

FINANCIAL MANAGEMENT

A business is an activity that is carried on with an intention of earning profits. It has different operations involved like production, marketing & finance. The finance function is the most important function and greatly affected by the forms of organization. The basic forms of business organizations are:

1. Proprietary firms.
2. Partnership firms &
3. Joint stock companies.

Proprietary firms:

The proprietary firm is the firm in which only one person is the owner, who is called as "proprietor". He is the direct person of profits & losses. He has the right to take the decisions individually. The following are the pros & cons:

Advantages:

1. Proprietary firms are the most easiest & economical form of business to form and operate.
2. The proprietor can be act as Manager and he has right of freedom to take decisions.
3. This is very suitable where the size of business is small and.
4. A proprietary firm does not require submitting more number of documents to the government.

Disadvantages:

1. A proprietary firm does not have any legal status.
2. The proprietor may not be capable to invest further, when the business is in downfall or complexed stages.
3. These are unlimited liability firms & the proprietor's property will always be at stake, if the liability is more than assets.
4. The proprietor needs to pay higher taxes, as he is the direct person, who is enjoying the profits.
5. Transferring of business is not easy.

Partnership firms:

The firm, in which the partners are more than 2 and less than 20 with an official written down document called "Partnership deed" or "Partnership agreement" is called as partnership firm. It is a contract and relationship between the partners. They will decide the percentage of investment, profit share and will also include the same in the agreement. The advantages and disadvantages are:

Advantages:

1. Partnership firms are easy and economical to operate and form.
2. As the numbers of partners are more, the capacity of the business to handle more complex business is better, when compared to proprietary firms.
3. The tax structure is at a flat rate of 35% and the following are the assumptions, while calculating the tax:
 - a) Interest paid to partners on the amount invested in the company. But the rate of interest should not exceed 12% per annum.
 - b) Remuneration paid to the partners in the form of salary, bonus, commission etc. However, the partners should be working partners, i.e., the person who is involved in day-to-day activities. Section 44AA of Income tax Act, 1961 says that the remuneration paid is depended and decided on the basis of its "Book Profits". Also, the same differs from a professional firm to a business firm.
4. Nominal government regulations.

Disadvantages:

1. The partnership firm does not have any legal status.
2. The retirement or death of a partner leads to dissolution of the partnership firm.
3. Decision making to improve the capacity of business or to raise funds is limited and time taking.
4. Partnership firm is an unlimited liability organization. Incase of losses, all the partners are liable to clear off the debts.
5. Transfer of ownership is not easy.

Joint stock Company:

The company, which has more number of partners, i.e., shareholders, is called as Joint Stock company. This form of organization raises its funds by issuing shares that carry a denomination value called as "Face Value" or "Nominal value". Each individual can participate in the capital requirement of the organization by purchasing the shares. He can exercise his rights through voting. The features of a Joint stock company are:

- ✓ The joint stock companies will gain legal ship by registering with Companies Act, 1956, that regulates the operations of joint stock companies in India. As a legal entity, the company can enter into any agreement, purchase or sell assets, etc.
- ✓ These are limited liability organizations. Shareholders are not responsible and their assets will not be on stake, incase of liabilities are more of the company.
- ✓ Even though the shareholders are owners, they will not participate in day-to-day activities of the company.
- ✓ It is an artificial legal person & allowed to sue or to be sued. It can also participate in any agreement, if necessary.

The following are the advantages and disadvantages:

Advantages:

1. Possibilities of raising funds, as the number of contributing persons are more.
2. As the company is a legal entity, shareholders assets will not be on stake.
3. Transfer of ownership is easier, when compared to proprietary and partnership firms.
(In case of private limited company, the shares are not easily transferable.)

Disadvantages:

1. The company needs to go through more number of legal and procedural formalities, as it is going to act as a legal entity.
2. Double taxation is another disadvantage. The company needs to pay tax for the profits earned & again the individual will be taxed for the income.

Also, in practical situations, there are two types of companies. They are:

- A. Private limited.
- B. Public limited.

