Unit 4 Introduction to Financial Management

Introduction to Finance

Finance may be defined as the art and science of managing money. The major areas of finance are Financial Services and Managerial Finance or Financial Management.

Financial Services is concerned with the design and delivery of advice and financial products to individuals, businesses and governments, within the areas of banking are related institutions, personal financial planning, investments, real estate, insurance and so on.

Financial Management is concerned with the duties of the financial managers in the business firm. Financial managers actively manage the financial affairs of any type of business, namely, financial and non-financial, private and public, large and small, profit seeking and not for profit. They perform such varied tasks as budgeting, financial forecasting, cash management, credit administration, investment analysis, funds management and so on.

Financial Management as an integral part of overall management is not a totally independent area. It shows heavily related disciplines and fields of study, such as economic, accounting, marketing, production and quantitative methods.

Unit 4 Introduction to Financial Management

Financial Management

Financial management provides a conceptual and analytical framework for financial decision making. Financial management is an integral part of overall management. It covers both financial function of acquisition of funds and allocation of funds. Thus, apart from this involves acquiring the external funds and the main concern of financial management is the efficient and allocation of funds to various uses.

The financial management consider various financial problems of a firm. The main contents of this approach are –
What is the total volume of a firm or enterprise?
What should an enterprise acquire specific assets?
How should the funds required be financed?

It also considers How should be enterprise large and how fast should it grow?

In what form should it hold assets and what is the position of its liabilities.

The financial management covers the major problems of the firm. The main solutions to this problem corresponding under the various decisions taken by the financial managers. Mostly it covers various fields like investment, financing, dividend policy, capital budgeting, working capital management and so on

Unit 4 Introduction to Financial Management

Financial Planning

Financial planning means to prepare the financial plan. A financial plan is also called plan. A financial plan is an estimate of the total capital requirements of the company. It selects the most economical sources of finance. It also tells us how to use this finance profitable. Financial plan gives a total picture of the future financial activities of the company.

Unit 4 Introduction to Financial Management

Financial Planning

Financial Planning is the mathematical sum of following parameters:

Financial Resources (FR) + Financial Techniques (FT) = Financial Planning.

Financial plan contains answers to the following points:

- How much finance (short-term, medium-term and long-term) will be required by the year?

- From where this finance will be acquired (gathered)? In other words, what are the sources of finance? That is owned capital (promoter contribution, share capital) and borrowed capital (debentures, loans, overdrafts, etc.)

- How the company will use this acquired finance? That is, application or utilization of funds.

Financial Planning

Financial plan is generally prepared during promotion stage. It is prepared by the Promoters (entrepreneurs) with the help of experienced (practicing) professional. The promoters must be very careful while preparing the financial plan. This is because a bad financial will lead to over-capitalization or under capitalization. It is very difficult to correct a bad financial plan. Hence immense care must be taken while preparing a financial plan.

Unit 4 Introduction to Financial Management

Capital Structure

Capital structure decision in concerned with the decision making about the mix of various sources of capital viz equity capital, preference capital, retained earnings and long term debt in the total capital of a firm.

According to Gerstenberg,” capital structure of a firm refers to the composition of makeup of its capitalization and it includes all long term capital resources viz loans, reserves, shares and bonds”.

R.H Wessel defined it,” The term capital structure is frequently used to indicate the long term sources of funds employed in a business enterprise.”

According to Weston and Brigham,” Capital structure is the permanent financing of the firm represented by the long term debt, preferred stock and net worth.”

Above definitions bring clearly the fact that capital structure refers to make ups of the capitalization of the firm i.e., the proportions in which the firm raises its long term funds from various sources of capital.

Unit 4 Introduction to Financial Management

Capital Structure

Capital structure is ordinary implies the proportion of debt and equity in the total capital of a company. Since a company may tap any one or more of the different available sources of funds to meet its total financial requirement. The total capital of a company may, thus, be composed of all such tapped sources. The term structure has been associated with the term capital the term capital may be defined as the long-term funds of the firm.

Capital is the aggregation of the items appearing on the left hand side of the balance sheet minus current liabilities in order words capital may also be expressed as follows:

Capital = “Total Assets—Current Liabilities.

