

FINANCIAL MANAGEMENT

Chapter 9





Business Finance



- ✚ Money required for carrying out business activities is called business finance.
- ✚ Finance is needed to establish a business, to run it, to modernize it, to expand, or diversify it.
- ✚ It is required for buying a variety of assets, & day-to-day operations of business, like buying material, paying bills, salaries, etc.
- ✚ Availability of adequate finance is, thus, very crucial for the survival and growth of a business.
- ✚ On the basis of ownership, the sources of business finance can be broadly classified into two categories viz., 'owners' funds' and 'borrowed funds'.



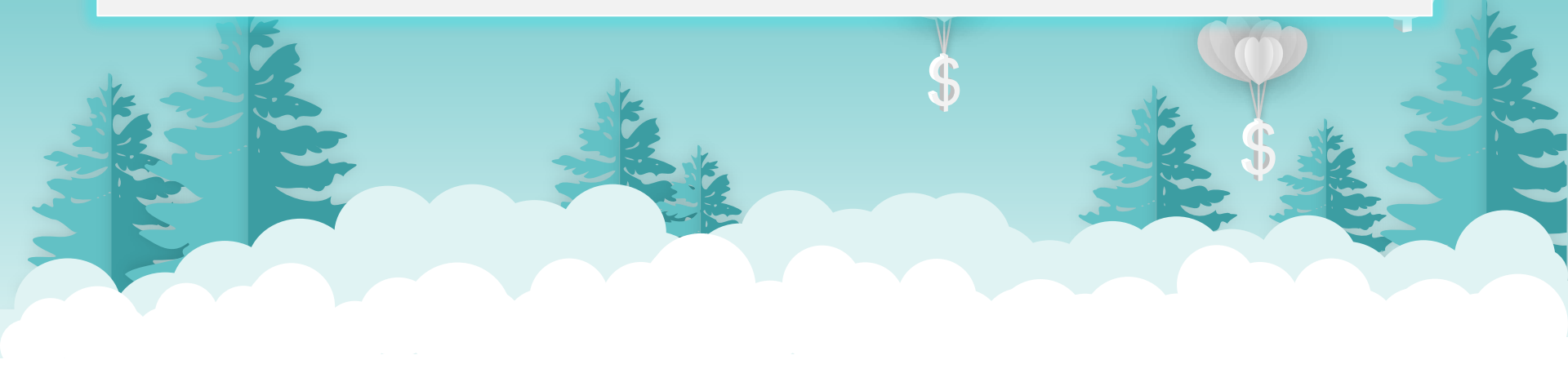
Financial Management



“Financial management is considered to be the management of the finance function”. It deals with planning, organizing, directing and controlling financial activities like procurement and utilization of funds and distribution of earnings to owners.”

“Financial management deals with procurement of funds and their effective utilization in the business”

- S.C. KUCHHAL



- ✚ Financial management aims at reducing the cost of funds procured, keeping the risk under control and achieving effective deployment of such funds.
- ✚ It also aims at ensuring availability of enough funds whenever required as well as avoiding idle finance.
- ✚ Financial management is concerned with optimal procurement as well as the usage of finance.
- ✚ For optimal procurement, different available sources of finance are identified and compared in terms of their costs and associated risks.
- ✚ Similarly, it is to be invested in a manner that the returns from the investment exceed the cost at which procurement has taken place.
- ✚ The future of a business depends a great deal on the quality of its financial management.





Role And Importance Of Financial Management



01

The size and the composition of fixed assets of the business: for example, a capital budgeting decision to invest a sum of Rs. 100 crores in fixed assets would raise the size of fixed assets block by this amount.

02

The quantum of current assets and its break-up into cash, inventory and receivables: with an increase in fixed assets, there is increase in working capital requirement. Decisions about credit and inventory management affect the total current assets as well as their composition.

03

The amount of long-term and short-term funds to be used: an organization wanting to have more liquid assets would raise relatively more amount on a long-term basis. There is a choice between liquidity and profitability.

