CBSE CLASS 12 BUSINESS STUDIES

CHAPTER – 9

FINANCIAL MANAGEMENT

REVISION NOTES

MEANING OF BUSINESS FINANCE

- **Business Finance** means money or funds available for a business for operations**.** It is indispensable for survival and growth of business, for production and distribution of goods and meeting day-to-day expenses etc.
- Finance is needed to establish a business, to run it, to modernise and expand, or diversify it.

MEANING OF FINANCIAL MANAGEMENT

- **Financial Management** includes those business activities that are concerned with acquisition and conservation of capital funds in meeting the financial needs and overall objectives of a business enterprise.
- **Financial Management** is concerned with optimal procurement as well as the usage of finance.

IMPORTANCE

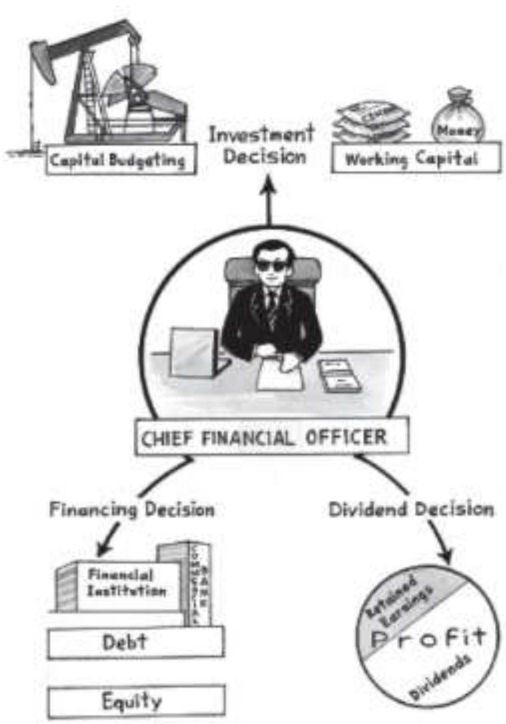
- The size and the composition of fixed assets of the business: A capital budgeting decision will increase the size of fixed assets of the company by that amount.
- The quantum of current assets and its break-up into cash, inventory and receivables: increase in the fixed assts in turn increse the working capital requirement.
- The amount of long-term and shortterm funds to be used: It involves decision related to composition of long term and short term funds depending on the profitability or liquidity goals of the enterprise.
- Break-up of long-term financing into debt, equity etc: The proportion of Debt and Equity is a financial descision.
- All items in the Profit and Loss Account, e.g., Interest, Expense, Depreciation, etc: Higher debt increases interest expense and higher equity increases dividend.

OBJECTIVES

- Primary objective: Is to maximize wealth of owners in the long run – Wealth Maximization concept.
- All financial decisions aim at ensuring that each decision is efficient and adds some value.
- 'Owners' of a company are the shareholders.
- The objective of financial management is to maximise the current price of equity shares of the company.
- The term wealth refers to wealth of owners as reflected by the market price of their shares.
- The market price of shares is linked to three basic financial decisions. Investing decision, financing decision and dividend decision.
- Decision making is eficient if best decision is selected out of all the alternatives.
- Increase in the market price of shares is an indicator of the financial health of a firm.

FINANCIAL DECISIONS

The finance function is concerned with three broad decisions which are explained below:



Financial Decisions

I. INVESTMENT DECISION

- Investment decision means judicious investment of firm's resources, from the available alternative proposals and choosing the cheapest one, which earns highest possible return for the investors.
- The various resources available with an organisation are scarce and can be put to alternate use. A firm must choose where to invest, wisely so as to earn the highest possible profits.
- Investment decisions are decisions about how the firm's funds are invested in different assets that is, in different investment proposals

INVESTMENT DECISIONS CAN BE LONG TERM AND SHORT TERM

Short Term investment decisions.

Working Capital Decisions: are concerned with the decisions about the levels of cash, inventory and receivables.

Long Term investment decisions

Capital Budgeting decisions: decisions related to evaluation of potential expenditures or investments on a long term basis.

FACTORS AFFECTING CAPITAL BUDGETING DECISIONS:

1. Cash flows of the project: a series of cash receipts and payments over the life of an investment proposal is considered and analyzed for selecting the best proposal.

2. The Rate of Return: The calculation of expected returns from each proposal and risk involved is taken into account to select the best proposal.