Further, Capital of a company may broadly be categorized into ‘equity’ and debt.

Unit 4 Introduction to Financial Management

Capital Structure

- Equity consists of the following :

Equity share capital Preference share capital + share premium + Free reserves + Surplus profits + Discretionary provisions for contingency + Development rebate reserve.

- Debt consists of the following:

All borrowing form government, semi-government statutory financial corporations and other agencies + Term Loans from Banks, financial institution etc + Debentures + All deferred payment liabilities

Internal and External source of Finance

Internal sources of capital are those sources that are generated within the business say through ploughing back of profits. Business, for example, can generate funds internally by accelerating collection of receivables, disposing of surplus inventories and ploughing back its profit. The internal sources of funds can fulfill only limited needs of the business

External sources of capital, on the other hand are those that are outside the business such as finance provided by suppliers, lenders, and investors. When large amount of money is required to be raised, it is generally done through the use of external sources.

External funds may be costly as compared to those raised through internal sources.

In some cases, business is required to mortgage its assets as security while obtaining funds from external sources. Issue of debentures, borrowing from commercial banks and financial institutions and accepting public deposits are some of the examples of external sources of funds commonly used by business organisations.

Internal Source of Finance includes;

- ✓ Retained Earnings

Using internal sources of finance is called purchase from internal financial statement. However, the easiest type of funding is using internal funds such as cumulative reservoirs.

- ✓ Controlling working capital

The money invested in current assets like raw material, finished goods and debtors etc. is working capital. In other words, money required for day-to-day operations of business/ project/enterprise is called ‘working capital’. The entrepreneur can keep a control on the working capital by prudently judging the requirements for day-to-day operations.

Internal Source of Finance includes;

- ✓ Sale of assets

New activities can be financed by a business or the debts paid off of assets such as vehicles, machinery, furniture and fittings, and property are sold off.

- ✓ Owner’s savings

Owner’s personal savings applies more to sole traders and partnership firms than to any other form of business. Owners might sometimes wish to invest a part of their own money as capital in the business.

- ✓ Reducing stock

One of the assets that a business can use for raising finance is stock, which consists of unsold finished goods, semi-finished goods and the raw material that the business holds.

Internal Source of Finance includes;

- ✓ Trade credit

In a business, things are usually not paid for prior to taking possession of them. Rather, orders are placed for inputs/supplies and payment is made after the receipt of the items. It is advisable to make the payment in good time (within a month or so) as this helps the business in developing good relations with the supplier.

- ✓ Promoters contribution

This is the first external source of finance for the project. The promoter brings his share of capital into the organization as seed capital to meet the start up expenses of the project. Financial institutions, investors, and lenders want to know the promoters contribution in the project, before they take a decision on investment or lending loan. Promoter contribution is required in some cases of assistance such as grants and subsidies from government for a project.

External Source of Finance includes;

- ✓ Equity finance

In joint stock companies, equity finance is one of the main types of finance in the capital structure. Equity finance means raising the capital by shares issue. It is the main element of capital structure by way of representing the investment on the project's promoters' behalf, and generally comes from individual investors, firms engaged in project promotion through sponsoring the project, manufacture of equipment and machinery, and from institutional investors such as energy investment funds that are expected to have some form of capital stake in the project or insurance companies.

Unit 4 Introduction to Financial Management

External Source of Finance includes;

- ✓ Debentures

Debentures are certificates of loan agreements that are given under the company’s stamp and that undertake to pay the principal amount as well as a fixed return (that is based on the rate of interest) to the debenture holder at the time of maturation of the debenture.

- ✓ Debt finance

It is one of the chief types of finance, essentially required to build an optimum capital structure. Debt finance means borrowing loans from commercial banks, financial institutions and money lenders for a period of time on fixed rates of interest. Debt finance normally refers to a conservative commercial bank loan.

External Source of Finance includes;

- ✓ Debentures

Debentures are certificates of loan agreements that are given under the company's stamp and that undertake to pay the principal amount as well as a fixed return (that is based on the rate of interest) to the debenture holder at the time of maturation of the debenture.

