

Module 3 - Chapter 4

Financial Management

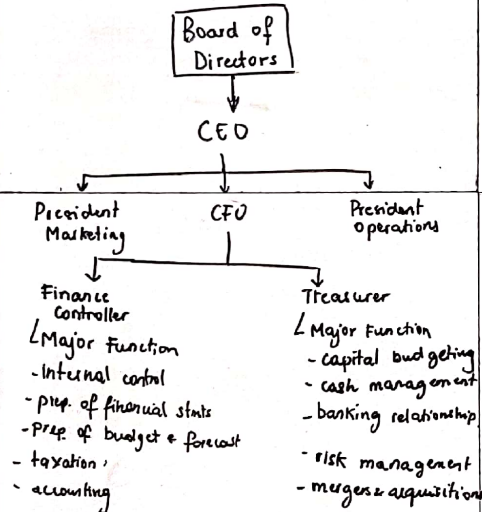
Financial Management Decisions

1) Investing decision

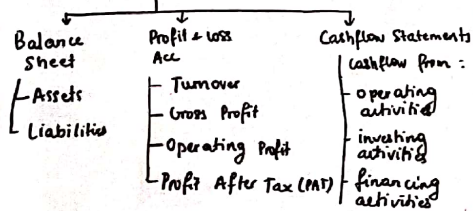
2) Financing decision

3) Dividend decision

Organization of Finance Function



Financial Statements



Categories of Profits

1) Gross Profit (GP)

2) Profit Before Depreciation, interest & taxes (PBDIT)

3) Operating profit (PBIT/EBIT)

4) Profit Before Tax (PBT)

5) Profit After Tax (PAT)

Financial Ratio Analysis

Parameters

- liquidity
- efficiency
- profitability
- capital structure
- valuation or stock market ratios

Current Ratio

$$= \frac{\text{current assets}}{\text{current liabilities}}$$

Quick Ratio

- also called Acid Test Ratio
- = $\frac{\text{current asset} - \text{inventories}}{\text{current liabilities}}$

Inventory Turnover

$$\text{Inventory Turnover Ratio} = \frac{\text{cost of goods sold (sales)}}{\text{Avg Inventory}}$$

$$\text{Inventory days} = \frac{365}{\text{Inventory}}$$

Debtor's Turnover

$$\text{Debtor Turnover Ratio} = \frac{\text{Sales}}{\text{Avg. Turnover}}$$

$$\text{Debtor days (Collection period)} = \frac{365}{\text{Debtor's turnover}}$$

Asset Turnover

$$\text{Asset Turnover Ratio} = \frac{\text{Sales}}{\text{Avg. total Assets}}$$

$$\text{Fixed Asset Turnover Ratio} = \frac{\text{Sales}}{\text{Avg. Fixed Assets}}$$

Profitability Ratio

$$1) \text{ Gross Profit Margin} = \frac{\text{GP}}{\text{Sales}}$$

$$\text{GP} = \text{Sales} - \text{cost of goods sold}$$

2) Operating Profit Margin

$$= \frac{\text{operating profits}}{\text{Sales}}$$

$$\text{operating profit} = \text{Sales} - \text{operating expenses}$$

3) PBDIT / EBITA Margin

$$\text{operating profit Margin} = \frac{\text{PBDIT}}{\text{Sales}}$$

$$\text{PBDIT} = \text{Sales} - \text{operating expenses} + \text{depreciation}$$

4) Net Profit Margin

$$= \frac{\text{PAT}}{\text{Sales}}$$

Capital Structure Ratios

$$1) \text{ Debt Equity Ratio} = \frac{\text{total debt}}{\text{total equity}}$$

$$2) \text{ Total Debt Ratio} = \frac{\text{total debt}}{\text{total capital}}$$

$$\text{total capital} = \text{total debt} + \text{total equity}$$

Return ratios

1) Return on Equity (ROE)

$$\text{ROE} = \frac{\text{PAT}}{\text{Avg Equity}} = \frac{\text{PAT}}{\text{Shareholder's Equity}}$$

2) Return on Investment (ROI)

$$\text{ROI} = \frac{\text{EBIT}}{\text{Avg. total assets}} = \frac{\text{EBIT}}{\text{total assets}}$$

Stock Market Ratios (Valuation Ratios)

1) Price to Earnings Ratio:

$$\text{PE Ratio} = \frac{P}{E} = \frac{\text{Share Price}}{\text{Earning per share}}$$

2) Price to Book Ratio

$$\text{PB Ratio} = \frac{P}{B} = \frac{\text{Share Price}}{\text{Book Value per share}}$$

3) Price to Sales Ratio:

$$\text{PS Ratio} = \frac{P}{S} = \frac{\text{Share Price}}{\text{Sales per share}}$$

Use of Ratio Analysis

- Trend Analysis
- Benchmarking with competition
- Areas of improvement
- Decision making

Limitations of Ratio Analysis

- Historical information
- External Factors
- Operational changes
- Changes in accounting policy
- Manipulation of financial statements
- Seasonality

Balance Sheet

- summary stmt of assets, liabilities & owner's equity at a point of time

Assets

1) Current assets (can be converted to cash within period of 1 year.)

2) Non current assets (fixed assets ex: IT assets) - cannot be liquidate within 1 year

Liabilities

1) Current liabilities

2) Non current liabilities