04

Break-up of long-term financing into debt, equity etc.: of the total long term finance, the proportion to be raised by way of debt and/or equity is also a financial management decision.

05

All items in the profit and loss account, e.g., interest, expense, depreciation, etc.: higher amount of debt means higher interest expense in future. It can, thus, be stated that the financial statements of a business are largely determined by financial management decisions taken earlier.



Objectives



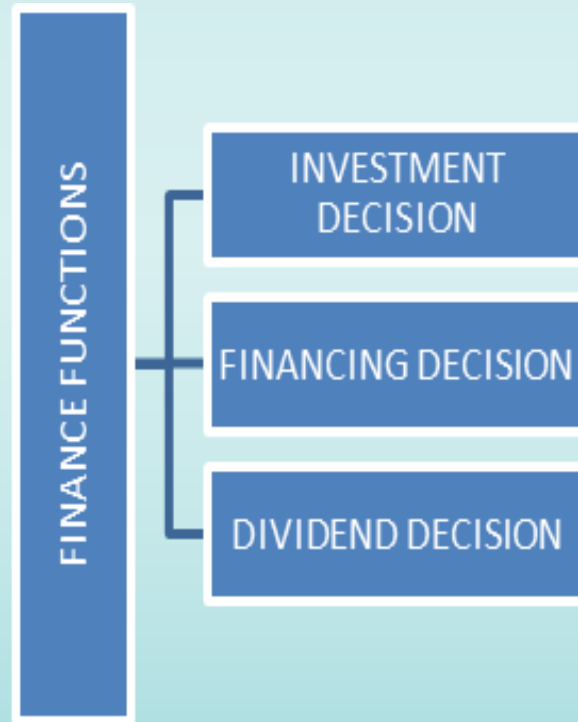
- ❖ The primary aim of financial management is to maximise shareholders' wealth, which is referred to as the **Wealth-Maximisation Concept**.
- ❖ The market price of a company's shares is linked to the three basic financial decisions
- ❖ This is because a company funds belong to the shareholders and the manner in which they are invested and the return earned by them determines their market value and price. All financial decisions aim at ensuring that each decision is efficient and adds some value. Such value additions tend to increase the market price of shares.
- ❖ Therefore, when a decision is taken about investment in a new machine, the aim of financial management is to ensure that benefits from the investment exceed the cost so that some value addition takes place.
- ❖ Similarly, when finance is procured, the aim is to reduce the cost so that the value addition is even higher.





Financial Decisions

Financial management is concerned with the solution of three major issues relating to the financial operations of a firm.





Investment Decisions

It is concerned with how firm's valuable funds are to be invested in various assets. It will include the following:

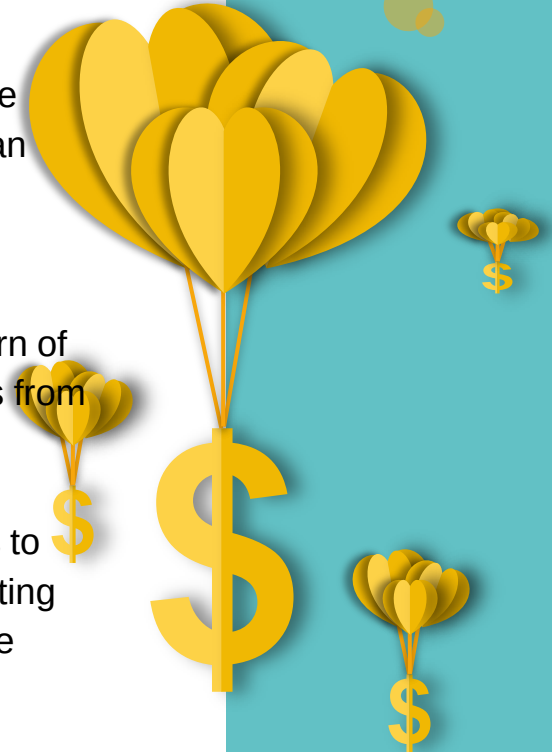
- **Long term investment decisions (capital budgeting decision)** - it involves committing the finance on a long- term basis. The size of assets, profitability and competitiveness are all affected by capital budgeting decisions. Moreover, these decisions normally involve huge amounts of investment and are irreversible except at a huge cost. E.g., purchasing a new machine, opening a new branch etc.
- **Short term investment decision (working capital decision)** – it is concerned with the decisions about the levels of cash, inventory and receivables. These decisions affect the day-to-day working of a business. These affect the liquidity as well as profitability of a business. Efficient cash management, inventory management and receivables management are essential ingredients of sound working capital management. E.g., level of cash in hand, inventory etc.