3. The Investment Criteria Involved: Various investment proposals are evaluated, based on capital budgeting techniques. These involve calculation regarding investment amount, cash flows, rate of return etc.

II. FINANCING DECISION

- This decision is about the quantum of finance to be raised from various long-term sources and short-term sources and selecting the cheapest one.
- Financing decisions involve: Decision related to the proportion of ownership (equity) and borrowed (Debt) funds.
- Financing decision aids in identifying various sources of the funds and select the best one by evaluating the different characteristics of the funds available and its impact on the firm's capital structure and returns.
- Firm/ companies needs a judicious mix of debt and equity as :
  (a)Debt involves 'Financial Risk' i.e. risk of default on payment of interest on borrowed funds and the repayment of the principle amount. E.g. Debentures, Public deposits etc.

(b) Shareholder’s funds involve no fixed commitment with respect to payment of returns or repayment of capital. E.g. Equity, Preference shares

FACTORS AFFECTING FINANCING DECISION

1. Cost: The cost of raising funds from different sources are different. A prudent manager will select the cheapest source.

2. Risk: The risk associated with different sources of fund is different. More risk is associated with borrowed funds as compared to owner’s fund as fixed interest has to be paid and redeemable as well after a fixed period of time.

3. Flotation Cost: The costs involved in issuing securities such as brokers commission, underwriters’ fees etc. are called as flotation costs. Higher the flotation cost, less attractive is the source of finance.

4. Cash flow position of the company: If a company has sound liquidity position then it can easily use borrowed funds and pay interest on time.

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.

6. Control Considerations: If the existing shareholders want to retain complete management control then raise finance through borrowed funds but if they are ready for dilution of control over business, equity can be used for raising finance.

7. State of Capital Markets: The capital market conditions also affect the choice of source of fund. If the capital market is raising, finance can easily be raised by issuing shares but during depression period, issue of equity share is difficult.

III. DIVIDEND DECISION

- Dividend is that portion of divisible profits that is distributed to the shareholders. It results in current income for the shareholders.
- Re-investment as retained earnings increases the firm's future earning capacity.
- Dividend decision is whether to distribute earnings to shareholder as dividends or to retain earnings to finance long-term projects of the firm.
- The dividend decisions are taken keeping in view the overall objective of maximizing shareholder's wealth

FACTORS AFFECTING DIVIDEND DECISIONS

1. Amount of Earnings: Dividends are paid out of profits, so earning of a company is very important factor in determining dividend decision. Companies having high and stable earning could declare high rate of dividends.

2. Stability of Dividends: Companies generally follow the policy of stable dividend. The dividend per share is not altered in case increase in earnings is small or of temporary nature.

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

4. Cash Flow Positions: The payment of dividends involve outflow of cash and thus, availability of adequate cash is required for declaration of dividends.

5. Shareholders preference: While deciding about dividend the preference of shareholders is also taken into account. If 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 than the company can declare more dividends.

7. Stock Market Reaction: For Investors an increase in dividend is a good news and stock prices react positively to it.

8. Access to Capital Market: Corporate companies and MNC's retain less profit as they have easy access to the capital market for project financing.

9. Legal constraints: Under provisions of Companies Act, all earnings can't be distributed and the company has to provide for various reserves. This limits the capacity of company to declare dividend.

10. Contractual Constraints: sometimes the lender may impose certain restrictions on the payment of dividends in future while granting loans to a company

FINANCIAL PLANNING

It involves the preparation of a financial blueprint of an organization. It is the process of estimating the fund requirement of a business and determining the possible sources from which it can be raised.

The objective of financial planning is to ensure that enough funds are available at right time.

Objectives of Financial Planning:

To ensure availability of funds whenever required: Includes proper estimation of the funds required for different purposes (long term assets/working cap requirement). There is a need to estimate the time at which these funds are to be made available. Financial planning also tries to specify possible sources of these funds.

To see that the firm does not raise resources unnecessarily: Excess funding is as bad as inadequate funding. Surplus funds reduces return and increases cost to a company.

IMPORTANCE OF FINANCIAL PLANNING

1. It helps in forecasting future happenings under different situations.
2. It helps in avoiding business shocks and surprises and volatilities and helps the company in preparing for the future.
3. If helps in coordinating various business functions, e.g., sales, marketing, production etc.
4. Detailed plans of action is prepared under financial planning reduce waste, duplication of efforts, and gaps in planning.
5. It tries to link the present with the future.
6. It provides a link between investment and financing decisions on a continuous basis.
7. By spelling out detailed objectives for various business segments, it makes the evaluation of actual performance easier.