- ✓ Debt finance

It is one of the chief types of finance, essentially required to build an optimum capital structure. Debt finance means borrowing loans from commercial banks, financial institutions and money lenders for a period of time on fixed rates of interest. Debt finance normally refers to a conservative commercial bank loan.

External Source of Finance includes;

- ✓ Bonds

Bonds are a type of debt. They are generally issued to meet long term financial needs of a project; this means that bonds are liable to be longterm obligations that have fixed repayment schedules and rates of interest.

- ✓ Grants

Grant is a nonreturnable source of funding that is offered to exporters or for covering capital costs. Governments as well as local bodies that are interested in developing the projects, persuade developers to contemplate considering projects that carry a higher degree of risk along with indeterminate returns by means of grants, because of the location factor and to fulfill the responsibility of balanced regional development.

External Source of Finance includes;

- ✓ Government grants are usually offered for particular projects that are instrumental in benefiting or sustaining the environment in some way or aid the disadvantaged minority segments or make a contribution towards regenerating underprivileged sections.

- ✓ Factoring Services

Factoring services are short-term sources of finance to provide working capital needs of a project. Factoring services relieve the project promoter from the tension of delay from debtors and from meeting the creditor’s demand of payment.

External Source of Finance includes;

- ✓ Banks

Banks are one of the important sources of finance to meet shortterm financial requirements, such as the working capital for tiny, ancillary, small scale sectors. To get a short term loan, the entrepreneur should first visit the bank branch with which he has an ongoing relationship, because the banker can easily assess his requirements and get an idea about his business operation.

- ✓ Insurance and Guarantees

Insurance and loan guarantees are fundamental constituents of financing. It is a general practice to put in place full insurance packages prior to finalizing the financing on a project.

Unit 4 Introduction to Financial Management

✓ Concept and Design of Working Capital

This traditional definition of working capital shows how much cash (or liquid assets) is available to satisfy the short-term cash requirements imposed by current liabilities. Working capital management is a business strategy designed to ensure that a company operates efficiently by monitoring and using its current assets and liabilities to the best effect. The primary purpose of working capital management is to enable the company to maintain sufficient cash flow to meet its short-term operating costs and short-term debt obligations.

Working capital management is concerned with the problems that arise in attempting to manage the current assets, the current liabilities and the interrelations that exist between them.

Current assets refer to those assets which in the ordinary course of business can be, or will be, converted into cash within one year without undergoing a diminution in value and without disrupting the operations of the firm. Examples- cash, marketable securities, accounts receivable and inventory.

- ✓ Concept and Design of Working Capital

Current liabilities are those liabilities which are intended, at their inception, to be paid in the ordinary course of business, within a year, out of the current assets or the earnings of the concern. Examples- accounts payable, bills payable, bank overdraft and outstanding expenses.

The goal of working capital management is to manage the firm's current assets and liabilities in such a way that a satisfactory level of working capital is maintained.

The interaction between current assets and current liabilities is, therefore the main theme of the theory of the working capital management.

Unit 4 Introduction to Financial Management

- ✓ Concept and Design of Working Capital

Concepts of Working Capital

There are two concepts of working capital- gross and net.

- ❖ Gross Working Capital: refers to the-firm's investment in current assets. Current assets are the assets which can be converted into cash within an accounting year and include cash, short-term securities, debtors, accounts receivable or book debts) bill receivable and stock (inventory)

- ❖ Net working capital: refers to the difference between current assets and current liabilities. Current abilities are those claims of outsiders which are expected to mature for payment within an accounting year and include creditors (account payable), bills payable, and outstanding expenses.

Net working capital can be positive or negative. A positive net working capital will arise when current assets exceed current liabilities. A negative net working capital occurs when current liabilities are in excess of current assets.

✓ Concept and Design of Working Capital

The two concepts of working capital—gross and net—are not exclusive rather, they have equal significance from the management viewpoint.

The gross working capital concepts forces attention-on two aspects of currents assets management

- ➢ How to optimize investment in current assets?
- ➢ How to should current assets be financed?