The main differences between these two are:

Sno	Description	Private limited	Public limited
1	Number of share holders Minimum: Maximum:	2 50	7 No limit
2	Issue of Shares to public	Not possible	Yes
3	Transfer of Shares	Very complex	Easy
4	Paid-up capital required	1 Lakh	5 Lakhs

Sources available to a corporate organization for raising its long term requirement of funds-

To meet the capital requirement, the company can issue shares, debentures and can also take term loans, accept public deposits and go for leasing and hire purchasing. The total amount is subdivided and allocated as per the requirements. However, equity shares, debentures, and preference shares are the sources for long-term funding. On the strength of these only, a company can avail short & medium term loans.

Equity shares:

The Equity shares play the vital role of the financial structure of the company. On the strength of these shares the company can procure other sources of capital. The characteristic features are:

1. Investors are treated as real owners. The investors are entitled to the profits earned and the losses incurred by the company.
2. The funds raised in the form of equity shares need to be repaid at the time of closure of the company.

3. Funds raised in the form of equity shares are on unsecured basis, i.e., company need not offer any security against the investment.
4. Company needs to pay the dividend in return, which is not fixed.
5. Equity shares are risk free source income to the company.
6. The investors have the right to vote. By exercising the voting rights, the investors can participate in the affairs regarding the business of the company.

However, the recent amendments to the Companies Act, 1956 – It may be possible for the companies to issue equity shares with disproportionate voting rights.

7. The equity shareholder cannot compel the company to pay dividend. However, if the company wants to issue additional equity shares, they need to be offered to the existing shareholders first, and then announce in the open market. These are called as "Pre-emptive rights". Some of the advantages are:

To the company:

- Need not offer any security.
- Need not commit the repayment.
- Need not offer a fixed dividend.

To the investor:

- Limited liability, only to the extent of the face value.
- Possibility of higher returns when compared to preference shareholders and debenture holders, as he will get dividend and good value in secondary market.
- Easily transferable.

Hence, the equity shares will be the good sources to acquire the capital.

Preference shares:

Preference shares are the other sources for the company to acquire long-term loans. It provides a specific dividend that is paid before any dividends are paid to common stock holders, and which takes precedence over common stock in the event of liquidation. Like common stock, preference shares represent partial ownership in a company, although preferred stock shareholders do not enjoy any of the voting rights of common stockholders. Also unlike common stock, preference shares pay a fixed dividend that does not fluctuate, although the company does not have to pay this dividend if it lacks the financial ability to do so. The main benefit to owning preference shares is that the investor has a greater claim on the company's assets than common stockholders.

Preferred shareholders always receive their dividends first and, in the event the company goes bankrupt, preferred shareholders are paid off before common stockholders. Also, the company needs to clear off the preference shares within 20 years. The features are:

1. Investors are not the absolute owners.
2. Funds raised as preference shares should be repaid within 20 years as per section 80 of Companies Act
3. The amount acquired is not treated as a permanent capital.
4. These shares will not carry any voting rights. However, as per companies Act, 1956, a preference share holder will have the right to vote under the following circumstances:

- a) If any resolution directly affecting the rights of preference shareholders is discussed by the equity shareholders.
- b) If the dividend has not been paid, the preference shareholders can vote on all the matters before the company in the meeting of the equity shareholders. However, the following criteria should be satisfied:
 - ✓ If the dividend is not paid for cumulative preference shares for an aggregate period of two years.
 - ✓ If the dividend is not paid for non-cumulative preference shares either for a period of two consecutive years or for an aggregate period of three years out of the six preceding years.

Also, the company can issue the following types of preference shares:

It is advised to issue convertible preference shares, as they can be converted to equity shares after a stipulated time. This helps the company to have long-term capital and the rate of dividends payable will also reduce after certain time.

Debentures:

A debenture is a document called as "Acknowledgement of Indebtedness", which is issued by the company. It is an agreement by the company to the investor that contains the date of repayment, interest rate, interest payments interval details etc. The characteristics are:

1. The investors are called as creditors, as the company needs to repay the investment as described in the "Acknowledgement of indebtedness."
2. Funds arise in the form of debentures need to be repaid in the stipulated time. Hence, these are considered as long-term sources.
3. The company will offer the investors a security against their investments.
4. Interest should be paid, even though the company did not earn profits.
5. The risk involved with debentures is two-fold in the company's point. If the company is not earning profits, it has to pay interest and after maturity period, it has to repay the investment.
6. The debentures will not carry any voting rights, as the debenture holders are treated as creditors.

