Unit 4 – FINANCIAL MANAGEMENT (Industrial Managemnet-R23)

--Prepared by Dr.P.Suresh Babu

(1) FINANCIAL MANAGEMENT:

Financial management is the strategic planning, organizing, directing, and controlling of an organization's financial resources to achieve its objectives efficiently and effectively.

Strategic Planning: Financial managers develop long-term plans and strategies for securing and utilizing funds, including capital budgeting, investment decisions, and financing strategies.
Organizing: They structure the financial activities of the organization, ensuring efficient operations and resource allocation.
Directing: Financial managers guide the flow of funds, making decisions about investments, expenditures, and cash management.
Controlling: They monitor financial performance, track expenses, and implement measures to ensure financial stability and compliance.

Objectives: The primary goal of financial management is to maximize shareholder wealth while ensuring the long-term sustainability and growth of the organization.

Key Areas of Focus:

Budgeting: Creating and managing budgets for various departments and projects.
Forecasting: Predicting future financial performance and trends.
Cash Flow Management: Ensuring sufficient cash on hand to meet obligations and invest in opportunities.
Investment Decisions: Evaluating and selecting investment opportunities that align with the company's objectives.
Risk Management: Identifying and mitigating potential financial risks.
Financial Reporting: Preparing accurate and timely financial statements and reports.

(2) SCOPE AND NATURE OF FINANCIAL MANAGEMENT:

In industrial management, financial management's scope encompasses planning, acquiring, utilizing, and controlling financial resources to achieve organizational goals, including investment decisions, financing, dividend policy, and working capital management.

Scope of Financial Management in Industrial Management:

Financial Planning:

- **Forecasting:** Predicting future financial needs and outcomes.
- **Budgeting:** Creating financial plans and allocating resources.
- **Strategic Planning:** Aligning financial strategies with the overall business strategy.

Investment Decisions:

- **Capital Budgeting:** Evaluating and selecting long-term investment projects.
- **Asset Allocation:** Determining the optimal mix of assets to invest in.

Financing Decisions:

- **Raising Capital:** Determining the best ways to finance the business, such as debt or equity.
- **Capital Structure:** Determining the optimal mix of debt and equity financing.

Dividend Policy:

- **Determining Dividends:** Deciding how much of the company's profits to distribute to shareholders.
- **Dividend Payout Ratio:** Determining the proportion of earnings paid out as dividends.

Working Capital Management:

- **Cash Flow Management:** Ensuring that the business has enough cash to meet its short-term obligations.
- **Inventory Management:** Managing inventory levels to minimize costs and maximize efficiency.
- **Accounts Receivable Management:** Collecting payments from customers in a timely manner.

Financial Analysis and Control:

- **Financial Statement Analysis:** Analyzing financial statements to assess the company's performance and financial health.
- **Ratio Analysis:** Using financial ratios to track key performance indicators.
- **Variance Analysis:** Comparing actual performance with budgeted performance to identify areas for improvement.

Risk Management:

- **Identifying and Assessing Risks:** Identifying potential risks that could impact the company's financial performance.
- **Developing Risk Mitigation Strategies:** Developing strategies to reduce the impact of potential risks.

Nature of Financial Management:

Goal-Oriented: Financial management is driven by the objectives of the organization, such as profit maximization, wealth maximization, or achieving specific financial targets.
Dynamic: The financial environment and business conditions are constantly changing, requiring financial managers to be adaptable and proactive.
Continuous Process: Financial management is not a one-time activity but an ongoing process of planning, monitoring, and controlling financial activities.
Universal: Financial management principles and techniques are applicable across different industries and organizations.
Multidimensional: Financial management involves various aspects, including financial planning, investment decisions, financing decisions, dividend policy, and working capital management.

(3) SOURCES OF FINANCE:

The main sources of finance for businesses are retained earnings, debt capital (loans, bonds), and equity capital (shares, venture capital).

- **Retained Earnings:** Profits a company keeps and reinvests rather than distributing to shareholders.
- **Debt Capital:** Borrowed funds, such as loans from banks or issuing bonds to investors.
- **Equity Capital:** Funds raised by selling ownership shares in the company (e.g., stocks) or through venture capital investments.