Factors Affecting Investment Decision

A number of projects are often available to a business to invest in. But each project has to be evaluated carefully and, depending upon the returns, a particular project is either selected or rejected:-

- 1. Cash flows of the project:** an investment decision involving huge amount is expected to generate some cash flows over the life of an investment. The amount of these cash flows should be carefully analyzed before considering a capital budgeting decision.
- 2. The rate of return:** the most important criterion is the rate of return of the project. These calculations are based on the expected returns from each proposal and the assessment of the risk involved
- 3. The investment criteria involved:** there are different techniques to evaluate investment proposals which are known as capital budgeting techniques. These techniques are applied to each proposal before selecting a particular project.





Financing Decisions



- ✚ A company can raise finance from various sources such as by issue of shares, debentures or by taking loan and advances.
- ✚ Deciding how much to raise from which source is concern of financing decision.
- ✚ Mainly sources of finance can be divided into two categories:
 1. Owners' fund - Share capital and retained earnings
 2. Borrowed fund - debentures, loans, bonds, etc.
- ✚ The main concern of finance manager is to decide how much to raise from owners' fund and how much to raise from borrowed fund.
- ✚ While taking this decision the finance manager compares the advantages and disadvantages of different sources of finance.
- ✚ The borrowed funds have to be paid back and involve some degree of risk whereas in owners' fund there is no fix commitment of repayment and there is no risk involved.
- ✚ finance manager prefers a mix of both types. Under financing decision finance manager fixes a ratio of owner fund and borrowed fund in the capital structure of the company.



Factors Affecting Financial Decision

1. **Cost:** the cost of raising funds through different sources are different would normally opt for a source which is the cheapest.
2. **Risk:** the risk associated with each of the sources is different.
3. **Floatation costs:** higher the floatation cost, less attractive the source.
4. **Cash flow position of the company:** a stronger cash flow position may make debt financing more viable than funding through equity.
5. **Fixed operating costs:** if a business has high fixed operating costs (e.g. Building rent, insurance premium, salaries, etc.), it must reduce fixed financing costs. Hence, lower debt financing is better.
6. **Control considerations:** issues of more equity may lead to dilution of management's control over the business. Debt financing has no such implication. Companies afraid of a takeover bid prefer debt to equity.
7. **State of capital market:** health of the capital market may also affect the choice of source of fund. During the period when stock market is rising, more people invest in equity. However, depressed capital market may make issue of equity shares difficult for any company.





RETAINED
EARNINGS

DIVIDENDS



Promoter Holding & Dividend

Company	Dividend Paid In FY19 (₹ Cr)	Promoter Holding (%)	Dividend Received by promoters (₹ Cr)
Vedanta	7,010	50.14	3,515
RIL	3,852	48.87	1,882
Bajaj Auto	1,736	53.52	929
Godrej Consumer	1,227	63.24	776
Graphite	1,075	65.22	701
HCL Technologies	1,084	59.98	650
Hero Morocorp	1,738	34.63	602
Asian Paints	1,007	52.79	532
JSW Steel	1,234	42.34	522
Tech Mahindra	1,242	35.87	446