Advantages associated by issuing debentures:

1. Cost associated with debentures is less when compared to equity shares.
2. During depression, if the investors are not ready to invest further, the company can issue debentures, as it is the other source for long-term loans.
3. By issuing debentures, the company can clear all the short term and medium term loans. This in return gives more profits.
4. As the "Debenture redemption reserve" is maintained, the company can easily repay the investments made by the debenture holders within the said time.

Working capital management or short-term financial management is a significant facet of financial management. It is important due to 2 reasons:

Investment in current assets represents a substantial portion of total investment. Investment in current assets and the level of current liabilities have to be geared quickly to changes in sales.

Working capital involves activities such as arranging short-term finance, negotiating favorable credit terms, controlling the movement of cash, administrating accounts receivables, and monitoring the investment in inventories also take a great deal of time.

What are current assets?

Assets are anything that the firm owns or has title to (in other words ownership of). Firms may have fixed assets, which are long-term assets - plant, machinery and equipment, but they will also have assets, which can be realized (cashed-in) in the short-term. This is generally taken in accounting terms to be less than a year.

The current assets are therefore ones that can be quickly realized and change frequently. The main current assets are stock, debtors and cash.

CURRENT ASSETS = Stock + Debtors + Cash

They are usually shown on the top half of the balance sheet, and the current liabilities are subtracted from them to show net current assets.

What are current liabilities?

A liability is something, which a firm owes to a person or another firm. It may be in the form of creditors - people or firms who have sold you goods which you have not yet paid for, or it may be money borrowed from a financial institution - loans or overdrafts.

Current Liabilities are generally taken in accounting terms to be less than a year. Any money that is owed in more than a year's time is considered to be a long-term liability. Short-term liabilities thus tend to be trade creditors and short-term borrowing such as overdrafts.

They are usually shown on the top half of the balance sheet, and are subtracted from the current assets to show net current assets.

Need for Working Capital?

Working Capital Cycle

Investment in working capital is influenced by four key events in the production and sales cycle. These events are: purchase of raw materials, payment for their purchase, the sale of finished goods, and collection of cash for the sales made.

Definition of operating cycle

The time lag between the purchase of raw materials and the collection of cash for sales is referred to as the operating cycle for the company.

The time lag between the payment for raw materials purchases and the collection of cash from sales is referred to as the cash cycle.

Operating cycle of the company

The entire sequence of operations in a company can be summarized as follows:

The operating cycle for a company primarily begins with the purchase of raw materials, which are paid for after a delay representing the creditor's payable period.

These purchased raw materials are then converted by the production unit into finished goods and then sold. The time lag between the purchase of raw materials and the sale of finished goods is known as the inventory period.

Upon sale of finished goods on credit terms, there exists a time lag between the sale of finished goods and the collection of cash on sale. This period is known as the accounts receivables period.

The following ratios will help in managing debtors, creditors and inventories

1. *Stock Turnover ratio = Cost of goods sold / Average Stock*
2. *Debtors Turnover ratio = [(Debtors + Bills receivable * 365)] / Net credit sales*
3. *Debtors Turnover rate = Credit sales / (Average Debtors + Bills receivable)*
4. *Creditors Turnover ratio = [(Creditors + Bills payable) * 365] / Credit purchases*
5. *Creditors Turnover rate = Credit purchases / Average Creditors*

The operating cycle can be depicted as:

The stage between purchase of raw materials and their payment is known as the creditors payables period.

The period between purchase of raw materials and production of finished goods is known as the inventory period.

The period between sale of finished goods and the collection of receivables is known as the accounts receivable period.