Other Sources:

- **Trade Credit:** Suppliers allow businesses to defer payment for goods or services.
- **Factoring:** Selling accounts receivable to a third party at a discount for immediate cash.
- **Lease Financing:** Leasing assets instead of buying them.
- **Public Deposits:** Taking deposits from the public.
- **Commercial Papers:** Short-term, unsecured debt instruments.
- **Venture Capital:** Funding provided to early-stage, high-growth companies.
- **Private Equity:** Funding provided to established companies, often with the goal of improving their performance.
- **Government Grants and Incentives:** Funding or tax breaks offered by governments.

(4) CONCEPT OF CAPITAL

In industrial management, "capital" refers to the resources a company uses to generate revenue and drive growth, encompassing both physical assets and investments, and is crucial for funding operations, investments, and managing risks.

Definition: Capital, in a business context, is the money or assets a company uses to operate and grow, including cash, investments, and assets like property, equipment, and intellectual property.

Importance:

- **Funding Operations:** Capital is essential for paying day-to-day expenses, salaries, and other operational costs.
- **Investing in Growth:** Capital allows companies to invest in new projects, expand operations, and develop new products or services.
- **Managing Risks:** Adequate capital helps companies weather economic downturns and unforeseen circumstances.

Types of Capital:

- **Working Capital:** This refers to the difference between a company's current assets (like cash, inventory, and accounts receivable) and current liabilities (like accounts payable and short-term debt). Effective working capital management is crucial for ensuring a company can meet its short-term obligations and maintain smooth operations.
- **Fixed Capital:** This includes long-term assets like buildings, machinery, and equipment, which are used for production and are not intended for immediate resale.
- **Debt Capital:** This refers to funds borrowed from lenders, such as loans or bonds.
- **Equity Capital:** This refers to funds invested by owners or shareholders.

Capital Management:

This involves the strategic planning and execution of how a company uses its capital to achieve its financial goals. It includes decisions about:

- **Capital Structure:** The mix of debt and equity used to finance the business.
- **Investment Decisions:** Choosing which projects and investments to fund.
- **Working Capital Management:** Optimizing the use of current assets and liabilities.

(5) WORKING CAPITAL CYCLE

The working capital cycle in industrial management measures the time it takes for a business to convert its investments in inventory and other resources into cash, encompassing inventory, accounts receivable, and payable management.

Definition: The working capital cycle, also known as the cash conversion cycle, is the time it takes a company to convert its investments in inventory and other resources into cash from sales.

Phases:

The cycle involves several key phases:

- **Inventory Management:** Purchasing raw materials, manufacturing, and selling finished goods.
- **Accounts Receivable:** The time it takes to collect payment from customers after selling goods or services on credit.
- **Accounts Payable:** The time it takes to pay suppliers for goods or services purchased on credit.
- **Cash Conversion:** The final stage where the company receives cash from customers and uses it to pay bills and other expenses.

Calculation:

The working capital cycle is calculated by adding the number of inventory days to the number of receivable days and then subtracting the number of payable days.

- **Formula:** (Inventory Days + Receivable Days) - Payable Days.

Importance:

- **Cash Flow:** A shorter working capital cycle indicates faster cash flow, which is crucial for maintaining smooth operations and meeting short-term financial obligations.
- **Operational Efficiency:** A well-managed working capital cycle demonstrates operational efficiency and the ability to convert resources into cash effectively.
- **Liquidity:** An efficient cycle helps ensure a business has enough liquidity to meet daily expenses, repay debts, and reinvest in growth.

Improving the Cycle: Businesses can improve their working capital cycle by:

- Optimizing inventory levels and turnover.
- Accelerating collections from customers.
- Negotiating better payment terms with suppliers.
- Minimizing inventory levels.

(6) FIXED CAPITAL V/S WORKING CAPITAL

Fixed capital represents long-term investments in assets used for sustained operations, like buildings and machinery, while working capital covers short-term needs for daily operations, such as cash, inventory, and accounts receivable.

Fixed Capital:

- **Definition:** Refers to long-term investments in assets that are used repeatedly in the production process and are not easily converted into cash.
- **Examples:** Buildings, machinery, equipment, land, and property.
- **Purpose:** Supports long-term growth and productivity, forming the foundation for a company's operations.