CAPITAL STRUCTURE

- One of the important decisions under financial management, that relates to the financing pattern or the proportion of the use of different sources in raising funds.

- On the basis of ownership, the business finance is divided into
  (a) Owners funds
  (b) Borrowed funds.

- Owners funds/ Equity = equity share capital + preference share capital + reserves and surpluses/ retained earnings

- Borrowed funds = loans + debentures + public deposits = DEBT

- Capital Structure is the mix of long-term sources of funds. It can be calculated as Debt/ Equity Ratio.ie. Debt/ Equity or Debt out of total capital (Debt/ Debt + Equity)

- Capital structure refers to the proportion of debt and equity used for financing the operations/ activities of a business.

Debt Vs Equity:

1. Cost of Debt is lower than cost of equity but Debt is more riskier than equity.

2. Cost of debt is less than the cost of equity as lenders risk is more than owner's risk.

3. Lender earns a fixed interest and assured repayment of capital.

4. Interest on debt is a tax-deductible expense so brings down the tax liability of a business whereas dividends are paid out of profit after tax.

5. Debt is more risky for the business as it adds to the financial risk faced by a business.

6. Any default of payment of interest or repayment of principle amount may lead to liquidation.

Capital structure affects both the profitability and the financial risk faced by a business.

- Optimal Capital Structure is that combination of debt and equity that maximizes the market value of shares of that company
- Decisions relating to capital structure gives more importance on increasing shareholders wealth.

- The proportion of debt in the overall capital is also called **financial leverage**. It is calculated as Debt/ Equity Ratio.ie. Debt/ Equity or Debt out of total capital (Debt/ Debt + Equity).

- When the financial leverage increases, the cost of funds declines because of increased use of cheaper debt but the financial risk increases.

- The impact of financial leverage on the profitability of a business can be identified through EBIT-EPS (Earning before Interest and Taxes-Earning per Share).

- **Trading on Equity** refers to the increase in profit earned by the equity shareholders due to the presence of fixed financial charges like interest. i.e benefits to the shareholder due to financial leveraging.

FACTORS AFFECTING THE CHOICE OF CAPITAL STRUCTURE

1. Cash flow position:

The size of the projected cash flows should be considered before deciding the capital structure of the firm. If there is sufficient cash flow, debt can be used but it must cover fixed payment obligations.

The company has certain cash payment obligation such as (I) normal business operations (ii) Investment in fixed assets (iii) Meeting debt service commitments as well as provide a sufficient buffer.

2. Interest coverage ratio :

- The interest coverage ratio refers to the number of times earnings before interest and taxes of a company covers the interest obligation. Which is calculated as follows: EBIT/ Interest
- Higher the Interest coverage ratio, lower shall be the risk of the company failing to meet its interest payment obligations.

3. Debt Service Coverage Ratio:

The cash profits generated by the operations are compared with the total cash required for the service of the debt and the preference share capital. It is calculated as follows:

$$\text{Debt. service coverage ratio} = \frac{\text{Profit after tax + Depreciation + Interest + Non Cash Expenses}}{\text{Preference Dividend + Interest + Repayment Obligation}}$$

4. Return On Investment

If return on investment of the company is higher, the company can choose to use trading on equity to increase its EPS, i.e., its ability to use debt is greater.

5. Cost Of Debt

More debt can be used if cost of Debt is raised at a lower rate.

6. Tax Rate

A higher tax rate makes debt relatively cheaper and increases its attraction as compared to equity as a company can avail tax benefit on interest payment.

7. Cost Of Equity

- If a company uses more debt, the financial risk faced by equity holders increase so their desired rate of return may increase.

- If debt is used beyond a point, cost of equity may go up sharply and share price may decrease in spite of increased EPS.

8. Floatation Cost

- Floatation cost is the cost involved for raising funds from the capital market.
- Cost of Public issue is more than the floatation cost of taking a loan.
- The floatation cost may affect the choice between debt and equity and hence the capital structure.

9. Risk Consideration

The total risk of business enterprise depends upon both the business risk and financial risk. If a firm‘s business risk is lower, its capacity to use debt is higher and vice versa.