Net working capital is a qualitative concept. It indicates the liquidity positions of the firm and suggests the extent to which working capital needs may be financed by permanent sources of funds.

Current assets should be sufficiently in excess of current liabilities to constitute a margin or buffer for maturing obligations within the ordinary operating cycle of a business. It is a conventional rule to maintain the level of current assets twice the level of current liabilities.

- ✓ Concept and Design of Working Capital

However, the quality of current assets should be considered in determining the level of current assets against current liabilities.

Net working capital concepts also cover the question of judicious mix of long-term and shortterm funds for financing current assets. For every firm, there is a minimum amount of net working capital which is permanent. Therefore, a portion of the working capital should be financed with the permanent sources of funds such as equity share capital, debentures, long-term debt, preference share capital or retained earnings. Management must, therefore, decide the extent to which current assets should be financed with equity capital and/or borrowed capital.

It may be emphasized that both gross and net concepts of working capital are equally important for the efficient management of working capital.

- ✓ Concept and Design of Working Capital

Determining Financing-mix

There are two sources from which funds can be raised for current assets financing

1) Short term sources, like current liabilities and,
2) Long term sources, such as share capital, long term borrowings, internally generated resources like retained earnings, etc.

The working capital requirements of a firm depends, to a great extent upon the operating cycle of the firm. The operating cycle may be defined as the time duration starting from the procurement of goods or raw materials and ending with the sales realization.

The length and nature of the operating cycle may differ from one firm to another depending upon the size and nature of the firm.

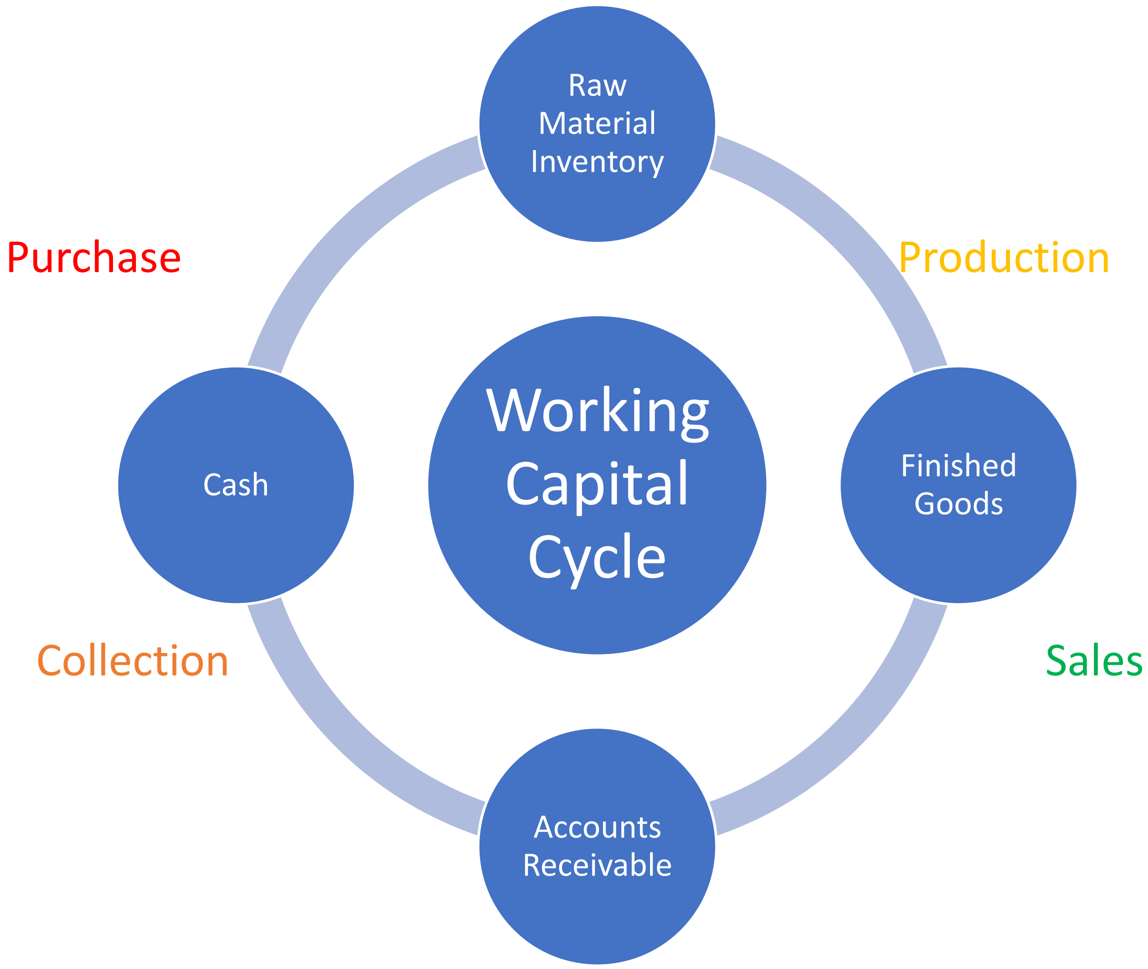
- ✓ Concept and Design of Working Capital