Characteristics:

- Non-current assets.
- Used over multiple accounting periods.
- Not easily converted to cash.
- Strategic investments aimed at enhancing productivity and capacity.

Working Capital:

- **Definition:** Refers to the liquid assets a company uses to finance day-to-day operations and short-term financial obligations.
- **Examples:** Cash, inventory, accounts receivable, and short-term investments.
- **Purpose:** Ensures smooth and efficient daily operations, allowing the business to meet its short-term financial obligations.

Characteristics:

- Current assets and liabilities.
- Highly liquid assets.
- Used to cover short-term expenses like payroll and bills.
- Indicates a company's short-term financial health.

Calculation:

Working capital is calculated by subtracting current liabilities from current assets.

Key Differences Summarized:

Feature	Fixed Capital	Working Capital
Nature	Long-term assets	Short-term assets and liabilities
Purpose	Supports long-term growth and productivity	Ensures smooth daily operations and liquidity
Liquidity	Not easily converted to cash	Highly liquid
Examples	Buildings, machinery, equipment	Cash, inventory, accounts receivable

(7) MANAGEMENT OF WORKING CAPITAL

Working capital management involves efficiently managing a company's short-term assets and liabilities to ensure smooth operations and financial stability, focusing on optimizing cash flow and meeting short-term obligations.

- **Definition:** Working capital management is about overseeing a company's day-to-day financial activities, including managing inventory, accounts receivable, accounts payable, and other short-term financial commitments.
- **Importantance:** It's crucial for ensuring a business can meet its short-term obligations, maintain liquidity, and fund its operations effectively.

Key Objectives:

- **Ensuring Liquidity:** Having enough working capital ensures a business can meet its short-term obligations (e.g., paying suppliers, employees, and other creditors).
- **Optimizing Cash Flow:** Efficient working capital management helps optimize cash flow, which is essential for smooth operations and growth.
- **Improving Operational Efficiency:** By managing working capital effectively, companies can free up cash that would otherwise be tied up on the balance sheet, leading to better operational efficiency.
- **Balancing Liquidity and Profitability:** There's a trade-off between having enough working capital (for liquidity) and keeping capital invested in profitable activities.

Key Components:

- **Inventory Management:** Managing inventory levels to avoid overstocking or stockouts, which can impact cash flow and profitability.
- **Accounts Receivable Management:** Ensuring timely collection of payments from customers to improve cash flow.
- **Accounts Payable Management:** Negotiating favorable payment terms with suppliers to improve cash flow.
- **Cash Management:** Managing cash balances to ensure sufficient liquidity while minimizing idle cash.

Tools and Techniques:

- **Cash Conversion Cycle (CCC):** Analyzing the time it takes for a company to convert its investments in inventory and accounts receivable into cash.
- **Current Ratio and Quick Ratio:** These ratios assess a company's ability to meet its short-term obligations.

- **Cash Flow Forecasting:** Predicting future cash inflows and outflows to plan for potential cash shortages or surpluses.
- **Negotiating with Suppliers:** Seeking longer payment terms or discounts for early payment to improve cash flow.
- **Streamlining Accounts Receivable:** Sending invoices promptly and following up on overdue payments.

Benefits of Effective Working Capital Management:

- Improved cash flow and liquidity.
- Reduced financial risk.
- Enhanced operational efficiency.
- Increased profitability.
- Better ability to respond to unexpected expenses or opportunities

(8) ESTIMATION OF WORKING CAPITAL REQUIREMENTS

To estimate working capital requirements, you can use methods like the projected balance sheet, percentage of sales, or operating cycle method, focusing on current assets (cash, receivables, and inventory) and liabilities (payables) to determine the funds needed for day-to-day operations.

Understanding Working Capital:

- Working capital represents the funds a company needs to cover its short-term operational expenses, including paying suppliers, employees, and other costs, while also managing its inventory and accounts receivable.
- It's calculated as: Working Capital = Current Assets - Current Liabilities.
- **Current Assets**: include cash, accounts receivable (money owed by customers), and inventory.
- **Current Liabilities**: include accounts payable (money owed to suppliers) and other short-term debts.