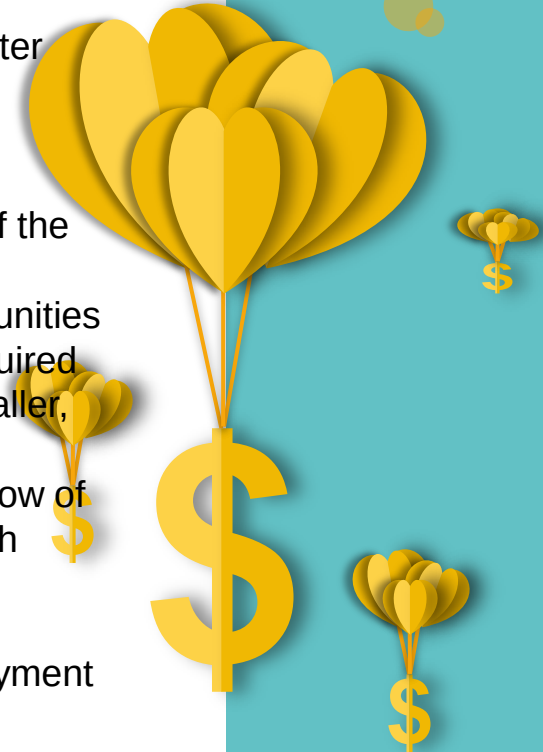
Dividend Decisions

- ✚ The third important decision that every financial manager has to take relates to the distribution of dividend. Dividend is that portion of profit which is distributed to shareholders.
- ✚ The decision involved here is how much of the profit earned by company (after paying tax) is to be distributed to the shareholders and how much of it should be retained in the business.
- ✚ While the dividend constitutes the current income, Re-investment as retained earnings increases the firm's future earning capacity.
- ✚ Since the firm does not require funds to the extent of re-invested retained earnings, the decision regarding dividend should be taken keeping in view the overall objective of maximizing shareholder's wealth.



Factors Affecting Dividend Decision

1. **Amount of Earnings:** Dividends are paid out of current and past earning. Therefore, earnings is a major determinant of the decision about dividend.
2. **Stability Earnings:** a company having stable earning is in a better position to declare higher dividends. As against this, a company having unstable earnings is likely to pay smaller dividend.
3. **Stability of Dividends:** Companies generally follow a policy of stabilising dividend per share. dividend per share is not altered if the change in earnings is small or seen to be temporary in nature.
4. **Growth Opportunities:** Companies having good growth opportunities retain more money out of their earnings so as to finance the required investment. The dividend in growth companies is, therefore, smaller, than that in the non-growth companies.
5. **Cash Flow Position:** The payment of dividend involves an outflow of cash. A company may be earning profit but may be short on cash necessary for declaration of dividend.
6. **Contractual Constraints:** While granting loans to a company, sometimes the lender may impose certain restrictions on the payment of dividends in future.



Factors Affecting Dividend Decision

7. **Taxation Policy:** The choice between the payment of dividend and retaining the earnings is, to some extent, affected by the difference in the tax treatment of dividends and capital gains. higher dividends may be declared if tax rates are relatively lower.
8. **Stock Market Reaction:** Investors, in general, view an increase in dividend as a good news and stock prices react positively to it. Thus, the possible impact of dividend policy on the equity share price is one of the important factors
9. **Access to Capital Market:** Large and reputed companies have easy access to the capital market and, depend less on retained earning to finance their growth thus These companies tend to pay higher dividends
10. **Legal Constraints:** Certain provisions of the Companies Act place restrictions on payouts as dividend. Such provisions must be adhered to while declaring the dividend.
11. **Shareholders' Preference:** While declaring dividends, managements must keep in mind the preferences of the shareholders in this regard. If the shareholders in general desire that at least a certain amount is paid as dividend, the companies are likely to declare the same.



A scenic landscape painting of a pond with three cyclists. The scene is set in a lush, green environment with dense trees in the background. Three people are riding bicycles along a narrow, grassy path that curves through the pond. Their reflections are clearly visible in the calm water. The overall atmosphere is peaceful and serene.

**VISIT PART 2 OF PPT FOR
REMAINING TOPICS**