The operating cycle of a firm consists of the time required for the completion of the chronological sequence of some or all of the following

1) Procurement of raw materials and services.
2) Conversion of raw materials into work-in-progress.
3) Conversion of work-in-progress into finished goods.
4) Sale of finished goods.
5) Conversion of receivables into cash.

✓ Concept and Design of Working Capital

The operating cycle or circulation flow of money can best be projected in the following manner.



✓ TYPES OF WORKING CAPITAL

According to the needs of business, the working capital may be classified into following two basis:

1) On the basis of periodicity
2) On the basis of concept

On the basis of periodicity: The requirements of working capital are continuous. More working capital is required in a particular season or the peck period of business activity.
On the basis of periodicity working capital can be divided under two categories as under:
1. Permanent working capital
2. Variable working capital

(a) Permanent working capital: This type of working capital is known as Fixed Working Capital. Permanent working capital means the part of working capital which is permanently locked up in the current assets to carry out the business smoothly. The minimum amount of current assets which is required to conduct the business smoothly during the year is called permanent working capital.

For example, investments required to maintain the minimum stock of raw materials or to cash balance. The amount of permanent working capital depends upon the size and growth of company. Fixed working capital can further be divided into two categories as under:

1. Regular Working capital: Minimum amount of working capital required to keep the primary circulation. Some amount of cash is necessary for the payment of wages, salaries etc.

2. Reserve Margin Working capital: Additional working capital may also be required for contingencies that may arise any time. The reserve working capital is the excess of capital over the needs of the regular working capital is kept aside as reserve for contingencies, such as strike, business depression etc.

(b) Variable or Temporary Working Capital: The term variable working capital refers that the level of working capital is temporary and fluctuating. Variable working capital may change from one assets to another and changes with the increase or decrease in the volume of business. The variable working capital may also be subdivided into following two sub-groups.

1. Seasonal Variable Working capital: Seasonal working capital is the additional amount which is required during the active business seasons of the year. Raw materials like raw-cotton or jute or sugarcane are purchased in particular season. The industry has to borrow funds for short period. It is particularly suited to a business of a seasonal nature. In short, seasonal working capital is required to meet the seasonal liquidity of the business.

2. Special variable working capital: Additional working capital may also be needed to provide additional current assets to meet the unexpected events or special operations such as extensive marketing campaigns or carrying of special job etc.

2) On the basis of concept: on the basis of concept working capital is divided into two categories as under:

(A) Gross Working Capital: Gross working capital refers to total investment in current assets. The current assets employed in business give the idea about the utilization of working capital and idea about the economic position of the company. Gross working capital concepts is popular and acceptable concept in the field of finance.

(B) Net Working Capital: Net working capital means current assets minus current liabilities. The difference between current assets and current liabilities is called the net working capital. If the net working capital is positive, business is able to meet its current liabilities. Net working capital concept provides the measurement for determining the creditworthiness of company.

Unit 4 Introduction to Financial Management

SOURCES OF WORKING CAPITAL

Business firm uses two types of sources to finance its working capital requirements:

A. Long Term Sources

B. Short Term Sources Long Term Sources of Working Capital Financing:

A. Long Term Sources
Every business is required to maintain a minimum balance of cash and other current assets at all times irrespective of business level of operations. The part of working capital which is continuously maintained by any business at all times to carry on its business is called the permanent working capital.