Methods for Estimating Working Capital Requirements:

- **Projected Balance Sheet Method:** This method involves projecting the company's balance sheet for the next period and using the projected figures to determine the working capital needs.
- **Percentage of Sales Method:** This method estimates working capital requirements as a percentage of projected sales.
- **Operating Cycle Method:** This method focuses on the time it takes for a company to convert its investments in inventory and other resources into cash from sales.

Factors Affecting Working Capital Requirements:

- **Industry:** Different industries have different working capital needs.
- **Business Cycle:** Economic conditions and seasonality can impact working capital requirements.
- **Sales Volume and Growth:** Higher sales volume and growth typically require more working capital.
- **Inventory Management:** Efficient inventory management can reduce the need for working capital.
- **Payment Terms:** The terms offered to customers and suppliers can affect the timing of cash inflows and outflows.
- **Production Cycle:** The length of the production cycle can impact the need for working capital.

(9) CAPITAL BUDGETING

Capital budgeting is a financial process that helps companies decide which projects to invest in. It involves long-term planning, and can include purchasing land, machinery, or trucks.

How it works

- **Evaluate cash flows**: Companies use cash flows to determine the value of a potential investment.
- **Compare returns to risks**: Companies compare the potential returns of a project to the associated risks.

- **Use metrics to track performance**: Companies use metrics like payback period, internal rate of return, and net present value to track the performance of a project.
  Common capital budgeting techniques
- **Payback period**: Determines how long it will take to recover the original investment
- **Internal rate of return**: Calculates the expected return on a project
- **Net present value**: Measures the excess or shortfall of cash flows after financing charges
- **Discounted cash flow analysis**: Estimates the value of an investment based on future cash flows
- **Throughput analysis**: Considers the entire company as a single profit-generating system
  Capital budgeting characteristics High risk, Fixed investment over the long run, Investments determine the future financial condition of the organization, and All projects require significant amounts of funding.

(10) NATURE OF INVESTMENT DECISIONS

Investment decisions involve allocating resources with the expectation of future returns, considering factors like risk, time horizon, and desired outcomes, and often utilize tools like capital budgeting and risk management to make informed choices.

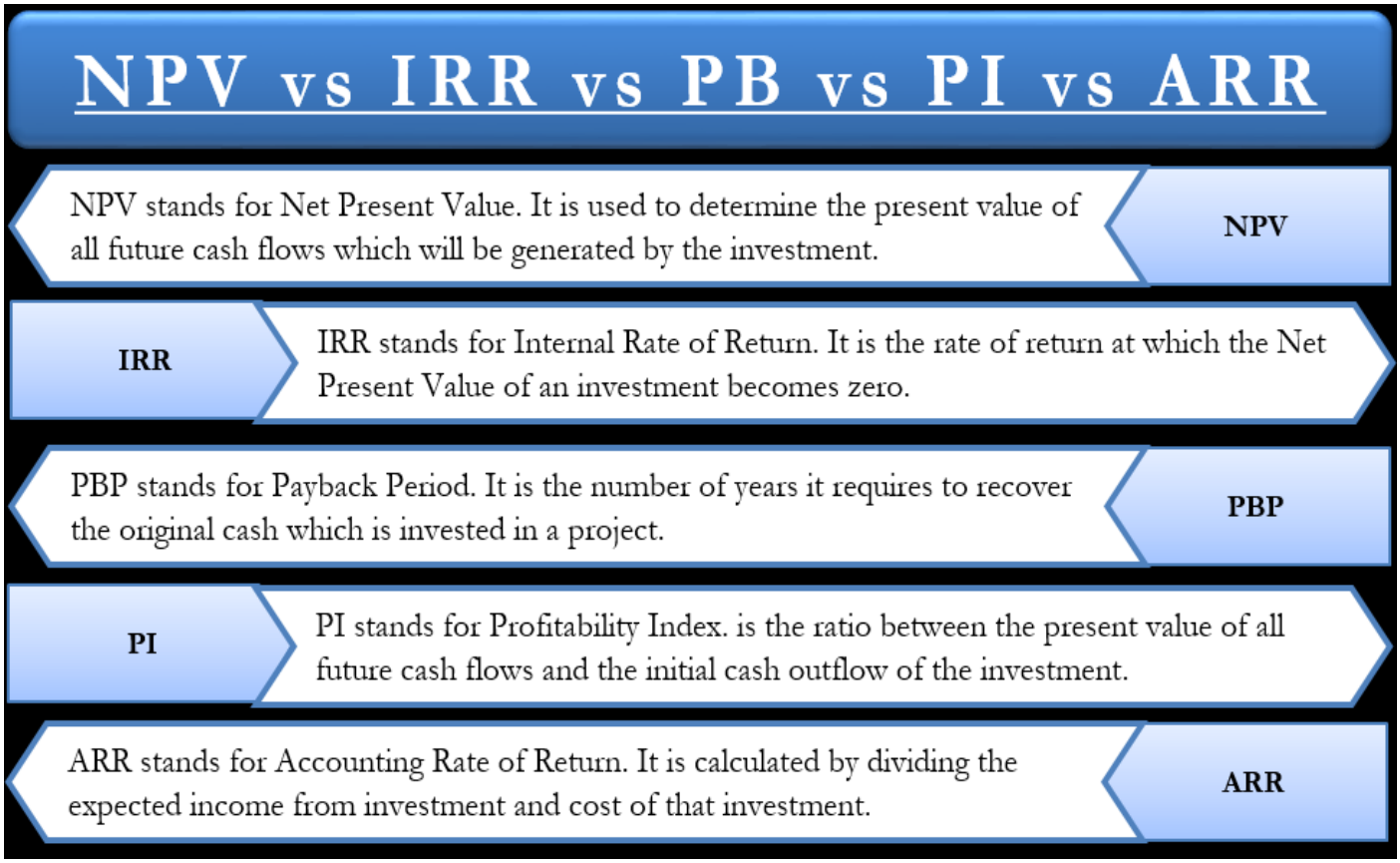
Key Characteristics:

