financial Management:

1. The primary aim of financial management is to maximise shareholders' wealth.
2. All financial decisions aim at ensuring that each decision is efficient and adds some value.

◊ Financial decision:

Financial Decisions: it means the selection of best financing alternative or best investment alternative.

Types of Financial Decisions:

1. **Investment Decision**: It is concerned with investment of firm's funds in different assets.
2. **Financing decision:** It refer to the decision relating to the amount and the source of procurement of finance.
3. **Dividend decision:** It determines the proportion of the profit to be distributed and retained with the enterprise.

◊ Investment decision:

Types of investment decision:

1. **Capital budgeting decision:** A long-term investment decision in fixed assets.
2. **Working capital decision:** A short-term investment decision in cash, inventory, and debtors.

Factors affecting capital budgeting decision are:

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1. **Cash flows of the project:** a company should analyse cashflow requirement and generated by the investment before making an investment.
2. **rate of return:** company make investment expecting something in return, company should analyse that is the investment going to fulfil the requirement of the business.
3. **Investment criteria:** a company should properly check all the terms and condition of the investment like, interest rate, cashflow, rate of return and many more.

◊ Financial decision:

Financing Decision: It refer to the decision relating to the amount and the source of procurement of finance.

Financial risk: The risk of default on payment.

Factors affecting Financing Decision are:

1. **Cost of funds:** The cost of raising funds through different sources are different.
2. **Cost of floatation:** Higher the floatation cost, less attractive the source.
3. **Risk:** The risk associated with each of the sources is different.
4. **Cash flow position of business.:** company should consider its current cashflow along with its cashflow requirement, before making any such decision.
5. **Control consideration:** financing by issue of equity share might lead to dilution of managerial control of the organisation.
6. **Capital market situation:** market situation also affects choice of source of fund, companies usually prefer shares when market is depressed.
7. **Fixed operating cost:** If a business has high fixed operating costs, lower debt financing is better.

◊ Dividend decision:

Dividend Decision: It determines the proportion of the profit to be distributed and retained with the enterprise.

Factors affecting dividend decisions are:

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1. **Amount of earnings:** as Dividends are paid out of current and past earning.
2. **Stability of earnings:** if a company having stable earning is in a better position to declare higher dividends
3. **Stability of dividends:** Companies generally follow a policy of stabilising dividend per share.
4. **Growth opportunities:** if company foresees any growth opportunity, it retains money to finance it.
5. **Cash flow position:** The payment of dividend involves an outflow of cash, Availability of enough cash in the company is necessary for declaration of dividend.
6. **Shareholders' preference**: If the shareholders in general desire that at least a certain amount is paid as dividend, the companies are likely to declare the same.
7. **Taxation policy:** when government increases tax, company finds debt financing, as it gives benefit of tax deduction.
8. **Stock market reaction:** increased dividend, positive impact; similarly, decrease, negative impact. Thus, the possible impact of dividend policy on the equity share price is one of the important factors
9. **Access to capital market:** large companies tend to pay higher dividends than the smaller companies which have relatively low access to the market.
10. **Legal constraint:** Certain provisions of the Companies Act place restrictions on pay-outs as dividend
11. **Contractual constraints:** While granting loans to a company, sometimes the lender may impose certain restrictions on the payment of dividends in future.

◊ Financial planning:

Objective of financial planning:

1. **To ensure availability of funds whenever required:** This include a proper estimation of the funds required for different purposes
2. **To see that the firm does not raise resources unnecessarily**, if, then put it to the best possible use

The importance of financial planning:

1. It helps in forecasting future happening under different business situations.
2. It helps in co-ordinating various business functions, by providing clear policies and procedures

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3. Detailed plans of action prepared under financial planning reduce waste, duplication of efforts, and gaps in planning
4. It tries to link the present with the future
5. It provides a link between investment and financing decisions on a continuous basis.
6. By spelling out detailed objectives for various business segments, it makes the evaluation of actual performance easier

◊ Capital structure:

Capital structure: the proportion of the use of different sources in raising funds.