Factors:

- If the company is a trading organization, it requires working capital to make purchases.
- If the size of the organization is very small, it requires high working capital, as it needs to purchase the raw material on cash. Also, it needs to sell the products in the market on credit.
- If there is inflationary or depression conditions, companies require more working capital.
- If the organization is a new entry, it may require more working capital, as it needs to purchase the raw material on cash, as the suppliers do not know about the status and the financial strengths of the organization.

- If the time taken to produce a certain good is more, company requires working capital, as the amount is blocked in the form of "unfinished goods" or raw materials in hand.

How a company can mobilize working capital?

Sources of additional working capital include the following:

Existing cash reserves
 Profits
 Bank overdrafts or lines of credit
 Commercial papers
 Inter-corporate Deposits
 Spontaneous sources

Existing cash reserves: Every Company will maintain cash reserve to meet the working capital needs. If the company does not have any cash reserves, then it can go for the alternatives. Mostly, the new companies will not keep more cash reserves, as it will become a blocked reserve.

Profits: If the company is earning profits, it can turn some percent of profits towards working capital reserves. In the time of inflation or depression, company can use this reserve as working capital.

Bank overdrafts or lines of credit: Banks play vital role in financing the working capital to the organizations. However, banker will look the following before financing:

1. The amount required by the company.
2. Form of issuing the working capital.
3. Security to be taken.
4. Regulations applicable for issuing the working capital.

The form of assistance may be either **Non-fund based** or **Fund based lending**. In case of non-fund based lending, the banker will not commit any physical outflow. It will be in the form of **Bank Guarantee** or **Letter of Credit**. Both the **Bank Guarantee** and **Letter of Credit** helps the organization to make purchases and selling goods overseas. These will also act as guarantee for the goods that are supplied.

Commercial papers:

Commercial Paper (CP) is widely used by top-rated corporate and an institution as a flexible short-term instrument that provides a cost-effective diversification of funding sources away from the banking sector.

It is an unsecured obligation issued by a corporation or bank to finance its short-term credit needs, such as accounts receivable and inventory. Maturities typically range from 15 to 365 days. Commercial paper is available in a wide range of denominations, can be either discounted or interest bearing, and usually have a limited or nonexistent secondary market. Companies with high credit ratings usually issue commercial paper, meaning that the investment is almost always relatively low risk.

Who can issue?

1. A company with a tangible net worth of more than 4 crores as per the latest audited balance sheet.
2. Borrowed amount of the company is classified as a standard asset by the bank.

The company needs to obtain satisfactory credit rating (Minimum rating required is p-2 of CRISIL or equal lent) from any credit rating agency before issuing CPs. The RBI approved credit rating companies are:

1. CRISIL
2. CARE
3. ICRA
4. Fitch Rating India (P) Ltd.

Who can invest?

NRIs, Individuals, Banks, Corporate Bodies, Foreign Institutional Investors.

Nature:

1. The maturity period ranges from 15 to 365 days.
2. The value of the CP is Rs.5 Lakhs.
3. Every renewal will be considered as a fresh issue.
4. It is not a deposit as per Provisions of Section 58-A of Companies Act, 1956.

Procedure to issue CPs:

- Company should appoint a Schedule bank as the Issuing and Paying Agent.
- IPA will check the credit rating and the documents submitted by the issuing company and the valid agreement.
- The issuing company needs to disclose the financial status of the company to the IPA.
- After the deal is confirmed, the issuing company needs to issue physical certificates to the investor.
- Every issue of CP should be reported to RBI through IPA with in three days from the date of completion of the issue.

Inter-corporate Deposits: This business involves movement of funds from funds-surplus companies to credit worthy corporate borrowers. However, these are not treated as deposits as per the provisions of Section 58-A of the Companies Act, 1956 and as such the regulations applicable to the public deposits do not apply to ICDs.

- ICDs are short-term loans, i.e., for three to six months.
- These are unsecured.
- The company on its own decides the rate of interest, and the period.

Spontaneous sources: These are the sources through which working capital is generated automatically and these are unsecured sources. For eg: If the company has good net worth, it can make purchases on credit and can avail a gap to make the payment.

These are the different sources to generate working capital.