- **Resource Allocation:** Investment decisions involve allocating resources, such as capital, to various opportunities with the aim of generating future returns.
- **Future Focus:** Investment decisions are inherently forward-looking, as they aim to generate returns or achieve goals in the future.
- **Risk and Return:** Investment decisions involve a trade-off between risk and potential return. Higher potential returns often come with higher risks, and investors need to assess their risk tolerance and investment objectives.
- **Time Horizon:** The time horizon, or the length of time an investment is held, is an important factor in investment decisions. Long-term investments typically have a longer time horizon and may be more suitable for certain goals, while short-term investments have a shorter time horizon and may be more suitable for other goals.
- **Liquidity:** Liquidity refers to the ease with which an investment can be converted into cash. Investors need to consider their liquidity needs and how easily they can access their investments if needed.
- **Investment Objectives:** Investment decisions are guided by an investor's objectives, which can include capital growth, income generation, or preservation of capital.
- **Capital Budgeting:** Capital budgeting is a process used to evaluate and make investment decisions, particularly for long-term projects or assets.
- **Financing Decisions:** Financing decisions are about how to fund investments, including choosing the right mix of debt and equity financing.
- **Risk Management:** Risk management involves identifying, assessing, and mitigating potential risks associated with investments.
- **Cash Flow Analysis:** Investment decisions often involve analyzing the cash flows associated with an investment, including both inflows (returns) and outflows (costs).

(11) INVESTMENT EVALUATION CRITERIA

When evaluating investments, consider risk tolerance, investment objectives, time horizon, liquidity needs, expected returns, and potential taxes. Also, analyze factors like market potential, financial health, management quality, and regulatory considerations.

For this we have to use the Project evaluation Techniques are PBP, ARR, NPV, IRR & PI, which are given below.



(12) NET PRESENT VALUE (NPV):

It is a financial technique that helps entrepreneurs and investors determine if an investment or project is profitable.

- NPV is calculated by comparing the present value of future cash flows to the initial cost of investment.
- This allows businesses and investors to determine whether a project or investment will be profitable.
- A positive NPV suggests that an investment will be profitable while a negative NPV suggests it will incur a loss.

NPV = Initial Investment + (Annual Cash Flow / (1 + Discount Rate))

Example: Initial investment of $3,000 and an expected cash flow of $1,500 per year for five years with a discount rate of 4%.

Answer: NPV = $3,000 + ($1,500 / (1 + 0.04)) = $4,442

In this example, the NPV is $4,442, which means the project is expected to generate a return of $1,442 more than the initial investment of $3,000.