This type of working is advised to be financed partly through long term sources as given under:
1. Issue of equity and preference share capital
2. Retained earnings
3. Issue of debentures and long term bonds
4. Long term loans from financial institutions

Short Term Sources

This working capital is termed as temporary working capital needed to support seasonal fluctuations in the operations. The examples of short term sources are given as under:

1. Bank credit, overdraft etc.
2. Public deposits
3. Trade credits
4. Sales revenues
5. Outstanding expenses
6. Provision for depreciation, taxes etc
7. Advances from customers
8. Employees’security money

✓ FACTORS DETERMINING WORKING CAPITAL

The following factor determine the amount of working capital

1. Nature of Companies: The composition of an asset is a function of the size of a business and the companies to which it belongs. Small companies have smaller proportions of cash, receivables and inventory than large corporation. This difference becomes more marked in large corporations. A public utility, for example, mostly employs fixed assets in its operations, while a merchandising department depends generally on inventory and receivable. Needs for working capital are thus determined by the nature of an enterprise.

2. Demand of Creditors: Creditors are interested in the security of loans. They want their obligations to be sufficiently covered. They want the amount of security in assets which are greater than the liability.

3. Cash Requirements: Cash is one of the current assets which are essential for the successful operations of the production cycle. A minimum level of cash is always required to keep the operations going. Adequate cash is also required to maintain good credit relation.

✓ FACTORS DETERMINING WORKING CAPITAL

4. Nature and Size of Business: The working capital requirements of a firm are basically influenced by the nature of its business. Trading and financial firms have a very less investment in fixed assets, but require a large sum of money to be invested in working capital. Retail stores, for example, must carry large stocks of a variety of goods to satisfy the varied and continues demand of their customers. Some manufacturing business, such as tobacco manufacturing and construction firms also have to invest substantially in working capital and a nominal amount in the fixed assets.

5. Time: The level of working capital depends upon the time required to manufacturing goods. If the time is longer, the size of working capital is great. Moreover, the amount of working capital depends upon inventory turnover and the unit cost of the goods that are sold. The greater this cost, the bigger is the amount of working capital.

6. Volume of Sales: This is the most important factor affecting the size and components of working capital. A firm maintains current assets because they are needed to support the operational activities which result in sales. They volume of sales and the size of the working capital are directly related to each other. As the volume of sales increase, there is an increase in the investment of working capital-in the cost of operations, in inventories and receivables.

- ✓ FACTORS DETERMINING WORKING CAPITAL

7. Terms of Purchases and Sales: If the credit terms of purchases are more favourable and those of sales liberal, less cash will be invested in inventory. With more favourable credit terms, working capital requirements can be reduced. A firm gets more time for payment to creditors or suppliers. A firm which enjoys greater credit with banks needs less working capital.

8. Business Cycle: Business expands during periods of prosperity and declines during the period of depression. Consequently, more working capital required during periods of prosperity and less during the periods of depression.

9. Production Cycle: The time taken to convert raw materials into finished products is referred to as the production cycle or operating cycle. The longer the production cycle, the greater is the requirements of the working capital. An utmost care should be taken to shorten the period of the production cycle in order to minimize working capital requirements.

✓ FACTORS DETERMINING WORKING CAPITAL

10. Liquidity and Profitability: If a firm desires to take a greater risk for bigger gains or losses, it reduces the size of its working capital in relation to its sales. If it is interested in improving its liquidity, it increase the level of its working capital. However, this policy is likely to result in a reduction of the sales volume, and therefore, of profitability. A firm, therefore, should choose between liquidity and profitability and decide about its working capital requirements accordingly.

11. Seasonal Fluctuations: Seasonal fluctuations in sales affect the level of variable working capital. Often, the demand for products may be of a seasonal nature. Yet inventories have got to be purchased during certain seasons only. The size of the working capital in one period may, therefore, be bigger than that in another.

Thank You….!!

QUESTIONS PLEASE