Banks as a source for financing working capital requirement:

Banks play vital role in financing the working capital to the organizations. However, banker will look the following before financing:

1. The amount required by the company (Amount of Assistance.)
2. Form of issuing the working capital.
3. Security to be taken.
4. Regulations applicable for issuing the working capital.

Amount of Assistance:

To avail the working capital from bank, the company needs to prepare working capital estimation and submit the same to the banker. The estimation of level of assets and level of liabilities needs to be prepared properly, as working capital is the difference between current assets and current liabilities. The techniques like Ratio analysis; trend analysis can be used. The company needs to submit the other required support documents to the bank. On the basis of the information provided, bank will decide the amount that can be extended. While extending the working capital assistance, the bank may prescribe the margin money requirement. The margin money stipulation is made by the banks in order to ensure the borrowing company's own stake in the business and also to provide the cushion against the possible reduction in the value of security offered to the bank. The percentage is depended on the company's net worth and directives of RBI from time to time.

Form of issuing the working capital:

The bank may not issue the extending amount in the form of cash. Based upon the documents produced and good will of the company, the form differs. The following are the two different forms:

1. Non-Fund based lending.
2. Fund based lending.

Non-Fund based lending:

Instead of providing cash funds to the company, the bank will provide working capital assistance in other forms, they are:

Bank Guarantee:

This is the document supplied by the bank by certifying that the company has the sufficient funds on deposit at the bank and can enter into the transaction. To issue the bank guarantee, the company needs to provide the information about the raw material or machinery that is purchasing. Bank will issue a letter to the company about the amount that can be used as working capital. After utilizing the bank guarantee, company needs to provide the corresponding documents.

Letter of Credit:

This is the primary or secondary source of security for a bond issue. Either a commercial bank or a private corporation can issue this. This is normally found in the International trade. If the

company is importing any goods from other country, he can approach the bank for the letter of credit on the exporter name. The banker will undertake to pay the exporter or accept the bills of draft drawn by the exporter on the exporter fulfilling the terms and conditions specified in the letter of credit.

There are different varieties:

1. Revocable or Irrevocable.
2. Confirmed or Unconfirmed.

Fund based lending:

Incase of Fund based lending, the bank commits physical outflow of funds. As such, the funds position of the lending bank does get affected. The fund based lending can be in the following forms:

1. Loans.
2. Overdraft.
3. Cash credit.
4. Bills purchased/discounted.
5. Working capital term loans.
6. Packing credit.

Security:

To avail working capital assistance, the company needs to provide security to the bank. The following are the different forms of security:

1. Hypothecation: Under this method, the company needs to provide any moveable property as security. The bank will not possess the security, unless the company has an outstanding amount. The banker has the right to sell the security.
2. Pledge: Under this method, the company needs to provide any moveable property as security. The bank will possess the security and provides assistance. If the company has an outstanding amount, the banker has the right to sell the security with issuing a notice to the company.
3. Lien: Under this method, the banker will keep the security with the bank. The company needs to clear the loan and can handover the security provided.
4. Mortgage: This mode is for immovable properties. If the company is providing buildings, machinery etc., then it will be treated as mortgage. The company need not possess the property to the banker at the time of availing the loan and he can use the same for production purpose. But, banker has the right to verify the security at any time and incase of outstanding amount he can sell the same.

Significance of Capital Budgeting decisions.

Capital budgeting decisions are the most crucial and critical decision for a business to take. This is the fact due to the various reasons.

- Capital decisions have long-term implications on the operations of the business. A wrong decision may affect the long-term survival of the company. The investment in fixed assets which is more than required may increase the operating costs of the company. The inadequate investment in fixed assets may make it difficult for the company to compete and may affect its market share.
- Capital budgeting decisions involve large amount of the funds. As such, it is necessary to take the decisions very carefully and to make the arrangement of the funds for the procurement of these assets.
- The capital budgeting decisions are irreversible due to the fact that it is difficult to find the market for such capital goods. The only alternative is to scrap these assets which involves huge losses.
- Capital budgeting decisions are difficult to make because it involves the assessment of future events which are difficult to ascertain. The investments are required to be made immediately but the returns are expected over a number of years.