(13) THE INTERNAL RATE OF RETURN (IRR):

It is the annual rate of growth that an investment is expected to generate.

- IRR is calculated using the same concept as net present value (NPV), except it sets the NPV equal to zero.

- The ultimate goal of IRR is to identify the rate of discount, which makes the present value of the sum of annual nominal cash inflows equal to the initial net cash outlay for the investment.
- IRR is ideal for analyzing capital budgeting projects to understand and compare potential rates of annual return over time.

The Formula for IRR:

$$0 = \text{NPV} = \sum_{t=1}^{T} \frac{C_t}{(1+IRR)^t} - C_0$$

where:

Ct = Net cash inflow during the period t

*C*0 = Total initial investment costs

IRR = The internal rate of return

t = *The number* of time periods

Example: Assume a company is assessing the profitability of Project X. Project X requires $250,000 in funding and is expected to generate $100,000 in after-tax cash flows in the first year and grow by $50,000 for each of the next four years.

	2020A	2021P	2022P	2023P	2024P	2025P	
Initial Investment	(250,000)						
After-Tax Cash Flows		100,000	150,000	200,000	250,000	300,000	
							IRR 56.72%

In this case, the IRR is 56.72%, which is quite high.

(14) PAYBACK PERIOD (PBP):

It is the length of time it takes to recover the cost of an investment or the length of time an investor needs to reach a breakeven point.

- Shorter paybacks mean more attractive investments, while longer payback periods are less desirable.
- The payback period is calculated by dividing the amount of the investment by the annual cash flow.
- Account and fund managers use the payback period to determine whether to go through with an investment.
- One of the downsides of the payback period is that it disregards the time value of money.
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$$\text{Payback Period} = \frac{\text{Cost of Investment}}{\text{Average Annual Cash Flow}}$$

Example: If solar panels cost $5,000 to install and the savings are $100 each month. Calculate PBP?

Answer: PBP = 5000/100 = 50 months = 4.2 years

(15) PROFITABILITY INDEX (PI):

It is used to assess the attractiveness of an investment or project. It's calculated by dividing the present value of future cash flows by the initial investment amount.

- A higher PI indicates a better investment. A PI of 1 means the project will break even, a PI less than 1 means the costs outweigh the benefits, and a PI greater than 1 means the venture is profitable.
- The PI uses an estimate of the cost of capital, which may not be entirely accurate. It's also not 100% reliable when choosing between mutually exclusive projects.
- The PI doesn't necessarily measure the value of a business, and it can sometimes indicate bad management techniques

$$\text{Profitability Index} = \frac{\text{Present Value (PV) of Future Cash Flows}}{\text{Initial Investment}}$$

For some general guidelines on interpreting the PI ratio:

- PI =1 → Neutral or Acceptable
- PI >1 → Approve Project
- PI <1 → Reject Project

Example 1: Nataraj Enterprise is considering a project with an initial investment of ₹10,00,00,000 and a present value of future cash flow of ₹13,00,00,000. Find the P.I

Solution: PI = ₹13,00,00,000 / ₹10,00,00,000 = 1.3, indicates that the investment is a good decision.

Example 2: A project has an initial investment of $1,000 and an anticipated return of $1,300. Find the P.I

Solution: PI = $1,300 / $1,000 = 1.3, indicates that the project will be profitable.

(16) ACCOUNTING RATE OF RETURN (ARR):

It is a financial ratio that measures the profitability of an investment by comparing the average annual profit to the initial cost. It is also known as the average rate of return.

- ARR is used in capital budgeting to help make decisions about investments, such as whether to continue with a project or acquisition.
- It is easy to understand and can be used to compare different investment options.
- It can help determine if an investment meets a company's minimum return rate.
- But, results can be inconsistent because it can be calculated in different ways

$$\text{ARR} = (\text{Average Annual Profit} / \text{Initial Investment}) \times 100$$

Example 1: Initial investment of $250,000 and expected annual revenue of $70,000 for five years. Find ARR.

Solution: ARR= $70,000 (annual revenue) / $250,000 (initial cost) = 28% ie., 0.28

Example 2: Investment of $200,000 in manufacturing equipment that generates an average annual profit of $40,000 for five years. Find ARR.

Solution: ARR= $40,000 / $200,000 = 20% ie., 0.2

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