Factors affecting the Choice of Capital Structure:

1. **Cash Flow Position:** Size of projected cash flows must be considered before borrowing. Cash flows must not only cover fixed cash payment obligations but there must be sufficient buffer also.
2. **Interest Coverage Ratio (ICR):** refers to the number of times earnings before interest and taxes of a company covers the interest obligation.

$$ICR = \frac{EBIT}{Interest}$$

3. **Debt Service Coverage Ratio (DSCR):** cash profits generated by the operations are compared with the total cash required for the service of the debt and the preference share capital.

$$\frac{\text{Profit after tax + Depreciation + Interest + Non Cash exp.}}{\text{Pref. Div + Interest + Repayment obligation}}$$

4. **Return on Investment (RoI):** If the RoI of the company is higher, it can choose to use trading on equity to increase its EPS
5. **Cost of debt:** A firm's ability to borrow at a lower rate increases its capacity to employ higher debt.
6. **Tax Rate:** Since interest is a deductible expense, which makes it more attractive to the company.
7. **Cost of equity:** As increase in debt leads to increase in risk, hence, desired rate of return may increase. It is for this reason that a company cannot use debt beyond a point. If debt is used beyond that point, cost of equity may go up sharply and share price may decrease in spite of increased EPS.

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8. **Floatation Costs:** Process of raising resources also involves some cost. Getting a loan from a financial institution may not cost so much.
9. **Risk Consideration:** risk refers to a position when a company is unable to meet its fixed financial charges Apart from the financial risk, every business has some operating risk depends upon fixed operating costs, company should properly analyse these risks properly.
10. **Flexibility:** If a firm uses its debt potential to the full, it loses flexibility to issue further debt. To maintain flexibility, it must maintain some borrowing power to take care of unforeseen circumstances.
11. **Capital Structure of other Companies:** There are usually some industry norms which may help.
12. **Control:** Debt normally does not cause a dilution of control. A public issue of equity may reduce the managements' holding in the company and make it vulnerable to takeover.

Trading on Equity: It refers to an increase in profit earned by the equity shareholders due to the presence of fixed financial charges like interest.

Factors affecting the requirement of fixed capital:

1. **Nature of business:** different type of business has different fixed capital requirement, for example, a trading concern needs lower investment in fixed assets
2. **Scale of operation:** A larger organisation operating at a higher scale needs bigger plant, more space etc.
3. **Choice of technique:** the organisation which use labour intensive technique, do not need to make higher fixed capital; those who use capital intensive, need higher capital requirement.
4. **Technology upgradation:** assets become obsolete sooner. Consequently, their replacements become due faster. Higher investment in fixed assets
5. **Growth prospects:** growth is expected, a company may choose to create higher capacity in order to meet the anticipated higher demand quicker.
6. **Diversification:** if a firm tries to diversify, it adds new product, and in order to produce it more of capital investment will be required.
7. **Level of Collaboration:** At times, certain business organisations share each other's facilities.

Working Capital = Current Assets - Current Liabilities

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Factors affecting the working capital requirements:

1. **Nature of business:** different type of business has different working capital requirement; trading organisation usually needs a smaller amount of working capital compared to a manufacturing organisation.
2. **Scale of operations:** organisations which operate on a higher scale of operation, the quantum of inventory and debtors required is generally high, therefore requires higher working capital.
3. **Business cycle:** Different phases of business cycles affect the requirement of working capital by a firm. In case of a boom, company requires more of working capital, to full fill orders.
4. **Seasonal factors:** Most business have some seasonality in their operations. In peak season, because of higher level of activity, larger amount of working capital is required.
5. **Production cycle:** Production cycle is the time span between the receipt of raw material and their conversion into finished goods. longer the production cycle higher the working capital requirement.
6. **Operating efficiency:** Firms manage their operations with varied degrees of efficiency. Higher the efficiency lowers the working capital requirement.
7. **Availability of raw material:** If the raw materials and other required materials are available freely and continuously, lower stock levels may suffice. Hence lower working capital required.
8. **Growth prospects:** if the growth potential is there, it will require larger amount of working capital so that it is able to meet higher production and sales target
9. **Level of competition:** Higher level of competitiveness may necessitate larger stocks of finished goods to meet urgent orders from customers. Leads to higher working capital requirement.
10. **Inflation:** With rising prices, larger amounts are required even to maintain a constant volume of production and sales.

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