10. Flexibility

- If the firm uses its debt potential to its full capacity, it loses the flexibility to use more debt.

- To maintain flexibility the company must maintain some borrowing power to take care of unforeseen circumstances.

11. Control

Debt normally does not cause dilution of control whereas a public issue makes the firm more vulnerable to takeovers. In order to retain control, firm should issue debt.

12. Regulatory Framework

Every company has to operate within a regulatory framework provided by the law e.g., public issue of shares and debentures have to be made under SEBI guidelines.

13. Stock Market Conditions: If the stock markets are bullish, equity shares can be sold even at a higher price.

14. Capital Structure of other Companies: A useful guideline in the capital structure planning is the debt equity ratios of other companies in the same industry. For e.g, if the business risk of a firm is higher, it cannot afford the same financial risk.

FIXED AND WORKING CAPITAL

I. FIXED CAPITAL

Fixed capital refers to investment in long-term assets. Investment in fixed assets is for longer duration and must be financed through long-term sources of capital. Decisions relating to fixed capital involve huge capital investments and are irreversible without incurring heavy losses.

FACTORS AFFECTING THE REQUIREMENT OF FIXED CAPITAL

1. Nature of Business: the type of business is a factor in determining the fixed capital requirements. For e.g. manufacturing concerns require huge capital investment in fixed assets but trading concerns need less fixed capital investment.

2. Scale of Operations: A larger organization operating on large scale requires more fixed capital investment as compared to an organization operating on small scale.

3. Choice of Technique: An organization using capital-intensive techniques requires more investment in fixed assets as compared to an organization using labour intensive techniques.

4. Technology upgradation: An organization using obsolete assets require more fixed capital as compared to other organizations.

5. Growth Prospects: Companies having higher growth prospects require more fixed capital investments, in order to expand their production capacity.

6. Diversification: If a company goes for diversification then it will require more fixed capital Investment in plant and machinery etc.

7. Financing Alternatives: A developed financial market can provide leasing facilities as an alternative to outright purchase.

8. Level of Collaboration: If companies are under collaboration, Joint venture etc. then they need less fixed capital as they share plant & machinery with their collaborators.

WORKING CAPITAL

Working Capital refers to the funds required for the day to day operations of an organization. Apart from the investment in fixed assets every business organization needs to invest in the current assets, which can be converted into cash or cash equivalents within a period of one year.

Working capital is of two types:

(a) Gross working capital: Investment in all the current assets is called as Gross Working Capital

(b) Net working capital : the excess of current assets over current liabilities is called Net Working Capital.

FACTORS AFFECTING THE WORKING CAPITAL REQUIREMENTS

1. Nature of Business: The basic nature of a business enterprise influences the amount of working capital required by it. For e.g. A trading organization needs a lower amount of working capital as compared to a manufacturing organization.

2. Scale of Operations: An organization which is operating on large scale will require more inventory as its working capital requirement will be more, compared to small organization.

3. Business Cycle: When there is a boom in the economy, more production will be undertaken and so more working capital will be required during that time as compared to depression in the economy.

4. Seasonal Factors: In peak season, demand for a product will be high and thus high working capital requirements will be more as compared to lean season.

5. Production Cycle: Production cycle is the time span between the receipt of raw material and their conversion into finished goods. working capital requirements will be higher in firms with longer processing cycle and lower in firms with shorter processing cycle.

6. Credit Allowed: Different firms allow different credit terms to their customers depending on their credit worthiness.

7. Credit Availed: Just as a firm allows credit to its customers it also may get credit from its suppliers.

8. Operating Efficiency: Different enterprises manage their operations with varied degrees of efficiency. Such efficiencies may reduce the level of raw materials, finished goods and debtors resulting in lower requirement of working capital.

9. Availability of Raw Material: If the raw materials and other required materials are available freely and continuously, enterprise can maintain adequate stock of materials.

If the lead time is more, larger the quantity of material to be stored and larger shall be the amount of working capital required.

10. Growth Prospects: If the growth potential of a concern is perceived to be higher, it will require larger amount of working capital.

11. Level of Competition: Higher level of competitiveness, necessitate larger stocks of finished goods to meet urgent orders from prospective customers.

12. Inflation: With rising prices, larger amounts are required even to maintain a constant volume of production and sales. For example, during inflation prices of raw material, wages also rise resulting in increase in the working capital requirements.